Legal Backgrounder

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FEDERAL CORPORATE GOVERNANCE: WHAT EXECUTIVES NEED TO KNOW

by

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The Sarbanes-Oxley Act of 2002 represents a major shift in securities regulation in the United States. It is the first major foray of the Federal government into the area of corporate governance — and a shift of regulation from the States to the Federal government. It was hastily enacted and accelerated through Congress as it was written, with many provisions ending up as far more draconian than reported in precursor bills.

More important, the Act represents a paradigm shift in securities regulation, and has created confusion as public companies and their officers and directors have tried to adapt. The securities laws were originally based on a disclosure paradigm; matters of internal corporate governance were left to State jurisdiction.[1] For better or for worse, the nose of the Federal camel is now inside the tent of corporate governance.

The Act has already garnered much criticism from lawyers and bar associations, including commentators whom have questioned the constitutionality of certain provisions. Some foreign governments have already started to question Washington's "unilateralist" intrusion into the internal corporate affairs of the nearly 1,300 foreign companies registered with the Securities and Exchange Commission (SEC). The unintended consequences of the Act are sweeping across many areas of legal and business practice. Many lawyers are still struggling to understand the implications of the Act for their clients — and for themselves.

[1]The original securities laws did not empower the SEC to ban any particular type of offering — or to regulate at all. In fact, there was no SEC to enforce the Securities Act of 1933 — the SEC was created the next year in the Securities Exchange Act of 1934. Further, the 1933 and 1934 Acts did not address internal corporate governance issues. By the end of the 1930s, Congress was more confident of its ability to enact laws to regulate the securities markets — and the Supreme Court was more pliant in upholding Federal regulation. Thus, the Trust Indenture Act of 1939 specifies the powers that must be held by a trustee — the "internal corporate governance," so to speak, of a bond offering. And the Investment Company Act of 1940 created a broad, complex regulatory scheme that still catches some unwitting promoters — even those represented by competent securities counsel.

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Among its many diverse provisions, the Act: (i) creates a new regulatory board named the Public Company Accounting Oversight Board to oversee the accounting industry; (ii) requires CEOs and CFOs to certify the filing company's financial statements and internal controls, with criminal penalties for false certifications bringing fines of up to $5,000,000 and prison terms of up to 20 years; and (iii) requires faster disclosure of significant financial information. In addition, CEOs and CFOs of the issuer may have to reimburse any bonus or other incentive-based or equity-based compensation received in the twelve month period prior to the publication or filing of any document that is materially non-compliant with the securities laws. The potential for forfeiture of incentive compensation has caught the eye of many CEOs and CFOs.

The Act imposes two new certification requirements on CEOs and CFOs,[2] and the SEC has started adopting new rules (the "New Rules") under the Securities Exchange Act of 1934, as amended (the "Exchange Act").[3] Among other things, the New Rules will require an issuer's principal executive and financial officers (usually the CEO and the CFO) each to certify the SEC reports in two broad areas. First, the certifying officer is required to give a "10b-5 representation," that is to certify that the report does not contain any untrue statement of a material fact or omit to state a material fact.

Second, the New Rules require the certifying officers to be responsible for the company's "disclosure controls and procedures," and to certify that they: (i) have designed such disclosure controls and procedures; (ii) have evaluated the effectiveness of the controls at least every quarter; and (iii) have presented their conclusions about the effectiveness of the disclosure controls and procedures in their public documents. The certifying officer must also certify that they have disclosed to the audit committee all significant deficiencies in the design of the internal controls and any fraud, without regard to whether the fraud is material. The certifying officer must also indicate in the report whether or not there were significant changes in internal controls, including any corrective actions. The New Rules do not apply solely to financial reporting under the Exchange Act. Rather, they complement existing requirements for reporting companies to establish and maintain systems of internal controls with respect to their SEC reporting obligations. Taken together, the New Rules will require the certifying officers to expose any weaknesses in internal controls in public filings with the SEC.

These certifications, and the other provisions of the Act, place a new, personal burden on CEOs and CFOs and subject them to loss of bonus compensation and criminal penalties in the event of a violation.[4] This LEGAL BACKGROUNDER offers practical tips to corporate executives for coping with these additional burdens.

WHAT YOU NEED TO KNOW

Individuals Are Responsible. Adequate disclosure is now a matter of individual responsibility. This emphasis on personal liability is a change from existing practice. Currently, the legal entity itself

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[2]These requirements — under Sections 302 and 906 of the Act — are in addition to the order issued by the SEC on June 27, 2002 (the "Fortune 1000 Order"). The Fortune 1000 Order required a one-time personal certification by CEOs and CFOs, under oath, that, to their knowledge, the periodic SEC filings made by their companies in 2002 do not contain any untrue statement of material fact or omit to state a material fact necessary to make the filings not misleading. As of August 14, all but 16 of the 691 companies whose certification were required by the Fortune 1000 Order had filed them with the SEC.

[3]*See*, *e.g.*, SEC Rel. No. 34-46427 (Aug. 29, 2002) and SEC Rel. No. 34-46701 (Oct. 22, 2002).

[4]In-house counsel are also facing new duties, responsibilities and risks. *See* Section 407 of the Act.

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is responsible for the accuracy of the registrant's financial statements. Thus, while your company may already be taking the necessary steps to ensure the accuracy of the information in its periodic reports and proxy statements, the principal executive and financial officers at your company should institute procedures to verify the accuracy of the information and to reduce any possibility of criminal liability.

Criminal Nature of the Sanction. The certification requirement increases the possibility of serious penalties for corporate officers. Officers should be aware that filing a false certificate in this environment, even prior to the effective date of the Act or the permanent regulations, is likely to carry serious penalties, and in addition to the new penalties specified in the Act might give rise to criminal prosecution for perjury, making false statements, or obstruction of justice.

Knowledge Requirement. Under the Act, the applicable executive and financial officers must make the certificate "based on the officer's knowledge." While it is not clear how that requirement will be interpreted under the Act, the SEC has indicated that the standard may be "subjective." Despite the SEC's view, most filing officers will want to make sure that they have "done their homework," especially since under the Act the signing officers must attest to their responsibility for designing internal controls and evaluating their effectiveness.

WHAT YOU SHOULD BE DOING NOW

Prepare for the Filing with "Back-Up" Certificates. In order to document your company's compliance with the new requirements, you may want to start an internal review now to ensure that the certificates you file will be accurate. The CEO and CFO have duties of inquiry with respect to the matters disclosed in their company's SEC reports, and it is not unreasonable for them to require those reporting to them to issue "back-up" reliance certificates.

If you are contemplating such certificates, you should have drafts ready as soon as possible, so that the reporting subordinates will know the standard that will apply to them and to your officers. Keep a written record of all the actions taken to comply with the certification requirements. You may even want to use a checklist based on the applicable regulations and the requirements of the Exchange Act. Your securities counsel can assist in this process.

Form a Disclosure Committee. Many companies are forming internal "disclosure committees," which include the CEO, the CFO, senior financial and legal officers, and officers in charge of risk management. The disclosure committee must include, at least in its final round, the officers who will be certifying the company's internal controls under Section 302 of the Act. The disclosure committee is not mandated, but acts much like a drafting committee for each public filing covered by the Exchange Act, and gives an additional layer of review over the company's disclosure and internal controls.

Marshall the Resources of the Audit Committee. The New Rules require the involvement of the audit committee. Participation in the discussions with the audit committee by your company's independent auditors and securities counsel will focus the discussion. You should plan the review at least one week, and maybe two weeks, before the certification is due. Any issues raised by the audit committee should be fully addressed prior to filing the certifications.

HOW TO PREPARE FOR THE FUTURE

Make Certification Routine. Under the Act, certification will now become an ongoing requirement. The processes described above will become part of your quarterly and annual filing

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processes. Use this opportunity to develop the efficiencies in that process, and to familiarize yourself and your outside advisors with the process and your company. If you are using "back-up" certificates and disclosure committees, make those processes part of your internal audit procedures.

Audit Your Compliance Programs. You may want to immediately commission an audit of the accounting and compliance procedures used within your company to prepare your company's periodic SEC reports. The evaluation should cover all the areas required in the certification. You may want to compare your efforts with the evaluation procedures of similarly situated companies. Your independent auditors and securities counsel can help you in this evaluation and the documentation of results.

Prepare the Relevant Personnel. Your audit committee should be prepared to take part in this new certification procedure once a quarter. This will likely increase the burden on the members of the audit committee, but that burden can be lessened with an effective disclosure committee. Note that some members of your audit committee may require financial training.[5] You should also review the charter of your audit committee to determine if amendments to it are appropriate.

Use Policies to Supplement a "Top Down" Review. Corporate officers are facing increased scrutiny, but the burden can be lessened with a full "top down" review of the procedures in place to ensure that your company's reports and procedures comply with existing laws. All public companies are required to adopt a new Code of Ethics for senior financial officers (including, under the new SEC regulations, the CEO). Under new rules proposed by the New York Stock Exchange, NYSE-listed companies will be required to adopt a Code of Business Conduct and Ethics. Whistleblower policies should be reviewed and updated. Companies should review their internal codes now, and use this opportunity to develop codes that will make the certification process part of your company's routine operations.

Documentation is Essential. It is not enough merely to comply with the Act and the new regulations requiring certification of financial reports, to minimize your exposure to personal liability you must *document* your compliance. Because infractions risk stiff criminal penalties, compliance should be meticulously documented in the event an investigation is ever initiated. Your securities counsel should assist in the documentation process to be sure that an appropriate record is maintained.

CONCLUSION

The Act imposes greater regulation on public companies, and will likely create greater compliance costs. But the Act does not fit well with existing legislative paradigms, and its internal inconsistencies alone will mean uncertainty for years to come. Even in its initial stages, it has been beset with ambiguous timetables and deadlines. Time will tell whether this is a quirky aberration caused by unique pressures, or the beginning of a new system of Federal corporation law.

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[5] *See* the new requirement of having a "financial expert" on the audit committee. SEC Rel. No. 34-46701 (Oct. 22, 2002).

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