The New Standards of Corporate Governance:

Assessing the Implications of Sarbanes-Oxley

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Confidence, Courage and Leadership in Corporate Governance: *Moving Beyond the New Letter of the Law*

Perspectives by Benjamin R. Civiletti
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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.

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.

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

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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.

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, underfunded 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 tough questions.

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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 board room 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 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

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.

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.

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.

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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 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.

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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 "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.

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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.

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.

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

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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.

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.

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. 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

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truly independent outside party. 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.

They Got Tougher:

New Criminal Penalties for Fraud and Obstruction Affect all Companies

Thomas J. Kelly Jr.
W. Warren Hamel
Kathleen S. Dolan

The Sarbanes-Oxley Act of 2002 is, most obviously, a significant addition to federal securities law. But it does not end there. Sarbanes-Oxley sets forth strict criminal provisions with the power to reach everybody in American business. As Assistant Attorney General Michael Chertoff told the Senate Judiciary Committee: “The act increases the white collar penalties, including measures to ensure that prison sentences – substantial ones – will be the rule, rather than the exception, in significant criminal cases.”

Sarbanes-Oxley raises the penalties for violations of a number of existing laws attacking fraud and contains sweeping new provisions against obstruction of justice by document destruction. It also directs the U.S. Sentencing Commission to revise the federal sentencing guidelines to reflect this new get-tougher approach.

Anti-Failure, Anti-Fraud

Because the relevant deadlines arrived so quickly, one criminal offense created by Sarbanes-Oxley received a lot of early publicity: the new Section 906 criminal penalties for certification of false financial reports by corporate officers. The CEO and the CFO of an issuing entity must now certify that financial statements comply with Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and that the information “fairly presents” the financial condition and results of business operations. Knowing false certification is punishable by a fine of up to $1 million and imprisonment of up to 10 years. Willful false certification is punishable by a fine of up to $5 million and imprisonment of up to 20 years.

This provision, single-handedly, may reshape the structure of American corporations. The criminal penalties are stifling, and their real effect is yet to be felt as public companies scramble to assess their current system for preparing financial reports. Companies, both large and small, must now devise systems that will allow the officers who must sign the financial reports to rely absolutely on the process and people by which the information for the reports was generated. Even more daunting is the prospect of this provision stretching beyond the bounds of financial reports to cover other reporting mechanisms that relay information to multiple federal agencies.

Mail and wire fraud receive similarly strong treatment in Sarbanes-Oxley. Section 900 drastically elevates the criminal penalties for these crimes. The maximum prison sentence has been increased to up to 20 years (except for fraud affecting a financial institution, which still earns the wrongdoer up to 30 years behind bars).

In addition, penalties for conspiracies to commit these fraudulent practices have been revised. Previously, conspiracy to violate the substantive federal fraud offenses was punishable by a maximum of five years’ imprisonment. Section 902 of Sarbanes-Oxley states that attempts and conspiracies to commit the substantive fraud offenses – mail, wire, bank, health, and now securities – will have the same maximum punishment as the substantive crime. In addition, the section explicitly provides that the attempt to commit any of these frauds is now a distinct federal crime.

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Sentencing Landscape

More broadly, Section 905 directs the U.S. Sentencing Commission to review the landscape of all white collar crimes and to revise the sentencing guidelines to implement the provisions of Sarbanes-Oxley. The commission must act to promulgate the appropriate guidelines or amends within 180 days.

Section 805 also directs the Sentencing Commission to review whether the sentencing guidelines sufficiently address obstruction-of-justice crimes. For new offenses, the commission is charged with ensuring that the guidelines provide sufficient deterrence and punishment. This includes providing a specific sentence enhancement for a fraud offense that endangers the solvency or financial security of a substantial number of victims.

Congress gave the Sentencing Commission emergency authority to meet its 180-day deadline. Since amendments must be presented to Congress by Jan. 25, 2003, normal procedures are being expedited, and the notice-and-comment period is on an abbreviated track.

Following a review, the commission will likely vote to promulgate issues and items for comment during its Nov. 19-20 meeting. There will be a shortened public comment period (perhaps 30 days), and the commission will likely vote to promulgate any new amendments at its Jan. 7-9, 2003, session. Amendments promulgated under emergency authority will be promulgated again on May 1, 2003, as part of the commission's regular cycle.

Paper Misdeeds

No doubt in light of the trouble that engulfed Arthur Andersen over its Enron work, Sarbanes-Oxley creates a more comprehensive and far-reaching regime imposing criminal liability for obstruction of justice by document destruction. The new provisions are crafted in the broadest possible language, and companies of all sizes, whether private or public, should review document retention policies to avoid potential criminal liability.

Prior to Sarbanes-Oxley, prosecutors relied on 18 U.S.C. §§1503, 1505, and 1512 to prosecute document destruction cases. Although these provisions provided some powerful tools, loopholes in the scheme required prosecutors to craft indictments with care. For instance, the government could prosecute an individual directly engaged in the destruction of documents under Sections 1503 and 1505, but not Section 1512. Defendants under Section 1512 were limited to those who "corruptly persuade" another to destroy documents.

As to the scope of liability, prosecutions under Sections 1503 and 1505 were limited to circumstances in which a proceeding or investigation was actually under way at the time of the obstructive conduct. By comparison, Section 1512 allowed prosecution for destruction in advance of an "official proceeding," but the case law reflected considerable disagreement over how far in advance it could have been. Decisions ranged from the narrow view that an official proceeding had to have begun or been scheduled to begin at the time of the obstruction, to a very broad reading under which evidence that the defendant may have foreseen an official proceeding at some time in the future sufficed. And some courts preferred to evaluate the reach of the statute on a case-by-case basis, which gave little guidance to prosecutors or the public.

Beyond Loopholes

Sarbanes-Oxley has closed these loopholes and replaced uncertainty about the reach of the law with the broadest standard of liability for document destruction. First, the act amends Section 1512 by adding a new provision allowing prosecutors to charge the "individual shredder" as well as the "corrupt persuader" for obstruction. 18 U.S.C. §1512(c).

More importantly, the act includes a new provision, 18 U.S.C. §1519, which broadens both the subject matter and the circumstances in which liability can

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attach for document destruction in advance of a federal proceeding. Section 1519 provides: "Whoever knowingly alters, destroys … 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 in relation to or contemplation of any such matter or case*, shall be … imprisoned not more than 20 years." (Emphasis added.)

The phrase "any matter within the jurisdiction of any department or agency of the United States" tracks, in part, the language of the federal false statement, statute, 18 U.S.C. §1001. The courts have consistently interpreted "any matter" under Section 1001 as including almost every conceivable area of interest for any federal agency. Looking forward, the new Section 1519, read with Section 1001, may also apply to matters only indirectly within the jurisdiction of the United States, such as where state and local governments, and even private contractors receive substantial federal funding or carry out delegated federal duties.

Moreover, by explicitly making document destruction "in relation to or contemplation of any such matter or case" subject to criminal sanction, Sarbanes-Oxley substantially enlarges the scope of liability for document destruction in advance of federal activity. The provision sweeps aside prior disputes about the timing of the destruction and codifies the broadest standard for determining when criminal liability attaches. The Justice Department has taken note of this broad power in its Sarbanes-Oxley field guidance, stating that Section 1519 "explicitly reaches activities by an individual 'in relation to or contemplation of' any matters," and suggesting that the amended Section 1512 should be read in conjunction with the new Section 1519. Obviously, prosecutors will be on the alert for opportunities to test this new authority.

The Idiot E-Mail

Section 1519 leaves open the question of when a matter or case is "contemplated," and thereby presents a potential danger for companies. For instance, if an employee sends an e-mail message to his co-worker about a corporate matter and states, "If the feds ever got wind of this, they'll be all over us like a...", and if the subject matter of the e-mail is in fact something that is properly within the jurisdiction of a federal agency, has a "matter" now been "contemplated" by the company under Sarbanes-Oxley? 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 prosecution under Section 1519, 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 for the government rather than a shield for the defendant.

In sum, new penalties and provisions for white collar crimes contained in Sarbanes-Oxley reach beyond public companies to all corporations, regardless of size, structure, or line of business, and to their executives. The Sentencing Commission's new directive may yield yet more revisions to the current guidelines and policy statements. And the document destruction provisions of Sarbanes-Oxley place a premium on developing a document management policy that reflects new potential liabilities. Although Sarbanes-Oxley was passed in response to recent corporate and accounting scandals, its criminal provisions are something that all white collar practitioners should know.

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SEC Movement Towards "Real-Time" Enforcement

Nancy R. Grunberg

In the current enforcement environment, corporate executives and legal counsel should be alert to the early, informal involvement of the SEC's Division of Enforcement in financial reporting and restatement discussions that the company may be having with representatives of other SEC divisions or offices, such as the Division of Corporation Finance or the Office of the Chief Accountant. With the Commission's current emphasis on the speedy conduct and resolution of enforcement cases, there is strong motivation for the Enforcement Division staff, and particularly the Division's accountants, to begin asking questions at an early stage in the financial reporting process. There is also a powerful push within the agency to wrap up the issues, if any issues are identified, as quickly as possible. Several recent cases illustrate the rapid pace of these informal inquiries and investigations, but one of the most dramatic examples is *In the Matter of Edison Schools, Inc*. (Securities Exchange Act Release No. 45925), in which the Commission issued a settled cease-and-desist order in a financial reporting case just three months after the Division of Enforcement began its informal inquiry into the matter.

Companies also have more opportunity and incentive in the current environment to investigate quickly and, if appropriate, report problems to the Commission. As Stephen Cutler, Director of the SEC's Division of Enforcement, stated last year, the SEC's policy of rewarding timely and thorough cooperation by issuers is "critical to achieving the Commission's goal of "`real-time enforcement.'" In other words, the Commission is committed to speeding up the enforcement process, and it enhances the speed of SEC investigations if the issuers themselves perform internal investigations, report the results, and otherwise cooperate with the enforcement process.

The rewards of timely cooperation are illustrated in two recent cases, *SEC v. John Giesecke, Jr., Joseph J. Shew and John Desimone* (C.D. Ca., filed September 25, 2002) and *SEC v. Dynegy Inc.* (S.D. Texas, filed September 24, 2002). In the *Giesecke* case, the SEC sued three former senior executives of Homestore Inc. for securities fraud, but determined not to bring any enforcement action against Homestore because of its swift and extensive cooperation in the Commission's investigation. That cooperation included reporting the possible misconduct to the Commission immediately after the audit committee learned of it, conducting an internal investigation, sharing the results of the internal investigation with the government (and not asserting privileges), terminating the wrongdoers, and taking other remedial actions. On the opposite end of the cooperation spectrum, the SEC obtained a cease-and-desist order and a $3 million civil penalty against the issuer in the *Dynegy* case. In the Commission's litigation release on the *Dynegy* matter, Enforcement Director Cutler stated that "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…"

These recent enforcement cases – combined with provisions in the new Sarbanes-Oxley Act – provide a strong incentive to move quickly with an internal inquiry if an accounting issue is discovered or brought to the attention of management or the Board. In carrying out such an inquiry, it may be appropriate to engage outside counsel and forensic accountants, who neither approved nor audited the transactions or items in question. Such prompt and independent investigation and cooperation may yield a much milder sanction for the company, and perhaps no sanction at all.

Being a Good Corporate Citizen: *Operating Under the Sarbanes-Oxley Disclosure Regime*

Wallace E. Christner
Thomas W. France

> "As officers of public companies, you are keepers of the public trust, not only for your own company, but also ultimately for the entire market. My hope is that the extensive governance reforms we are in the process of implementing will provide an opportunity for companies to engage in real self-examination and learning regarding what it takes to be a good corporate citizen."

This quote from SEC Commissioner Cynthia Glassman articulates perhaps the most ambitious goal of the Sarbanes-Oxley Act of 2002. Since President Bush signed Sarbanes-Oxley into law on July 30, 2002, there has been much discussion and anticipation about the impact and consequences the Act will have on corporate America. Sarbanes-Oxley affects the most significant changes in the regulation of corporate activity since the 1930s, including additional disclosure obligations of public companies, new corporate governance requirements, a new scheme for regulating the accounting industry, and enhanced enforcement powers and criminal penalties to fight corporate malfeasance. But as Commissioner Glassman suggests, beyond the legal and regulatory changes, the Act seeks to change the very culture that underlies and shapes corporate behavior.

One of the primary tools Sarbanes-Oxley employs to influence the corporate behavior of public companies is the requirement that a company's principal executive officer and principal financial officer certify the contents of the company's quarterly and annual reports filed under the Securities Exchange Act of 1934. On August 27, 2002, the Securities and Exchange Commission issued the first set of rules mandated by Sarbanes-Oxley, including rules implementing these new certifications. The SEC also adopted rules requiring a public company to establish and maintain a system of disclosure controls and procedures to ensure the company is able to satisfy its disclosure obligations to its investors and the public markets. This requirement to establish and maintain disclosure controls and procedures is central to the intent of the new certification requirements under the SEC rules and requires companies to re-examine and perhaps reinvent the manner in which they prepare their Exchange Act reports.

Certification of Annual and Quarterly Reports

The new SEC rules implementing the Sarbanes-Oxley certification requirements can be broken into three basic topics: (1) periodic report assurances, (2) internal control assurances and (3) implementation of disclosure control policies and procedures. The periodic report assurances in the new SEC rules require the principal executive officer and principal financial officer to evaluate and provide assurances regarding the quality of the information contained in the company's annual and quarterly reports. These officers must certify that:

- He or she has reviewed the report;
- Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit a material fact necessary in order to make the

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statements made, in light of the circumstances under which such statements were made, not misleading;

- Based on his or her knowledge, the financial statements and other financial information included in the report fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report.

While the third certification appears similar to language typically used in an independent auditor's report, it contains no reference to generally accepted accounting principles. In fact, the SEC intended this third certification "to provide assurances that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles." In the SEC's view, the determination of whether the report "fairly presents" the financial condition, results of operations and cash flows of the company "encompasses the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of [the company's] financial condition, results of operations and cash flows."

The new SEC rules also require the certifying officer to provide certain assurances about the company's internal controls:

- He or she has disclosed to the issuer's auditors and audit committee of the board of directors (1) all significant deficiencies in the design or operation of the internal controls that could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the auditors any material weaknesses in internal controls, and (2) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

- He or she has indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Finally, the new SEC rules require certifications with respect to a new concept of "disclosure controls and procedures" as follows:

- The certifying officer (1) is responsible for establishing and maintaining "disclosure controls and procedures", (2) has designed such disclosure controls and procedures to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to him or her, particularly during the period in which the periodic report is being prepared, (3) has evaluated the effectiveness of the disclosure controls and procedures as of a date within 90 days prior to the report, and (4) has presented in the report his or her con clusions about the effectiveness of the disclosure controls and procedures.

Disclosure controls and procedures is a new concept distinct from internal controls and is "intended to embody controls and procedures addressing the quality and timeliness of disclosure." The new rules define the term as "controls and other procedures of an issuer designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the [Exchange Act] is recorded, processed, summarized and reported, within the time periods specified in the [SEC]'s rules and forms." Such controls and procedures should ensure that information required to be disclosed is "accumulated and communicated" to management in a manner to allow for timely decisions about disclosure.

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The new SEC rules concerning disclosure controls and procedures expand the existing requirements to maintain systems of internal controls with respect to financial information to all information required to be disclosed in annual and quarterly reports. Accordingly, these controls and procedures must provide for the collection and evaluation of information subject to disclosure under Regulation S-X and Regulation S-K of the SEC rules, information relevant to developments and risks in the company's business and any other material information required to ensure that the disclosure contained in the company's reports is not misleading. Although many, if not most, companies likely have some controls and procedures in place already, the new rules now formalize this practice and mandate a continuing evaluation of such controls and procedures. Because of the scope of information and regulatory requirements encompassed, the current lack of guidance provided by Sarbanes-Oxley and the SEC rules, and the enhanced scrutiny and liability that the top executive officers face, ensuring that the controls and procedures in place comply with these new legal requirements may be the most significant challenge for public companies under the Sarbanes-Oxley disclosure regime.

Responding to the New Disclosure Regime

Public companies are left largely without specific guidance from the SEC to determine the appropriate processes for establishing and maintaining disclosure controls and procedures. The SEC has stated instead that it "expect[s] each issuer to develop a process that is consistent with its business and internal management and supervisory practices." This lack of specificity is understandable and probably appropriate given the wide divergence of companies subject to the new rules. Companies in different industries obviously will have different processes for collecting, processing and presenting information for disclosure purposes. Large Fortune 500 companies may have entire departments with dozens of employees involved in preparing Exchange Act reports, whereas smaller companies may depend on only two or three people. Moreover, many companies with detailed, formal controls and procedures for preparing Exchange Act reports already in place may not experience much of a change in the way they operate than companies that have followed a more informal process in the past.

The descriptions of disclosure controls and procedures provided by the SEC show substantial similarity to principles provided in accounting literature regarding internal control policies and procedures. Financial institutions with more than $500 million in total assets are subject to internal control requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"). Similar to the SEC disclosure controls and procedures, FDICIA requires preparation of an annual management report setting forth management's responsibilities for establishing and maintaining an adequate internal control structure and for annually assessing the effectiveness of the internal control structure and procedures as of the end of the fiscal year.

Federal bank regulators have stated that internal controls that satisfy the guidelines of the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission's Internal Controls-Integrated Framework (the "Framework") will satisfy federal requirements. The Framework defines internal control as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting and compliance with applicable laws and regulations. Further, the Framework describes components of internal controls to include: a control environment, risk assessment, control activities, information and communication and monitoring. Based on these principles, regardless of a company's particular circumstances, there are some general guidelines it should consider in developing and evaluating its disclosure controls and procedures.

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Identifying and Involving the Appropriate Persons

Perhaps the most obvious principle to be garnered from Sarbanes-Oxley, the SEC rules and the Framework principles is that companies must identify the officers and employees who should be involved in the disclosure process and clearly define the responsibilities of such persons. The Act and the rules explicitly identify the principal executive and financial officers as the persons ultimately responsible for the company's disclosures by requiring them to certify that they have read the report and that it contains all material information and fairly presents the financial picture of the company. By requiring these officers to attest to the accuracy of the company's reports, however, the certifications also serve to encourage senior management to more actively define and police the responsibilities of those persons involved in collecting, processing and presenting information for disclosure.

One of the few specific suggestions the SEC offers is that companies "create a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis." Members of such a committee could include the controller or other principal accounting officer, general counsel, principal risk management officer, investor relations officer and officers or employees associated with the company's business units. Sarbanes-Oxley also mandates a meaningful and regular role for the audit committee in the disclosure process by requiring the principal executives to certify that certain matters are disclosed to the committee in connection with each report. Another suggestion for companies is to have written policies that clearly identify the officers and employees involved in the preparation of the company's reports and define the responsibilities of such persons. In adopting and reevaluating such policies, companies should ensure that the officers and employees identified have access to all information about the company's business and that the responsibilities of such persons are commensurate with their position and capabilities.

Facilitating Communication

Closely related to identifying the persons who should be involved in the disclosure process is the goal of ensuring that such persons communicate the necessary information openly and effectively. Commissioner Glasser expresses this goal clearly:

> "Recognizing that awareness must precede action, Sarbanes-Oxley and the [SEC]'s rules require the CEO and Board to make certain that procedures are in place to ensure that they hear bad news. Under the [SEC]'s recently adopted rules, these procedures must ensure that all material information—both financial and non-financial—gets to those responsible for reporting it to the investing public."

Additionally, the definition of "disclosure controls and procedures" under the SEC rules provides that such controls and procedures should ensure that the necessary information "is accumulated *and communicated*" to management.

The appropriate methods for ensuring the effective communication of information will depend on the size and organization of the company. Obviously, smaller companies may enjoy the advantage of being able to have senior management interact directly with the persons responsible for collecting and processing information, whereas practical limitations may require larger companies to rely on more formal committee or business unit meetings to transmit information from the gatherers to the decision makers. Nonetheless, regardless of its particular circumstances, a company must be vigilant in examining its processes for communicating information with an eye towards identifying and addressing potential breakdowns.

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Documenting the Process

Companies must also carefully evaluate the manner in which they document the preparation of their Exchange Act reports. Documenting the process operates hand-in-hand with facilitating communication. In larger companies in which it is impossible or impracticable for senior management to interact directly with all of the employees involved in collecting and processing information for disclosure, the documentation procedures utilized will be the key mechanism for getting the requisite information to those officers ultimately responsible for the company's disclosures. Even in companies in which the executive officers may be more actively involved in collecting information and preparing the reports, it will be essential to document the process by which reports have been prepared in order to provide the principal executive and financial officers with the support they will need to make the required certifications and conduct the evaluations of the disclosure controls and processes, as well as to establish a due diligence paper trail.

Methods of documenting the process for preparing reports include written policies and charters, minutes and notes from meetings, checklists and questionnaires and employee certifications. As mentioned above, policies and charters should identify the persons involved in the process and their respective responsibilities and should also set forth at a minimum the general procedures and rules to be followed. Notes of meetings may be in the form of minutes if a company has set up a formal disclosure committee or informal written notes from meetings and interviews between officers and other employees involved in preparing the reports. The detail and content of such minutes or notes will depend upon the particular circumstances in which they are used—for instance, if they are utilized to communicate information to senior officers or merely to document procedures that have been followed.

Many companies already use checklists to document procedures that have been followed in preparing reports. Such checklists may be in the form of a simple list of items and actions or more detailed questionnaires and can serve as a useful guide for employees involved in preparing the reports and provide officers in a supervisory role with a mechanism for gathering information and confirming that procedures have been followed in preparing the report. Regardless of the types of documentation employed, there are important considerations regarding the amount of detail and the content included in any written materials. For instance, written materials a company prepares in connection with preparing its Exchange Act reports could be used as a road map by regulators or private litigants in the event of an enforcement action or private suit. Therefore, companies may be well advised to maintain policies, minutes and checklists that are general in nature and have employees and officers communicate and discuss issues, problems and more specific matters orally. The type and scope of written materials that will be appropriate for each company will depend on its particular circumstances—large companies for instance may have to include more detail and substantive content in the written materials they employ if such materials are the primary means of communicating information to senior management. Accordingly, companies should carefully consider the requirements for the written materials they use and should also consult with their legal counsel in determining the appropriate form and content of such materials.

Another means many companies are using or considering to document compliance with disclosure controls and procedures are certifications signed by employees involved in preparing reports. Such certifications are typically similar to those required to be made by the principal executive and financial officers and require officers and employees down the line to certify as to their knowledge about the information contained in the reports and/or their actions in preparing the reports. Although these certifications can be useful in focussing these officers and employees on their responsibilities in preparing the disclosure reports and provide senior management with a means of documenting compliance with the company's controls and procedures, they cannot serve as a substitute for

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active participation by the principal executive and financial officers in the process of preparing the reports and evaluating the effectiveness of the company's disclosure controls and procedures. Moreover, companies that utilize such certifications must give careful consideration to their response to employees who refuse to sign. For instance, Sarbanes-Oxley provides new protections to an employee of a public company who provides evidence or assists in any securities or antifraud proceeding or investigation involving the company. Accordingly, disciplining an employee who refuses to sign a certification could have serious consequences for a company, depending on the circumstances.

Ongoing Evaluation Process

One of the clear mandates underlying Sarbanes-Oxley and the new rules is that the internal evaluation of disclosure controls and procedures must be "fresh" for each report filed. No matter how detailed and effective a company's existing controls and procedures may be, senior management must subject such controls and procedures to an ongoing critical review to ensure they remain effective as the company's business changes and compliance practices and requirements evolve. This review should entail making sure the proper employees are involved in the process and evaluating the performance of their respective responsibilities, ensuring that communication and information flow among the various parties is open and effective, and reviewing and updating policies and checklists.

Public companies employ their outside auditors to perform regular audits of their internal controls relating to financial information. Companies should consider engaging outside legal counsel to perform similar reviews of disclosure controls and procedures relating to non-financial reporting obligations. As discussed above, the SEC's definition of "disclosure controls and procedures" is much broader than the traditional concept of internal controls and encompasses a broad scope of complex and detailed laws and regulations that are constantly evolving. Legal counsel can serve as a valuable resource in educating and updating officers and employees on these legal requirements. Moreover, legal counsel can assist not only in formulating appropriate policies, forms and checklists, but also can help evaluate the company's policies, procedure and practices on an ongoing basis.

Enhanced Liability

In adopting the new rules, the SEC noted that the certifications set forth in the rules are "not meant to change the current obligations of corporate officers in connection with the discharge of their duties." Prior to the enactment of Sarbanes-Oxley and the adoption of these rules, the principal executive and financial officers, as signatories to the company's Exchange Act reports, could be held liable for material misstatements and omissions in such reports under general anti-fraud standards. Under the new rules, an officer providing a false certification could also be subject to SEC action for violating Section 13(a) or 15(d) of the Exchange Act, in addition to his or her potential liability in SEC or private actions for violating the anti-fraud provisions. Further, Section 906 of Sarbanes-Oxley, which requires additional certifications separate from those mandated by Section 302 and the SEC rules, subjects principal executive and financial officers to potential criminal liability if the certifications made under Section 906 are false. Finally, although not expressly connected to the certification requirements under Section 302, several other provisions of Sarbanes-Oxley increase the criminal penalties and consequences for misconduct related to violations of the securities laws and provide regulators with additional tools and mandates to uncover and punish such misconduct. For instance, the Act increased the SEC's budget by more than 75% for fiscal year 2003, to $776 million, and expressly directs the SEC to review company reports "on a regular and systematic basis," and in no event less frequent than once every three years. Accord-

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ingly, although the obligations of corporate officers in connection with the discharge of their duties may be the same today as they were prior to July 30, 2002, the consequences of failing to live up to those obligations could be much different.

Conclusion

In responding to Sarbanes-Oxley and the rules issued thereunder, companies must evaluate not only the practices and policies they employ in preparing disclosure reports, but also the environment and culture underlying those practices and policies. They must ensure that employees involved in the process have the guidance and support necessary to carry out their responsibilities and that the environment in which such employees operate not just encourages, but demands the sharing of all material information—good or bad. Perhaps most importantly, companies must be vigilant that their disclosure process is open to active, critical analysis on an ongoing basis and does not become a rote, mechanical exercise of checking boxes and relying on form and procedure. Only by creating the appropriate culture will a company be able to take on the "real self-examination and learning regarding what it takes to be a corporate citizen" that is at the heart of Sarbanes-Oxley.

It's Not *Just* about Enron: A Guide to the Sarbanes-Oxley Act for Nonprofit Organizations

W. Warren Hamel

In the midst of the extraordinary corporate and accounting scandals that have captured the attention of federal regulators and the public in the past year, Congress passed new and far-reaching corporate governance legislation, the "American Competitiveness and Corporate Accountability Act of 2002," often referred to as the "Sarbanes-Oxley Act." It is a common misperception that Sarbanes-Oxley, enacted as a response to the disclosure of financial misdeeds at Enron, Arthur Andersen, Worldcom, and others, applies only to publicly traded companies subject to the Securities and Exchange Act of 1934. In fact, Sarbanes-Oxley contains a number of provisions, among them new and sweeping criminal provisions, that apply to everyone, including nonprofit organizations and their officers and boards. Even the provisions that apply only to publicly traded companies are coming to be viewed as setting new standards for corporate governance, or "best practices," that all companies – public, private and nonprofit – should consider adopting.

Sarbanes-Oxley Criminal Provisions: Document Destruction

Sarbanes-Oxley includes strict new criminal provisions dealing with obstruction of justice by document destruction and retaliation against informants. These provisions have been added to Title 18 of the U.S. Code – the federal general criminal code – and they apply to *everyone.* The combined effect of these new criminal provisions is to vastly increase the scope of potential criminal liability for a variety of conduct.

For instance, prior to Sarbanes-Oxley, federal prosecutors relied on a series of obstruction of justice crimes to prosecute individuals for destruction of documents. Although these statutes provided some powerful tools, they were fraught with loopholes, and prosecutors were required to craft indictments with great care. Under some provisions, the government could prosecute an individual directly engaged in the destruction of documents, but only if a government proceeding was underway 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. The government's prosecution of Arthur Andersen was based on this "corrupt persuader" theory. Sarbanes-Oxley has changed all of that by introducing a sweeping new criminal provision, 18 U.S.C. Section 1519, which 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" tracks the language of the federal false statements statute, 18 U.S.C. Section 1001, and has been interpreted by the courts to include almost every conceivable area of interest on the part of the federal government. In addition, courts have upheld the use of Section 1001 to prosecute false statements to state agencies and private contractors who either receive federal funds or carry out delegated federal programs. If the new Section 1519 is read by the courts *in pari materia* with Section 1001, even the destruction of documents that implicate a federal interest only indirectly may become a matter for prosecution.

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Moreover, by explicitly making document destruction "in relation to or contemplation of any such matter or case" subject to criminal prosecution, the Act codifies the broadest possible standard for determining when document shredding becomes a crime. The Act leaves open, however, the question of when a federal matter is contemplated. As an example, suppose an employee sends an email to co-workers about an organizational 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]." 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 organization under the Act? And if the documents are destroyed, through the operation of a document retention policy or otherwise, are the organization and individuals 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. Recent heightened scrutiny of corporate malfeasance, both in the for-profit and nonprofit sectors, virtually assures that this provision will be tested in the future.

Whistleblower Protection

The Act also provides new protections for whistleblowers against retaliation in terms of employment. Section 1107 makes it a crime for anyone, with the intent to retaliate, to take any action that is harmful to any person, including interference with lawful employment or livelihood, for "providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense." The maximum punishment is ten years incarceration and a fine. Again, this provision is not limited to public companies, but applies to everyone. The statutory definition of "law enforcement officer" is "an officer or employee of the Federal Government . . . authorized under law to engage in or supervise the prevention, detection, investigation or prosecution of an offense. . . ." Thus, investigators in various federal agencies such as IRS, the FTC, the FBI, the SEC, and others are likely to be included as "law enforcement officers." Nonprofit organizations should therefore examine whether their internal procedures are adequate to prevent retaliation against employees who report problems or raise questions regarding the organization's financial or other affairs.

Potential Impact on Nonprofit Organizations

These two criminal provisions are particularly important for nonprofit organizations that receive, as many nonprofits do, federal funding through direct grants or loans, or grants or loans from state or private organizations that administer federally funded programs. Most federal agencies take some basic measures to assure that funds granted or loaned to organizations are not misused or embezzled. This effort can take the form of routine file reviews, accounting audits and even investigations by the agency Inspector General's office. Sarbanes-Oxley's criminal provisions mandate harsh consequences for tampering with either documents or witnesses, and as a consequence, nonprofit organizations should adopt document management policies and employment policies, or review their current policies and procedures, to ensure that they will not run afoul of the new law.

Voluntary Compliance: Best Practices

Beyond the criminal provisions that apply directly to everyone, Sarbanes-Oxley's corporate governance requirements for publicly traded companies are worth considering, and perhaps adopting, even by nonprofit organizations, as "best practices." For instance, the combination of Sarbanes-Oxley and new stock exchange rules emphasizes the importance of a strong and independent board of directors, with certain committees of the board either a majority or completely

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comprised of independent directors. The Act creates extensive protections for Audit Committees in particular, including the requirement that Audit Committee members be independent of the company, and that at least one member of the Audit Committee be a "financial expert." Sarbanes-Oxley gives the Audit Committee sole responsibility for appointing, compensating and supervising auditors, and requires the Audit Committee to set up internal procedures for receiving and reacting to complaints concerning accounting, internal control, or auditing matters, including establishing a mechanism for handling confidential, anonymous concerns of employees.

The Act directs the SEC to require each company to adopt a code of ethics for its senior financial officers and to disclose the contents of that code in its public filings, or disclose and explain the fact that it has not adopted such a code. The SEC, in proposed rules, has broadened the ethics code requirement to cover the CEO. Sarbanes-Oxley also makes it unlawful for any officer or director to fraudulently influence an auditor in the performance of an audit, for the purpose of rendering the financial statements misleading.

In addition, there are new financial disclosure requirements for public companies, including disclosure of material correcting adjustments proposed by the auditor, material off-balance sheet transactions, and relationships with unconsolidated entities that might have a material effect on the issuer. A covered company also must include a report on internal controls with the annual report. The Act requires a covered company to disclose information concerning material changes in its financial condition or operations on a prompt and current basis, and periodic public financial filings must be accompanied by a certification by the CEO and CFO that the financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer.

As a practical matter, many nonprofits will have neither the resources nor the personnel to create complex internal structures as described above. Some of these "best practices," however, can be tailored to fit even very small organizations to help ensure compliance with the letter of the law as required, and the spirit of the law where the organization chooses. For instance, if it does not already have one, a small nonprofit might consider creating an Audit Committee from the current board, and seeking a "financial expert" specifically to sit on the Audit Committee and help guide its work. The board and management may want to adopt a code of ethics addressing the areas suggested by the SEC's proposed rule for ethics codes for senior officers and directors. At a minimum, a nonprofit organization should establish a document management policy to guide employees in handling and disposing of documents, specifically focused on documents that may relate to "matters within the jurisdiction of an agency" of the federal government; whether it is tax matters within the jurisdiction of the IRS, employment matters within the jurisdiction of the EEOC, or antitrust matters within the jurisdiction of the U.S. Department of Justice or Federal Trade Commission, many nonprofit organization documents fall within this realm. Finally, nonprofits should consider adopting some form of employment policy and procedure to encourage internal disclosure of misconduct or mishandling of funds, to ensure both that funds are properly handled and that any certifications or reports made to funders – especially those administering federal funds – are correct and fairly represent the finances and operation of the organization.

Although Sarbanes-Oxley was passed in response to recent corporate and accounting scandals affecting some of the largest publicly traded companies in the country, the impact of its criminal provisions will be felt throughout the economy and society, and many of its provisions will likely become benchmarks for all companies and organizations, including nonprofits. Accordingly, the staff, officers and directors of nonprofits should review the policies and operations of their organizations in light of the Sarbanes-Oxley Act, and make the adjustments necessary to comply with the law and to incorporate new standards of corporate governance.

About Venable's Corporate Governance and Investigations Practice

Venable has proven itself a reliable advisor to corporate management teams and boards of directors who want to guard against corporate impropriety — or to take swift action when allegations arise. Long before new corporate governance legislation ushered in increased corporate accountability, Venable was helping management teams ensure that their companies are run with the highest ethical and operational standards. Led by Benjamin R. Civiletti, former Attorney General of the United States, Venable has an interdisciplinary team of attorneys from across its various practices to assist senior executives, boards of directors and audit committees in managing their risk, ensuring compliance and protecting company reputations.

Venable has conducted high-profile investigations in industries such as banking, retail, petroleum, consumer products and others. The firm has attorneys with SEC experience and more than a dozen former prosecutors and regulators, including former senior United States Justice Department officials, Assistant United States Attorneys, former federal banking regulators, as well as former Assistant State's Attorneys and Public Defenders. Having been in government service, Venable attorneys know what prosecutors expect and demand. We get matters resolved efficiently by getting to the bottom of an issue — and zealously advocating the right outcome.

Venable can assist companies with the full range of issues brought about by the new corporate governance legislation. Venable's integrated team has the experience to advise clients on issues, including:

- Securities law, SEC matters, financial disclosure and certification
- Corporate governance and risk management issues
- Executive compensation and employee benefit issues
- Fraud prevention and compliance programs
- Board Special Committee and Director/Officer representation
- Bankruptcy and independent examination
- Corporate investigations and white collar defense

Clients can leverage the experience of the Corporate Governance and Investigations team to provide:

- Program and Operations Audits
- Drafting and Review of Compliance and Policy Statements
- Development of a Model Code of Ethics for senior Financial Officers and Board of Directors
- Document Management Policy
- Model Guidelines for General Counsel
- Guidance on Establishing an Internal Audit Function
- Ethics and Compliance Training

Venable's integrated team provides clients with an aggressive, coordinated approach both to preventing and resolving corporate governance or management issues before they become criminal, civil or administrative proceedings.