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Weighing Sarbanes-Oxley: Changes Appear To Be Profound

By Rebecca Walker

The effect of recent legislation and rule-making on corporate compliance will perhaps be as important as anything that has happened in this field since the promulgation of the U.S. Sentencing Guidelines for Organizations in 1991. It will undoubtedly take years to ascertain the full impact of recent legislation and rule-making that has resulted from the many corporate scandals and corporate failures of the past months.

This article attempts to take an early look at the ways in which compliance programs are already changing in the wake of recent events, and to anticipate some future implications. Because the focus of the legislation and rule-making is on codes of conduct, and because that is where the changes are currently most evident, this article will concentrate on codes. It is, however, important to note that these changes in codes of conduct seem to be indicative of more profound changes in both the way compliance programs work and how we view them.

The new rules make a company's code of conduct and its compliance program applicable to its directors. This represents a fairly monumental shift.

New rules and proposed rules

The new rules and proposed rules include (i) the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), which became law on July 30, and the Securities and Exchange Commission's (SEC) proposed regulations to implement certain provisions of that legislation, which were released on October 22, 2002 (SEC Proposed Regulations), (ii) the New York Stock Exchange's (NYSE) Corporate Governance Rule Proposals (NYSE Rule Proposals), which were submitted to the SEC on August 16, 2002, and (iii) the Nasdaq's Corporate Governance Rule Proposals (Nasdaq Rule Proposals), submitted to the SEC on October 9, 2002.[1]

Each of these undertakings, while directed at a host of corporate governance and other issues, also includes new rules for corporate compliance, generally embodied

Rebecca Walker is an associate specializing in corporate compliance at the law firm of Skadden, Arps, Slate, Meagher & Flom LLP, in Los Angeles, California. The views expressed herein are the author's and do not necessarily represent the views of the firm.

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Companies have added language to their codes providing that the CEO must disclose potential conflicts of interest directly to the audit committee.

in the form of rules requiring (or requiring disclosure regarding) codes of conduct. Each approaches the issue of codes somewhat differently, but each approach has important implications for codes of conduct and compliance generally.

Applicability to directors

Both the NYSE Rule Proposals and the Nasdaq Rule Proposals will require listed companies to adopt codes of conduct applicable to all employees, officers and directors. Prior to these rule proposals, boards of directors often approved codes of conduct and put their official imprimatur on the establishment of the compliance program—but most codes did not apply to directors. This rule change will require many listed companies to modify the applicability of their codes to encompass directors.

Many companies are now doing this, and are also grappling with the concept of how in practice a company's code should and will apply to directors. Some employment and workplace policies have little, if any, applicability to directors. For example, a company's policies pertaining to use of the company's computer resources (which directors may never use), protecting the environment, and workplace health and safety may have no applicability to directors. And, given that most directors have other full-time jobs, the code's applicability may be different in some ways for directors than for employees. To deal with this problem, some companies have included language in their codes providing that the code will be applicable to directors insofar as the directors are carrying out their duties on behalf of the company, while other companies have merely considered this implicit in the code (as, indeed, applicability to employees is also limited in many ways to their function as employees, which most companies have generally considered implicit in their codes).

Much more profound, however, than the mere reworking of a company's code, is the concept of making a code of conduct and a company's compliance program applicable to its directors. Compliance has traditionally been defined as a system of internal policies and procedures designed, implemented and enforced so as to prevent and detect violations of law, regulations and company policies by employees and other agents. Interestingly, directors have rarely been included in the "other agents" category. Indeed, very little has been said or written about the applicability of a compliance program to boards of directors, as distinguished from the role of boards in the oversight of compliance programs, a topic that has received substantial attention. The movement from viewing boards as the mere overseers of compliance to the subject of compliance programs is a fairly monumental shift in the way compliance programs are designed and perceived. It creates a new dimension in the workings of compliance programs, the full effects of which will only be

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known with the passage of time.

Oversight by directors

Since the Delaware Chancery Court's 1996 decision in *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959, there has been much discussion about the scope of a director's duty of care with respect to the oversight of a company's compliance program. The role of the board in overseeing a company's compliance program will undoubtedly be increased and formalized with the impact of recent legislation and rule-making.

Section 7(b)(i)(A) of the NYSE Rule Proposals provides that an audit committee's purpose is to assist board oversight of a company's compliance with legal and regulatory requirements. While board oversight of compliance is far from a novel concept, the NYSE Rule Proposals have already had the effect of making many boards more cognizant of their role as overseers of compliance, and of increasing boards' attentiveness to compliance programs.[2]

Role of directors in the function of the program

Section 301 of Sarbanes-Oxley requires the SEC to adopt a rule by April 26, 2003 directing the national securities exchanges and associations to prohibit the listing of securities of any company where the audit committee of the company has not established procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls, or auditing matters and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

The legislation, which makes audit committees responsible for establishing procedures to receive reports of accounting and auditing misconduct, represents a significant change with respect to the role of the audit committee in the implementation of a compliance program. In this area of compliance, the audit committee now has more than mere oversight responsibility; it must actively engage in establishing compliance procedures for reporting certain types of misconduct.

Focus on upper management

While most codes of conduct have always been applicable to all employees—from the chief executive officer down—there is, with recent corporate scandals and failures (and reflected in the recent legislation and rule-making), a new focus on the applicability of compliance programs to upper-level management. Compliance has typically been considered, in part, an educational and information tool emanating from the upper levels of management (as most agree that it must in order to be effective), informing and providing guidance to those below. Given the high level at which much of the recently reported wrongdoing has taken place, however, current legislation and rule-making is understandably focused on the applicability of the rules to those at the very top of companies.

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For example, section 406 of Sarbanes-Oxley requires the SEC to adopt rules requiring issuers to disclose whether they have a code of ethics for the CFO and the controller or persons performing similar functions. The SEC's Proposed Regulations implementing this provision of Sarbanes-Oxley have expanded the applicability to include the CEO, and have asked for comments on whether the required code should also apply to the General Counsel and to others in a company. The code of ethics contemplated by Sarbanes-Oxley is a fairly generic code, including policies relating to honest and ethical conduct, conflicts of interest and compliance with rules and regulations, as well as full, fair and accurate disclosures in periodic reports. To limit the applicability to senior financial officers is thus somewhat surprising, as much of what the code of ethics concerns is presumably applicable to everyone in an organization. The NYSE Rule Proposals and Nasdaq Rule Proposals have a similar focus on upper-level management in their requirement that those waivers of a company's code of conduct made for executive officers and directors be publicly disclosed.

This focus on the highest levels of management—and on the rules applicable to them—is causing companies to rethink their codes' applicability to senior management, with a greater focus on those issues (like conflicts of interest, discussed below) where upper-level management can create the most harm. It also has

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important implications for the reporting procedures that are laid out in a code and that are implemented in a company's compliance program, as discussed more fully below.

Perhaps most important, this focus on potential harm caused by the most senior executives has caused corporate compliance practitioners to rethink how compliance programs protect against high-level risk. The harms that can be caused by the highest levels of management are great, and the controls oftentimes are much more difficult to implement—both from a practical perspective and from a political perspective. (The outside lawyer, the in-house lawyer and the compliance officer all report to the CEO in some manner, and so making suggestions for policing that individual is a much more difficult proposition than making suggestions for policing the sales force or the human resources department, for example.) These concerns highlight the importance of both having the audit committee involved in the oversight of the compliance program, as discussed above, and of creating appropriate reporting procedures.

Reporting procedures

We are already seeing changes in the way companies structure reporting procedures and avenues for employees and directors to seek guidance and make disclosures regarding potentially problematic conduct. Whereas, in the past, most companies have been content to set forth avenues of reporting misconduct and disclosing conflicts that included, for example, the compliance officer, the human resources department and the legal department, many companies' recently revised codes provide additional methods for the CEO and directors to report misconduct, seek guidance or make disclosures regarding potentially problematic conduct. After all, it is likely not appropriate to have the CEO seek approval to engage in a transaction that may constitute a conflict of interest from the compliance officer, who likely reports to the CEO.

Indeed, the commentary to the SEC's Proposed Regulations implementing section 406 of Sarbanes-Oxley (the code of ethics section) notes that the persons to whom disclosures regarding conflicts of interest and reports of misconduct should be made "should have sufficient status within the company to engender respect for the code and the authority to adequately deal with the persons subject to the code, regardless of their status in the company." (SEC Proposed Regulations n. 67 and 69.) Many companies have thus added language to their codes providing that the CEO, CFO and other high-level officers must disclose their own potential conflicts of interest directly to the audit committee or some other committee of the board and may report suspected misconduct directly to the audit committee or some other committee of the board. (There may be instances where it would not be appropriate for executive officers and directors to report suspected misconduct to the board, such as, for example, when the purported misconduct is perpetrated by lower-level employees, and the legal or compliance department is fully equipped to respond.)

As discussed above, Sarbanes-Oxley requires the SEC to prohibit the listing of any issuer whose audit committee has not established procedures for the receipt of complaints regarding accounting, internal accounting controls or auditing matters and for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters. Sarbanes-Oxley also provides criminal penalties for retaliation against persons who provide law enforcement officers with information relating to the possible commission of a federal offense (with penalties of fines and up to ten years imprisonment) and for civil causes of action for persons who are discriminated against in the terms of their employment for reporting information about fraudulent activities or violations of SEC rules and regulations.

Given the additional obligations that have been placed on companies regarding reports of misconduct, some companies are for the first time developing policies to be separately disseminated to employees regarding reporting procedures and whistleblower protections. Other companies are expanding the discussion of reporting in their codes of conduct and other compliance policies. And, pursuant to the new obligations

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Sarbanes-Oxley. . . *Continued from page 4*

created by section 301 of Sarbanes-Oxley, the internal reporting of suspected accounting and auditing misconduct is receiving special attention.

As with other areas of recent change, the big news here may be much greater than a simple change in the language of codes of conduct or the development of separate policies regarding reporting procedures. This may instead evidence a change in how companies manage the way employees report suspected misconduct or make disclosures. There seems to be a much greater focus on ensuring that reports of suspected misconduct will reach appropriate levels within the organization and on adopting suitable safeguards to make employees feel comfortable making such reports and expressing concerns. Reporting procedures, non-retaliation provisions and promises of confidentiality are much more than buzz words these days; they are important components of effective compliance programs.

Enhanced public scrutiny

The SEC's Proposed Regulations to implement section 406 of Sarbanes-Oxley require companies to file their codes of ethics as an exhibit to their annual reports. The NYSE Rule Proposals require public companies to adopt and "disclose" codes of business conduct and ethics. Under the SEC's Proposed Regulations,

the NYSE Rule Proposals and the Nasdaq Rule Proposals, waivers of codes for certain persons must be publicly disclosed. The new requirements to make codes publicly available combined with the requirements to disclose waivers for certain employees and for directors, could lead to the "watering down" of codes as companies attempt to draft codes so that waivers will rarely—if ever—be required.

Codes may also suffer from greater uniformity as companies seek to implement codes that place them firmly in step with every other company in their industry or at their level of market capitalization. Indeed, while the SEC's Proposed Regulations to implement section 406 of Sarbanes-Oxley expressly recognize that codes "do, and should, vary from company to company" and that "decisions as to the specific provisions of the code, compliance procedures and disciplinary measures for ethical breaches are best left to the company," one of the consequences of the legislation and rule-making could well be greater uniformity in all types of codes. As codes are disseminated and become publicly available, even more uniformity may result. The outcome may unfortunately be greater focus on the contents of a company's code relative to the codes of other companies and less focus on the suitability of a code to a particular company's culture, history, and compliance program.

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Contents of codes

Another effect of recent rule-making may be a recasting of the contents of codes. Many companies are focusing their codes on those topics that the legislators and regulators deemed worthy of inclusion in their definitions of what constitutes a code, and some recently-adopted codes address those topics either entirely or in large measure, leaving out other topics that have traditionally been included and that may be both informative to employees and helpful to companies, but were not mentioned in the legislation or rule-making. Examples include policies addressing equal employment opportunity, harassment, workplace health and safety, environmental policies, use of computer and communication resources, and privacy. Because these topics were not the subject of recent rule-making, they are, in many instances, getting less attention than topics like conflicts of interest and maintaining accurate books and records.

Companies developing codes for the first time or revising their codes in light of recent rule-making should remember that codes can serve a far greater purpose than simply satisfying regulatory requirements. Codes can and should be at the heart of a company's compliance program, serving to educate employees and directors about legal obligations and company standards and about their obligations to report suspected misconduct, and setting forth the structure and parameters of a company's program to prevent and detect violations of the law. As the NYSE Rule Proposals point out, while "[n]o code of business conduct and ethics can replace the thoughtful behavior of an ethical director, officer or employee," codes "can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability." Codes should be drafted and revised with all of these goals in mind.

Conclusion

The full impact of the recent spate of rule-making and legislation on corporate compliance programs remains to be seen, and it may not be known for many years to come. What is already clear, however, is that compliance programs are in for some rather significant changes, and things are certain to look different when it is all over. ❑

Footnotes:

[1]With the exception of Sarbanes-Oxley, which became law on July 30, 2002, the regulations and rules discussed herein are not yet final, and are thus subject to modification.

[2]In addition, section 301 of Sarbanes-Oxley requires that audit committees must have the authority to engage independent counsel and other advisors, as the audit committee deems necessary to carry out its duties. Among other things, this provision may translate into audit committees' hiring outside counsel to review a company's compliance program and report the results of that review directly to the audit committee. It is certainly not without precedent that an audit committee would ask outside counsel to review a company's compliance program, but it is somewhat unusual. This provision could make that circumstance much more commonplace. ❑