Confidence, Courage and Leadership in Corporate Governance:

Moving Beyond the New Letter of the Law

PERSPECTIVES BY

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The Sarbanes-Oxley Act is a landmark piece of legislation, one that will make sweeping changes in the way we govern and manage companies. It is a law written, in large part, to redress specific weaknesses in the controls and processes that ensure sound corporate management. We find in Sarbanes-Oxley meaningful responses to the most egregious events surrounding Enron, Arthur Andersen, WorldCom and others: document tampering and destruction; fair and uniform application of blackout periods in retirement plans filled with company stock; increased oversight of the accounting profession; mandatory auditor rotation; and understandable disclosure of off-balance sheet risks.

All the talk, all the seminars and all the articles about Sarbanes-Oxley should not lead us to the conclusion that understanding and implementing the new letter of the law is all we need to do.

Much as those of us who live and work in Washington, D.C. would like to think so, Sarbanes-Oxley by itself will not restore confidence in American companies. All the talk, all the seminars and all the articles about Sarbanes-Oxley should not lead us to the conclusion that understanding and implementing the new letter of the law is all we need to do. Of course, we must all become familiar with the new letter of the law. That said, however, we will not restore the public's confidence in America's corporations and markets until we also understand – and put into practice – the spirit and intent of Sarbanes-Oxley.

I. Restoring Confidence in Corporate Governance

We can begin restoring confidence in our companies and markets by ensuring transparency, accountability, courage and leadership in corporate governance. We should use the current malaise as an opportunity to step back and evaluate the shortcomings of our corporate governance structures. We must take an honest view of what, fundamentally, brought us to this place. How do we present the integrity of our corporations to the public? Sarbanes-Oxley is intended to help do just that. I see several basic issues that we must address broadly as we make essential changes to comply with Sarbanes-Oxley.

A. WORKING WITH NOMINATING COMMITTEES TO FIND THE RIGHT DIRECTORS

Nominating Committees must be on a constant search for board candidates. They should establish a mechanism for continually identifying and recruiting top-notch candidates in the same manner that companies search for top executive talent. Nominating Committees should begin this process by articulating clearly their selection criteria for outstanding directors – they should be well qualified, independent and represent the diversity of viewpoints necessary for rigorous and healthy debate about the company's strategies, operations and results.

Nominating Committees should also articulate clearly the goals they have set for the composition of their boards, including the specific qualifications and experience they are seeking in their directors. They should outline explicitly the restrictions or limitations they place on their board members, including the standards of independence required by Sarbanes-Oxley and any other relevant limitations, such as the number of other boards on which each director is allowed to serve. In my view, for example, directors should be allowed to serve on no more than four boards in total.

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B. ENSURING THAT DIRECTORS ARE PROPERLY EDUCATED ABOUT THE FUNDAMENTALS OF THE BUSINESS

Not all board members have a clear understanding of the business they are overseeing.

Not all board members have a clear understanding of the business they are overseeing. They are not all able to evaluate critically the decisions the company is making or how well senior management is running the business. Board members do not always understand in sufficient detail the nature of the business, the industry and competitive landscape it operates in, exactly how the business makes money, where the risks are, or how those risks are (or should be) managed and reported. Too few directors really understand the strength of the company's checks and balances.

While the selection of a so-called "financial expert" under Sarbanes-Oxley may help, all board members should have a basic understanding of accounting and financial reporting. For example, some directors do not understand clearly the difference between pro forma and GAAP accounting. Board members may not have a sufficiently clear understanding of the key financial metrics and norms of a given industry, against which they should judge their company's results.

If we are going to expect our board members to do an effective job of governing our companies, we must have an effective continuing education program to ensure that each director understands the fundamentals of the business. Companies should develop programs in which senior leaders of key departments – including finance, treasury, legal, risk management, marketing and key operating divisions – regularly brief members of the board. They should likewise solicit an overview of the company and its industry from the external auditor, with special emphasis on important risk areas.

Most importantly, the board should spend time with the leaders of the internal audit team to ensure that the function is strong, sufficiently staffed, appropriately skeptical and inquisitive, and understands its direct line of reporting and communication to the audit committee. Too often, internal audit is understaffed, under-funded and relegated to policing petty cash. The Board must ensure that it has a strong and capable monitor within the company.

C. ENSURING DIRECTOR INDEPENDENCE

Independence in the real sense means strength of character. The NYSE and NASDAQ have both issued specific proposals governing the independence of directors and the criteria for determining independence, and Sarbanes-Oxley contains a provision dealing generally with director-only compensation. These provisions seek, in essence, to promote independence in thought and action, and to communicate this independence to the public. In other words, members of these important committees should not be beholden to management in any way.

D. DEMONSTRATING CONFIDENCE, A SENSE OF DUTY AND COURAGE IN CORPORATE BOARDROOMS

Some board members have for too long regarded their board roles as merely advisory. They have conducted their board responsibilities with great politeness and civility, but without a sufficiently deep sense of obligation to understand the business and ask the

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tough questions. They have rested too comfortably in the belief and assumption that their role was to trust and endorse the recommendations and actions of senior management, the accountants or other advisors entirely, and to become engaged only when that trust was betrayed.

We need directors who have demonstrated courage and a strong sense of duty throughout their careers. We must honor a boardroom environment that encourages thorough reviews and expects tough questions. We need directors who do their homework and who feel confident asking the simple but critical question that will support management's final judgments.

If a board of directors carries out its duties with diligence and independence as I have outlined, the results will be good for the company, for investors and for consumers. But it can also help the company's bottom line when it comes to government interest in a potential problem. On the one hand, the SEC and DOJ have demonstrated that they will impose substantial penalties when they find corporate fraud, and especially when they believe that the company has failed to cooperate with an investigation. In the SEC's statement regarding its civil penalty against Dynegy, Enforcement Director Stephen Cutler stated, "The $3 million penalty imposed directly against Dynegy in this case reflects the Commission's dissatisfaction with Dynegy's lack of full cooperation in the early stages of the Commission's investigation . . . ."

In other cases the SEC has announced over the past year, it has rewarded companies that police themselves and cooperate with law enforcement if accounting or other issues do arise.

In other cases the SEC has announced over the past year, it has rewarded companies that police themselves and cooperate with law enforcement if accounting or other issues do arise. In a case the SEC filed in September against three former executives of Homestore Inc. for securities fraud, the Commission determined not to bring any enforcement action against Homestore because of its swift and extensive cooperation in the Commission's investigation. Homestore reported possible misconduct to the Commission immediately after the Audit Committee learned of it, conducted an internal investigation, shared the results of the internal investigation with the government (without asserting privileges), fired the wrongdoers and took other remedial actions.

The need for independence, experience, honesty, character and courage in all corporate board members is rooted in the goals of Sarbanes-Oxley and in the very practical considerations of how a fraud will be handled once it is discovered.

II. Creating a Culture of Transparency, Accountability and Active Disclosure

Several of the leading business magazines have questioned whether we have now moved beyond the era of the imperious chief executive – those large personalities who are bent on self-aggrandizement, ruthless in their pursuit of operating results and, perhaps unwittingly, highly threatening to any messenger bearing bad news. While I don't know if we can safely say we've dethroned them all, I do know we must work to restore a more genuine model of leadership, one that is reasonably aggressive and competitive but ultimately guided by sound values; one that cultivates an environment of openness and honesty; one that seeks out all perspectives – including the hard truth, if that's in order.

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We need senior executives who visibly hold themselves to account, encourage transparency and create a culture where full disclosure – whether it be good news or bad news – is the most honorable act; a culture where performance standards are objectively derived and measured; a culture that expects both senior executives and managers to have command of the details and does not suffer anyone who is either aloof from the facts or a manipulator of them; a culture where reasonable results, legitimately gained, are applauded and where stellar results, gained illegitimately, are grounds for dismissal; a culture where no one is ever shot solely for having the courage to bear bad news or to ask the hard question.

Our corporations need no more emperors. We need leaders who live and lead by a code of ethics and a code of honor – leaders who are secure in themselves. I believe we have those leaders, and we must honor them and keep them.

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To encourage a renewed culture of accountability and transparency, we certainly need the Justice Department and the SEC to single out and appropriately punish those who do not play by the rules, those who gain illegitimate or unfair competitive advantage, or who operate with malignant intent. But we also need a Justice Department and an SEC that will work with those companies operating in good faith, with a track record of trying to do the right thing.

A. SUPPORTING STRONG AND INDEPENDENT AUDIT COMMITTEES

One of the best ways to assure that a company does, indeed, "do the right thing," is to create and support a strong, capable and independent audit committee with access to all of the resources and information necessary to exercise the audit function as it was intended. Although the Audit Committee historically has had responsibility for oversight and monitoring of a company's accounting and financial reporting processes, Sarbanes-Oxley, of course, has underscored the importance of those roles. The Act imposes specific requirements for Audit Committees and for audit firms, and the ways Audit Committees and independent auditors interact.

For example, Sarbanes-Oxley requires audit firms to report to Audit Committees on a variety of specific topics, and Audit Committee members must be prepared to spend the time and energy to probe the issues discussed by the auditors and to work with the auditors to temper management's advocacy of an aggressive approach to a particular accounting or reporting issue. The Audit Committee cannot function simply as a "review panel" in the financial reporting process.

The Audit Committee must build a strong relationship with the auditor. This requires more than a few regularly scheduled meetings. The duties of independent auditors and Audit Committee members include the consideration of employee reports with respect to accounting methods utilized by the audited companies, and the accuracy of financial reports.

B. PROTECTING AND DEFENDING WHISTLEBLOWERS

Consistent with a policy of transparency and an appropriate legal risk management strategy, boards of directors and senior management should protect and defend those who speak up and speak out. Sarbanes-Oxley clearly encourages employees of public companies to report conduct reasonably believed to be in violation of the Act itself or

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in violation of SEC regulations and any federal law relating to fraud against shareholders. Indeed, by providing wide federal whistleblower protections to employees, Congress sent a clear message to employers and auditors alike that they ignore the reports of such employees at their peril.

Sarbanes-Oxley makes it illegal for any officer, employee contractor, subcontractor or agent of a publicly held company to discharge, demote, suspend, threaten, harass or in any other manner discriminate against an employee with respect to the terms and conditions of employment on account of the employee's participation in whistleblower activities. Under certain circumstances, employers found to have violated the whistleblower protections may also be subject to criminal sanctions, including fines and imprisonment of up to 10 years.

C. RESTORING ACCOUNTABILITY AND CONFIDENCE TO EXECUTIVE COMPENSATION

The reports of personal enrichment, self-dealing and excessive perks by senior executives at Enron, Tyco and others have created a heightened environment of suspicion and potential shareholder distrust over executive compensation. Competition has put tremendous pressure on Compensation Committees to deliver bigger and better compensation packages to attract and retain top executive talent. Recent excesses in compensation and perks may give Compensation Committees the basis they need to adjust compensation standards to more reasonable and acceptable levels. Regardless of the political or media environment surrounding executive compensation, boards have a duty to develop compensation standards that are reasonable, well stated and – most importantly – to see that those standards are followed. Executive compensation must be considered in total, taking into account all items of value an executive receives, while at the same time rewarding the executive well for the contributions he or she makes to the company's success and well-being.

Compensation Committees should take steps to minimize the level, or use, of those aspects of executive compensation that have become politically charged and have the potential to incite a backlash from shareholders, the media or employee groups. I would include "royal" perks such as expensive and/or exclusive club memberships, excessive personal travel on corporate jets, luxury hotels or huge golden parachutes. Compensation Committees should avoid substantial increases in bonuses or stock options that bear no relationship to the company's overall financial performance.

III. Accountability and Enforcement Issues

A. NEW CRIMINAL PROVISIONS AND ENHANCED PENALTIES UNDER SARBANES-OXLEY

The flurry of publicity surrounding filing of financial disclosures with the SEC in late August highlighted a new provision, Section 906 of the Act, which imposes enhanced criminal penalties for false certification of financial reports by corporate officers. While making false statements in public filings has always been subject to prosecution, an aspect of this new law is worth noting – namely, the requirement that financial statements

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"fairly present" the company's status. That means more than simply complying with GAAP in presenting the company's financial data. It is not clear what additional information needs to be accounted for in the certification beyond the well-known materiality standard; however, if a reasonable investor would want to know about it before buying or selling, the SEC will likely consider it to be "material" under Sarbanes-Oxley.

This provision, in tandem with Section 302 outlining disclosure obligations in more detail, will put greater pressure on the internal structures of many corporations. The increased penalties imposed on making false certifications, along with likely changes in the federal sentencing guidelines and increased penalties for mail fraud, wire fraud and a new securities fraud provision, heighten the consequences for failure to come to grips with this aspect of Sarbanes-Oxley.

B. THE SEC'S NEW "REAL-TIME ENFORCEMENT"

The SEC has moved aggressively to a model it calls "real-time enforcement." When the WorldCom case first broke, the SEC filed its suit against WorldCom just 24 hours after the company released information about its massive earnings restatement.

In the post-Sarbanes-Oxley environment, not only have prosecutors and regulators been given more powerful weapons and expanded authority, they have also changed the way they carry out their duties. The SEC has moved aggressively to a model it calls "real-time enforcement." When the WorldCom case first broke, the SEC filed its suit against WorldCom just 24 hours after the company released information about its massive earnings restatement. Enforcement Director Stephen Cutler and others at the SEC have said that they intend to make such "real-time enforcement" actions the rule rather than the exception.

Prior to Sarbanes-Oxley and this year's corporate scandals, companies were accustomed to dealing with the Division of Corporation Finance or the Office of the Chief Accountant, on accounting, reporting and financial restatement issues. This was one side of the SEC, separate from the Enforcement Division. If there were truly a civil or potentially criminal matter that arose, the SEC Enforcement Division would become involved later – first by conducting an extensive investigation and then possibly taking action. Now, members of the SEC Enforcement Division may become involved in meetings and conference calls with companies at the early stages of any discussions about restatements or other financial or accounting issues, and may move much more swiftly if an enforcement issue is identified. Companies should be alert to this possibility and should be prepared for the possibility of an investigation when they bring issues to the attention of the SEC.

C. THE NEED FOR NEW DOCUMENT MANAGEMENT AND EMAIL POLICIES

Sarbanes-Oxley also includes strict new criminal provisions dealing with document destruction, obstruction of justice, and retaliation against informants – provisions that apply to *everyone* and not just to public companies. Prior to Sarbanes-Oxley, federal prosecutors relied on several document destruction provisions in the federal criminal code, but those provisions had loopholes. Under some provisions, the government could prosecute an individual directly engaged in the destruction of documents, but only if a government proceeding was under way at the time of the document destruction. Another section allowed prosecution in advance of a proceeding, but was limited to those who "corruptly persuade" another to destroy documents, as in the government's prosecution of Arthur Andersen.

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Sarbanes-Oxley has changed all of that by introducing a sweeping new criminal provision that broadens both the subject matter and the range of circumstances in which the government can prosecute document destruction. Section 1519 makes it a crime knowingly to destroy a document with the intent to obstruct or "influence *the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States . . . or in relation to or contemplation of any such matter or case.*" The phrase "any matter within the jurisdiction of any department or agency of the United States" has been interpreted in other sections of the criminal code to include almost every conceivable area of interest on the part of a federal agency. Moreover, by explicitly making document destruction "in relation to or contemplation of any such matter or case" subject to criminal prosecution, the Act sweeps aside prior disputes about document destruction in advance of a federal proceeding. It codifies the broadest possible standard for determining when document shredding becomes a crime.

Let us now spend a moment on what I call the "Idiot email" problem and the need to establish improved document management and electronic communication protocols. If an employee sends an email to his co-workers about a corporate matter and states, "If the Feds ever get wind of this, they'll be all over us like a . . . (insert whatever you care to here)," and if the subject matter of the email is, in fact, something that is properly within the jurisdiction of a federal agency, has a "matter" now been "contemplated" by the company under the Act? If the company fails to suspend the application of its document retention policy as to these materials and they are purged in due course, is the company exposed to criminal liability? Although this is probably the outer edge of circumstances that would give rise to a criminal case, it is by no means an unusual circumstance. The government's case against Arthur Andersen shows that a document retention policy, if not handled properly, can be a sword in the hand of the government rather than a shield for the defendant.

So, the document destruction criminal provisions place a premium on developing a document management policy that reflects an understanding of potential liabilities under the Act. The effects of these criminal provisions will be felt throughout the business community.

IV. The Role of General Counsel in Leading Positive Change

A. THE NEW RESPONSIBILITIES OF ATTORNEYS

While executive management and boards of directors will have to grapple with new roles, responsibilities and challenges under Sarbanes-Oxley, corporate counsel will have an opportunity and – many would say – an obligation both as a professional and a legal matter. Guiding powerful executives and well-established institutions into their new roles and responsibilities will require the strongest leadership and diplomatic skills of corporate counsel. In private practice, it can be difficult to say no to a client. For corporate counsel, it is even more difficult to say to no to members of the executive management team or even to the board. Nevertheless, we must develop an environment and an attitude where a constructive "no" is not only possible but acceptable. We must do so for the welfare of the company, for the well-being of our profession and for our own protection.

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Sarbanes-Oxley has imposed obligations on lawyers "who practice before the (Securities and Exchange) Commission" to report violations of securities laws and breaches of fiduciary duties to the chief legal officer or to both the chief legal office and the CEO and, if no action is taken, to the audit committee or the board. The ABA has established a task force to address the interpretation and implementation of Section 307, a task force I have been asked to join. The SEC's proposed rules implementing this provision cover not only corporate counsel for a company but also independent counsel retained to represent the entity. The proposed rules require an attorney to report "up the ladder" when he or she "'reasonably believes' that a material violation has occurred, is occurring or is about to occur," and in certain circumstances require a "noisy withdrawal" if no action is taken.

While lawyers in the past have been guided by their professional and ethical responsibilities to act in the best interests of their corporation client as a whole, the new statute and proposed rules will give these responsibilities the force of law. It also puts corporate counsel in the role of watchdog. If the organization perceives corporate counsel to be operating as a watchdog, however, they may find their access limited and their ability to influence decisions declining. That would be a dangerous result for the corporation as an institution and for the individual members of management and the board. The leadership challenge for corporate counsel lies in balancing a supportive, "can-do" executive leadership attitude with an unwavering sense of ethical, professional and legal responsibility. Our leadership challenge lies in using wisdom, judgment, diplomacy and creativity to accomplish legitimate business objectives through honest and lawful means. Corporate counsel must operate – and be perceived – as both aggressive business leaders and protectors of the business.

B. CONDUCTING INTERNAL INVESTIGATIONS

If we are to restore confidence in our companies' stock and in the capital markets, we must also investigate all allegations of wrongdoing vigorously, objectively and thoroughly. While there are many examples of egregious conduct leading up to the enactment of Sarbanes-Oxley, one of the more troubling aspects for me has been where employees raised red flags to management, but management – including in-house counsel – failed to investigate the allegations adequately. Corporate America simply cannot let these acts repeat themselves. It is critical that we conduct objective and thorough internal investigations.

Once an allegation of wrongdoing surfaces, corporate management should promptly investigate the facts and circumstances surrounding it.

Once an allegation of wrongdoing surfaces, corporate management should promptly investigate the facts and circumstances surrounding it. Corporate counsel must be involved in the initial stages of the investigation to help assess the gravity of the situation and the potential ramifications if the allegation warrants further review. A timely reaction by management accomplishes two things. First, if the allegation has merit, the wrongdoing can be stopped and the damage can be limited. Second, if the conduct is serious enough, a prompt disclosure can be made to the appropriate agency, which may lead to more lenient treatment.

Further, internal investigations must be conducted by someone who has no financial stake in the outcome. Corporate counsel must be cognizant of the inherent dangers in handling a serious inquiry without seeking the advice of a truly independent outside party.

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Moreover, with the encouragement of management, those conducting the inquiry must have unlimited access to all documents, employees, consultants and any other resources necessary to ensure that the investigation is thorough. Once the decision is made to conduct an internal investigation, the company cannot afford to hold back or limit the access of those conducting the investigation. To do so can create more trouble for the company if it turns out that there is merit to the allegations. In today's climate, a responsible company wants to be able to say, "We discovered a problem, we investigated it, we corrected it and we disclosed the results of our investigation."

A company's internal oversight mechanism must be beyond reproach. Only when a company can demonstrate that all reports of alleged, material wrongdoing are fully and fairly investigated will public confidence rise. Until that time, companies must structure and develop channels for open communication such that corporate activities are freely discussed and questionable ones are discovered and handled appropriately. Companies are judged just as harshly on *how* they respond to a crisis as they are for creating the crisis in the first place. By encouraging transparency and creating a culture of full disclosure, companies will be in the best possible position to survive a crisis.

V. Conclusion

I hope that this focus on both the letter and the intent of the new corporate governance legislation will help guide you as you implement the details of Sarbanes-Oxley. The structure of the Act and many of its provisions were developed by the Senate Banking Committee and its Chairman, Senator Paul Sarbanes, before the recent wave of corporate governance and accounting scandals broke. Senator Sarbanes set out in a low-profile, intelligent and thorough process to create new legislation that would make significant and substantive reforms. The Act is, in many respects, highly detailed and addresses specific problems that have harmed investors and shaken confidence in our capital markets. In your efforts to address those specific problems and to implement details of the new law, I hope you will not lose sight of its broader intent and the need to reassert strong, ethical leadership in American business. I trust all of you will rise to this leadership challenge. It requires that you know the right course of action and have the courage to be an advocate for that course of action.

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