Sorting Out SARBANES-OXLEY

Determining How to Comply with the New Federal Disclosure Law for Corporations Won't Be Easy

WHEN CLIENTS ASK attorney Paul Berkowitz to explain the purpose behind the Sarbanes-Oxley Act, he responds that they need look no further than recent news reports.

"If you wonder what caused Congress to react the way it did, or why something is in the act, you just need to go back to the headlines," says Berkowitz, a partner at Greenberg Traurig in Miami. "Congress didn't want to see any more CEOs or CFOs with their hands raised, saying, 'I didn't know.' "

In its essence, the Sarbanes-Oxley Act of 2002 is about disclosure. Crafted by Congress in the aftermath of financial collapses at corporations like Enron, Global Crossing and WorldCom, the new law establishes the framework for a new regime of accountability by public companies in the areas of financial reporting and disclosure, audits, conflicts of interest and governance.

Sarbanes-Oxley imposes the responsibility for meeting these financial disclosure requirements directly on corporate chief executive officers and chief financial officers. Moreover, the act draws attorneys and accountants more tightly into its web of responsibility by requiring them to report evidence of material violations of federal securities laws or breaches of fiduciary duties to appropriate company officials.

Corporate law experts say Sarbanes signifies an about-

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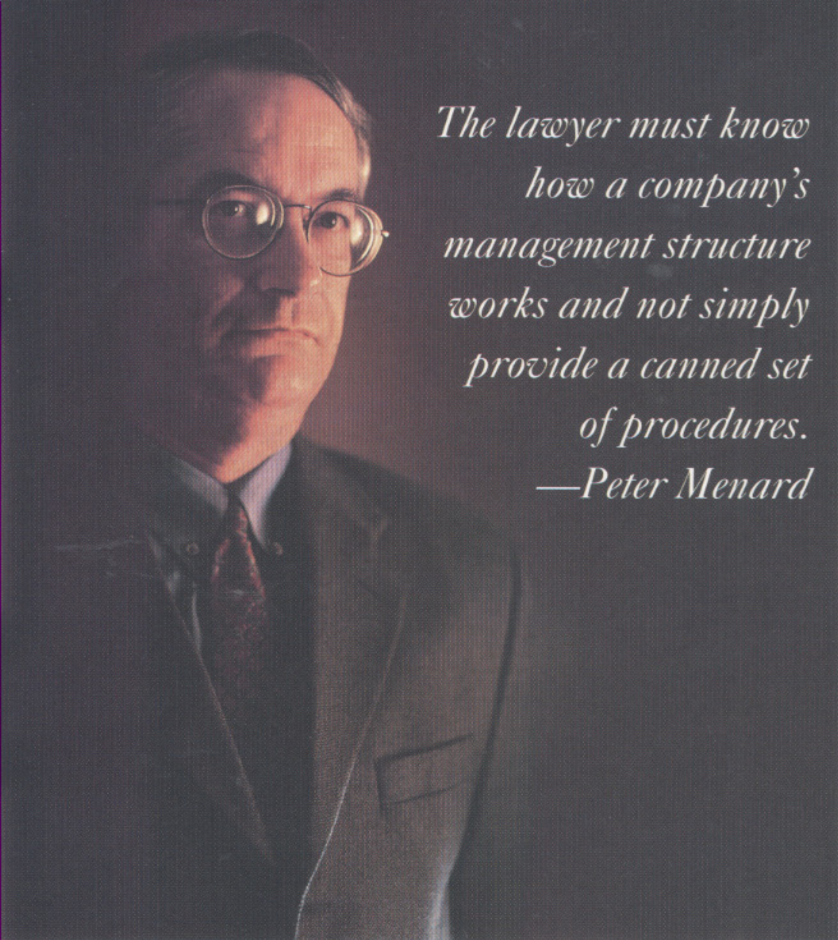
ILLUSTRATION BY BRIAN STAUFFER



face from the wink-and-nod approach to corporate governance of the 1990s. In that decade, cases such as *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), eliminated private actions against secondary actors like accountants and lawyers for aiding and abetting various types of corporate wrongdoing under the Securities Exchange Act of 1934 and related laws.

Sarbanes "is very ambitious on a lot of levels, and it is certainly going to ensure that everyone strives toward the same goals," says Jean M. Davis of Gray Plant Mooty in Minneapolis. "Life as we know it will just have to change."

But while it is clear that Sarbanes will change corporate financial-disclosure procedures, as well as the ways attorneys advise their corporate clients on disclosure and related issues, it is still too early to know what the details of those changes will be.

Although the act went into effect on July 30, 2002, it empowered the Securities and Exchange Commission to issue and implement the fine print of regulations that will govern its implementation. The SEC's timetable for issuing rules under the act extends into April.

But the commission already has implemented, or is about to implement, key provisions of the Sarbanes-Oxley Act—section 302, which governs the corporate disclosure process; and section 307, which sets forth rules of practice for lawyers. These rules require a practitioner to report evidence of material violations of federal securities laws or breaches of fiduciary duty to the general counsel or chief executive officer of a company the lawyer represents.

But even the SEC regulations may not provide all the answers for corporations and their lawyers seeking to comply with the law. Attorneys in the field have expressed some concerns that the regulations, at least regarding corporate disclosure, will emphasize the development of "best practices" by each company, rather than set forth black-letter rules.

As a result, experts say that dealing with the anticipated ambiguities of regulations implementing sections 302 and 307 will call on the counseling skills of corporate lawyers perhaps more than ever before to help their clients comply with the act.

Law firms also will need to examine their own internal practice procedures to comply and avoid the possibility of sanctions for failing to do so.

"The act is a cultural shift as well as a legal shift, so it's trying to accomplish two things at once," says John A. Burgess of Hale and Dorr in Boston. "You have a changing dynamic in the boardroom plus a bunch of new regulations. The board has to feel out how new relationships will work, and this is part of what the lawyer has to help with."

Section 302 of the Sarbanes-Oxley Act makes corpo-

Sarbanes-Oxley Toolbox

Sources of additional information on the Sarbanes-Oxley Act are listed below:

- The ABA Task Force on Implementation of Section 307 of the Sarbanes-Oxley Act has posted its comments on proposed lawyer ethics rules at www.abanet.org/poladv/factsheet.html.
- The home page of the ABA Task Force on Corporate Responsibility at www.abanet.org/buslaw/corporateresponsibility contains the text of the preliminary report of the Corporate Responsibility Task Force, transcripts of testimony from that task force's public hearings, and related information on corporate governance issues.
- The ABA has produced a number of CLE products focusing on the Sarbanes-Oxley Act. Among them is an audiotape program titled The Complete Sarbanes-Oxley Package. This four-tape course covers certification rules, deadlines, enforcement issues, financial statements and whistle-blower provisions. The program has been approved for six hours of MCLE credit in eligible states. The package is priced at $375. To order, call 800-285-2221 or log onto www.abanet.org/cle/catalog, which contains a full listing of products relating to Sarbanes.
- To obtain information on rulemaking activity straight from the horse's mouth, log onto the Web site of the U.S. Securities and Exchange Commission, at www.sec.gov/rules.shtml. The site contains the commission's proposed rules, as well as interpretive materials.

ABAJ/MARK ROBERT HALPER

rate financial disclosure a personal matter for the principal executive officers and financial officers of public corporations.

Section 302 requires CEOs and CFOs to personally certify the information contained in the quarterly and annual reports that their companies publish. The SEC rules implementing section 302 went into effect on Aug. 29, 2002.

But the CEO's and CFO's certification will come at the end of an involved process that corporations will have to develop to comply with Sarbanes and the SEC regulations implementing it.

As part of the process, a CEO and CFO must certify that the company maintains and regularly reviews internal controls, which are generally financial in nature.

The certification requirement is not new, but unlike regulations in the past, the SEC's new rules spell out explicitly what the commission wants to know about a company's internal controls. The commission seeks specific information about how the internal controls work, how their effectiveness is reviewed, and whether any significant changes followed the review of their effectiveness.

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PROGRAM

Begins at 1 p.m. (ET) Feb. 19 and discusses compliance with the new federal disclosure law.

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REGISTRATION INFORMATION

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CORPORATIONS TO DEVELOP PROCEDURES

WITHIN THE FRAMEWORK OF THESE FINANCIAL CONTROLS, the CEO and CFO also must certify that disclosure controls and procedures are in place for the company. The SEC explains disclosure controls and procedures as an internal reporting system to assure that material information is reported to corporate officers. The SEC regulations state that a company must adopt, maintain and regularly evaluate its disclosure controls and procedures. In published comments, the SEC has suggested that these disclosure controls and procedures are intended to be broader than the existing concept of internal controls, to encompass both financial and nonfinancial considerations.

While the SEC regulations are explicit about what information a company must disclose, they do not set forth specific procedures that a corporation must implement to produce the information. Rather, the commission has stated that each company should develop, implement and maintain procedures that work best for it.

That lack of specificity is enough to keep even the most diligent corporate officers awake at night—and wanting to confer with their corporate attorneys amid their insomnia.

" 'Disclosure procedures and controls' is a new term, but the concept is not new," says Peter M. Menard, a partner in the Los Angeles office of Sheppard Mullin Richter & Hampton. "Since the very beginnings of federal securities laws, it's been unlawful to have material misstatements or omissions in filings, so most companies have already developed procedures to ensure the accuracy of information."

Now, however, companies may no longer be able to rest on their existing procedures, says Menard. And that's where a lawyer who is in tune with the company and its operations can make a significant difference, he notes.

"The lawyer can't simply provide a canned set of procedures," he says. "You have to understand the political currents in the company, the management style, how the management structure works, and then craft an individual set of procedures."

The procedures should be matched with the company and its needs, says Berkowitz. "What works for smaller companies might not have a prayer of working for Fortune 50 companies," he says.

One of the few concrete suggestions that the SEC makes in its regulations is that corporations consider establishing disclosure committees to coordinate the internal process. The purpose of the disclosure committee, suggests the SEC, would be to review information coming up the corporate chain through disclosure controls and procedures, and determine whether it meets the commission's requirements under Sarbanes.

While the notion of handling such issues through a committee predates Sarbanes, the SEC's emphasis on disclosure committees in its regulations has renewed interest in their use.

Putting together a disclosure committee might not be much of a challenge for a larger company, but it can be a tough task for smaller companies that lack the personnel with qualifications necessary to perform such a committee's functions.

"The vast majority of smaller companies don't have an internal audit department," says Menard. "They don't have a legal department, they don't have a separate risk-management department or an investor relations person."

In this kind of situation, Menard suggests reviewing the company's management to determine which executives are most important to the company's disclosure process. These are the people who should serve on the committee. Menard typically begins this examination not with a list of job titles but rather with a determination of each executive's daily duties.

"I go through each item of the most common SEC reports and then list, by item, whose job [affords] the most familiarity with this aspect of the company's business. The goal is to identify the people most likely to know about developments early and be able to assess their materiality."

While it is important to snare the right people for the committee, Dixie L. Johnson says it is equally important not to crowd the committee with too many people. An attorney at Fried, Frank, Harris, Shriver & Jacobson in Washington, D.C., she is vice chair of the Federal Regu-

Lawyers should not be pressured to look the other way when faced with potential securities problems.
—Gene Pratter

lation of Securities Committee in the ABA Section of Business Law.

"You must resist the temptation to load up the committee," says Johnson. "The committee must be able to stay quick on its feet," especially since reporting deadlines have been tightened under Sarbanes.

Another critical element of the process is to appoint a single person to act as a disclosure-controls monitor, says Menard. This person would be responsible for documenting compliance with the company's disclosure controls and procedures, preparing each SEC filing for the committee's review, and suggesting improvements in the disclosure controls.

In addition to assisting a corporate client in determining who will oversee the disclosure process, an attorney must advise the company on how to fine-tune the actual controls and procedures so that information can quickly and easily move up the chain of command, regardless of the company's size.

Many lawyers are creating customized checklists for managers at every corporate level to ensure that the appropriate information is being reviewed within the proper timeframe.

Using a checklist instead of a narrative procedure manual often makes it easier for "people who are probably already overstretched to immediately recognize disclosure issues," says Burgess of Hale and Dorr.

By evaluating the checklists, a company also can recognize areas in which it may be requesting duplicative or extraneous information. "More disclosure isn't automatically the answer," he says. "Every element isn't relevant every quarter, and everything's not always going to be an issue. This is an evolving process."

Also important to the effectiveness of any controls and procedures is a corporate culture that emphasizes change as an important component of accurate and timely disclosure, says Johnson.

"You don't want to create an environment where people are afraid to say the controls can be improved," she says. "You have to let them know that every control can be improved and that doesn't mean it was defective. It's important for companies and investors to recognize that procedures do change and should change as you learn more about them."

A lawyer who is closely familiar with a client company will be able to advise the company more effectively on its controls and procedures, says Davis of Gray Plant Mooty.

You can't just do SEC filings, she says. "You have to go to board meetings, you have to get involved. That's the only way you're going to have the comfort level to know what's material and what to address in filings."

Menard agrees. "Advising public companies on their disclosure obligations requires a genuine empathy with management and a deep understanding of both the client's actual business practices and disclosure theory," he says. "That type of knowledge must be earned—and you can't fake it."

LAWYERS PREPARE FOR NEW CHALLENGES

LAWYERS DEALING WITH THE DISCLOSURE REQUIREMENTS affecting them directly under the Sarbanes-Oxley Act face a special dilemma.

Section 307 of the act requires lawyers to report evidence of a material violation of federal securities law or a breach of fiduciary duty to a client company's general counsel or chief executive officer. If the general counsel or CEO does not appropriately respond to the information, the lawyer must report the matter to the company's board of directors or audit board.

The act directs the SEC to implement these requirements as rules of practice for lawyers, and on Nov. 21 the commission issued its proposed minimum standards of professional conduct for lawyers who appear and practice before it. (The rules were scheduled to be finalized by Jan. 26.)

Under the proposed rules, a private attorney who reports the evidence "up the ladder" of corporate leadership without an appropriate response must make a "noisy withdrawal" from representation. That step must include a written disavowal to the SEC of any document the lawyer helped prepare that was filed with the commission containing questionable information. In-house counsel must take similar steps to disavow such filings.

The SEC took a particularly expansive view of which lawyers are covered by its proposed rule. The term "appear and practice" encompasses attorneys transacting

business or communicating with the SEC, representing any person in connection with any SEC investigation or inquiry, and rendering advice on or helping to prepare documents that the lawyer reasonably believes could be filed with or submitted to the SEC.

But some members of the legal profession say the proposed rules of practice for lawyers that the SEC issued pursuant to Sarbanes raise a dilemma because lawyers generally are regulated under professional codes adopted at the state level.

Shortly before the SEC released its proposed standards for lawyers, ABA President Alfred P. Carlton Jr. of Raleigh, N.C., appointed a task force to provide the association's views on those standards to the commission.

In comments issued on Dec. 18, the task force urged the SEC to defer any regulations beyond the scope of what Congress mandated, citing the noisy-withdrawal requirement as an example. "Congress did not intend for the SEC to impose such requirements," Carlton said at a news conference to release the comments. He noted that the act's up-the-ladder reporting requirement had not included the SEC's directive to ultimately report information to parties outside the client corporation. (See "Going Before the SEC," Dec. 20 *ABA Journal eReport.*)

"Some of these proposals raise fundamental issues regarding the role of lawyers and the attorney-client relationship," said Carlton. "It would be tragic if we squandered this golden opportunity to fashion the most effective measures that offer real protections to investors in favor of quick but illusory and ineffective fixes."

It was not known at press time whether the SEC accepted the ABA's recommendations. Even before the issue was resolved, lawyers were already in motion, gearing up their compliance plans to be ready when the whistle sounded.

"In the end, the message coming from Congress and the SEC will be that if you have problems and address them, you will be in a better position than if you try to hide them," says A. Robert Pietrzak, co-chair of the risk management committee at Sidley Austin Brown & Wood in New York City.

In some cases, law firms are examining their own internal management and operational structures in efforts to minimize their levels of risk under Sarbanes while representing corporate clients.

"I think a lot of firms today probably have the kind of processes and requirements that address these issues, but it will be a question of refocusing and fine-tuning," says Pietrzak.

The first step many firms have taken is to make sure every lawyer, not just those in the corporate practice group, understands and appreciates the impact of Sarbanes.

At Duane Morris in Philadelphia, firm general counsel Gene E.K. Pratter is making sure that every single lawyer, from firm leadership down to the newest associate, knows that he or she must bring information with potential section 307 implications to the attention of the corporate-and-securities and loss-prevention partners.

"It is challenging to make sure 500 lawyers in 19 offices are sensitive to the issues that, at first blush, they may not think is their bailiwick," she says. "But there are important twin considerations: service to clients and protection of the firm. We want to help make sure our clients are meeting their SEC obligations, and we also want to make sure our lawyers are not brought into a potential claims situation."

The goal of every firm, says Peter Menard, should be to raise awareness of its lawyers at least to the level that they bring information to the colleague who is in a position to assess whether it has potential section 307 implications.

Menard says his Los Angeles firm is concerned not so much with the self-serving memo to file as it is with ensuring that the client clearly discloses all material information to the public in a timely manner.

Pratter says Duane Morris has offered myriad internal CLE programs on the proposed SEC rules for lawyers. The firm also has worked with representatives from its insurance carrier.

One thing Pratter's firm has not done is rely exclusively on e-mail to get the word out. "We don't want our people to say, 'Yeah, yeah,' and just delete the e-mails inundating us all on this subject," she says.

Pratter says a commitment to doing the right thing also is vital to accommodating changes that Sarbanes-Oxley is bringing for lawyers.

"The last thing we want our lawyers to be concerned about is outside or inside pressure to look the other way when faced with a potential section 307 problem," says Pratter. "The firm stands behind every lawyer who acts in good faith on a matter of professional responsibility or concern about the firm."

That support even extends to lawyers who may fear acting on a mistaken belief or wrong information, says Pratter. "We want our lawyers to be loyal to the firm and to become skilled at exercising judgment," she says. "The only way they can learn is by feeling comfortable and knowing that the firm is behind them. It's a variation on the theme that there are never any stupid questions, only the foolishness of ignoring problems until it's too late."

Even as the rules for lawyers and the corporations they represent shift under Sarbanes, some lawyers say it is important to focus on the purpose of the law rather than the problems it may create. For Menard, Sarbanes merely confirms what thoughtful businesspeople and lawyers have been doing all along. "It's all about what's fundamentally fair," he says. "If you're just out to make a huge profit, it will always catch up with you." ■