How Will Recent Changes in Corporate Governance, Public Auditing, and the Role of In-house Counsel Affect You?

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The collapses of Enron and WorldCom have focused public attention on the adequacy of our system of financial reporting and disclosure, of corporate governance and ethics, and of regulation of the accounting profession. Congress, the White House, the U.S. Securities and Exchange Commission ("SEC"), the stock exchanges, business-related professional associations, and institutional investors have called for reforms to fix perceived inadequacies in those areas. And those calls have been answered. Before the end of July, by an overwhelming majority in both the House and the Senate, Congress passed and President Bush signed into law a corporate governance and accounting oversight bill, the Sarbanes-Oxley Act of 2002, that not only affects accountants, corporate executives, and shareholders, but also directly affects lawyers. In particular, the law requires the SEC to promulgate a rule requiring lawyers to report securities law violations to a corporation's directors if senior management does not rectify the violations. In addition, the American Bar Association has offered its views on the corporate responsibility crisis, issuing preliminary recommendations aimed not only at strengthening corporate governance, but also at setting new ethical standards for lawyers.

CORPORATE GOVERNANCE AND ACCOUNTING OVERSIGHT BILL

The publicity surrounding the collapse of Enron and, more recently, the events involving WorldCom, led, quite predictably, to a flurry of action on Capitol Hill. The culmination of this activity was the Sarbanes-Oxley Act of 2002. The House passed the bill 423-3, and a few hours later, the Senate approved the bill 99-0. According to the *Wall Street Journal*, President Bush called the bill "a good piece of legislation" and promised to sign it before the Senate had even voted.[1]

The Sarbanes-Oxley Act will—

- Grant the SEC broad authorization to "promulgate such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of this Act."
- Establish a new, independent regulatory body, which will be the five-member Public Company Accounting Oversight Board ("Board"), "to oversee the audit of public companies that are subject to the securities laws." No more than two of the Board's five members may have worked as certified public accountants. The Board will (1) register auditors, (2) establish or adopt auditing, quality control, ethics, independence, and other standards for auditors, (3) inspect auditors, (4) conduct investigations and disciplinary proceedings, and (5) enforce compliance with the Act and the rules of the Board. The SEC will appoint Board members after consultation with the Fed Chairman and the Secretary of the Treasury. The Board will have jurisdiction to regulate "persons associated with a public accounting firm."[2] The Board will be

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funded by fees assessed on issuers of publicly traded securities.

- Require public auditors to register with the Public Company Accounting Board.
- Require the Public Company Accounting Oversight Board to include in its auditing standards, requirements that (1) each public auditing firm maintain audit documents for seven years, (2) each audit report be approved by a partner other than the one in charge of the audit, and (3) each audit report describe the auditor's testing of compliance with law.
- Require the Public Company Oversight Accounting Board to include in its quality control standards requirements relating to monitoring of professional ethics and independence, consultation on accounting and auditing questions, supervision of audit work, hiring and development of personnel, the acceptance and continuation of engagements, and internal inspection.
- Require the Public Company Accounting Board to conduct a continuing program of inspections of auditors.
- Grant the SEC oversight and enforcement authority over the Board.
- Prohibit public auditors from providing most nonaudit services to their audit clients. The law permits public auditors to provide tax services to audit clients only if the client's audit committee gives advance approval.
- Require the rotation of the lead auditor and the audit partner responsible for reviewing the audit on each account at least once every five years.
- Require auditors to provide reports to audit committees.
- Prohibit auditors from auditing clients in cases in which a top executive came from the auditor and participated in audits within the past year.
- Require the Comptroller General to conduct a study of the effects of requiring mandatory rotation of audit firms.
- Require the SEC to direct national exchanges to prohibit the listing of any company that does not have an audit committee meeting specified standards.
- Require the CEO and CFO to personally certify the veracity of financial statements.
- Require the CEO and CFO to reimburse the company for bonuses and stock profits received if the company is required to restate its profits.
- Prohibit corporate insiders from trading during blackout periods.
- Make it unlawful for an officer or a director to improperly interfere with an audit.
- Require the SEC to establish rules "setting forth *minimum standards of professional conduct for attorneys* appearing and practicing before the [SEC] in any way in the representation of public companies." (Emphasis supplied.) The law requires that such rules include a rule requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty by the company or its agent to the chief legal counsel of the company or the CEO of the company and, if the counsel or officer "does not appropriately respond," requiring the attorney to report the matter to the audit committee or another committee composed solely of outside directors or to the entire board of directors.[3]
- Direct funds obtained by the SEC through disgorgement orders or civil penalties to victimized investors.
- Require increased financial disclosures.
- Require the SEC to adopt rules to address analyst conflicts of interests and to conduct a study regarding the role and function of credit rating agencies.
- Require the SEC to review and analyze enforcement actions from the past five years.

Do Not Miss John K. Villa's
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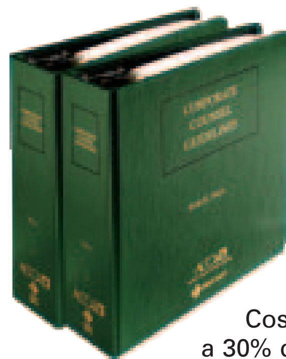

In this post-Enron environment, you need the best ethics guidance that you can get. Here it is. *Corporate Counsel Guidelines* is a two-volume treatise written expressly for in-house counsel. This treatise tackles the most common issues facing corporate counsel, even those issues that have no guiding precedent or ethics opinions. Cost: $220, and ACCA members receive a 30% discount. To order, contact West at 800.344.5009 or at www.westgroup.com.

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- Authorize $776 million for the SEC.
- Make it a criminal offense to destroy or alter a document "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 any case filed under title 11 [bankruptcy], or in relation to or contemplation of any such matter or case," with a maximum sentence of 20 years.
- Make it criminal for an auditor to knowingly and willingly fail to maintain all documents sent, received, or created in connection with an audit or review for five years from the end of the fiscal period for which the audit or review was conducted.
- Make debts incurred because of settlements, judgments, or orders stemming from securities law violations nondischargeable in bankruptcy.
- Extend the statute of limitations for securities fraud suits.
- Direct the U.S. Sentencing Commission to review and amend as appropriate the Federal Sentencing Guidelines to ensure that (1) offense levels and increases for document destruction or fabrication and for obstruction of justice are adequate, (2) the guidelines for the law's newly enacted crimes are sufficient, (3) a specific offence increase is added for a fraud offense that endangers the solvency or financial security of a substantial number of victims, and (4) the guidelines that apply to organizations are sufficient to deter and punish organizational criminal misconduct.
- Provide protections for whistleblowers employed at publicly traded companies.
- Create a criminal offense of securities fraud similar to the currently existing offenses of mail fraud, wire fraud, and bank fraud.
- Make attempt and conspiracy relating to certain white collar crimes offenses subject to the same penalties as the underlying crime.
- Increase the maximum penalties for mail and wire fraud from 5 to 20 years per violation.
- Increase the maximum penalties for ERISA violations.
- Direct the U.S. Sentencing Commission to review the sentencing guidelines applicable to securities and accounting fraud and related offenses.

AMERICAN BAR ASSOCIATION

Also before the end of July, the ABA's Task Force on Corporate Responsibility ("Task Force") made available to the public its preliminary report on improving corporate responsibility.[4] The Task Force's core conclusion is that outside directors, outside auditors, and outside lawyers have "fallen short" in providing "active and informed stewardship of the best interests of the corporation." In other words, these independent advisors have lost their independence, thereby failing to help ensure that corporate boards act in the best interests of shareholders rather than corporate executives. To restore the independence of such advisors, the Task Force endorses recommendations in two principal areas: strengthening ethical rules for lawyers and reforming the way corporate boards operate.

Recommendations Relating to Lawyer Responsibilities and Conduct

The Task Force suggests a number of changes to the ABA's model rules of professional responsibility:

- Amend rule 1.13 to make clear that the rule requires a lawyer to pursue the remedial measures outlined in Rule 1.13(c)(1) through (3), including referring the matter to higher corporate authority,[5] in a matter either related to the lawyer's representation (as currently provided in the rule) or that has come to the lawyer's attention through the representation, where the misconduct by a corporate officer, employee, or agent involves crime or fraud, including violations of federal securities laws and regulations, and change both the text and comments of Rule 1.13 to encourage counsel to take action to prevent or rectify corporate misconduct (the Task Force believes that the current rule unduly discourages such action by counsel).
- Extend permissible disclosure of confidential information under Rule 1.6 to reach conduct that has resulted or is reasonably certain to result in substantial injury to the financial interests or property of another and require disclosure under Rule 1.6 to prevent felonies or other serious crimes, including violations of the federal

ACCA/GCCA Advocacy Efforts

ACCA/GCCA's board Advocacy Committee plans to take up these issues. To contribute your views for the committee's consideration, please email advocacy@acca.com. To view additional information on corporate responsibility, including the "Sarbanes-Oxley Act of 2002," see the special Corporate Responsibility section of ACCA Online℠ at www.acca.com/legres/enron/index.php. For additional information on the ABA Task Force, go to www.abanet.org/buslaw/corporateresponsibility/.

securities laws (the Task Force criticizes the current rule for being permissive rather than mandatory).

- Expand rules 1.2(d), 1.13, and 4.1 to reach beyond actual knowledge to circumstances in which the lawyer reasonably should know of the crime or the fraud.[6]
- Improve the linkage among the Model Rules relating to a lawyer's obligations when faced with illegal conduct or breach of fiduciary duty in representing a corporate client.

In addition to amending the Model Rules, the Task Force recommends the adoption of two corporate governance policies that it believes would facilitate and encourage independent oversight of potential violations of law and breaches of duty. First, the audit committee or other independent directors of the board should meet regularly with general counsel in executive sessions. Second, all engagements of outside counsel should establish at the outset a direct line of communication between outside counsel and general counsel. Through this line of communication, outside counsel would be expected to inform the general counsel of violations or potential violations of law and duty to the corporation.

Corporate Governance Recommendations

To improve the way that boards of public companies function, the Task Force recommends that boards adhere to all of the following standards:

- Boards should include a substantial majority of independent directors, with independence defined as recently proposed by the New York Stock Exchange.
- A corporate governance committee composed entirely of independent directors should be formed to identify, contact, and recommend to the board potential independent directors.
- Audit committees should consist entirely of independent directors and have authority to (1) recommend or take action regarding the outside auditor's engagement and removal, (2) engage independent accounting and legal advisers when necessary or appropriate, and (3) establish policies relating to nonaudit services by the outside auditor and other matters that may affect the auditor's independence.
- Compensation committees should consist entirely of independent directors and have (1) the authority to recommend or take action regarding senior executive compensation and (2) the authority and resources to hire independent executive compensation and legal advisers when necessary or appropriate.
- Corporate governance committees or some other committees of independent directors should recommend a corporate code of ethics and conduct with a mechanism, such as a hot line, an ombudsman, or compliance certification, for employees to communicate to independent directors information about violations of law or breaches of duty to the corporation.
- A committee of independent directors should review all material transactions between the corporation and executive officers and directors.
- Corporate governance committees and audit committees should develop procedures for meeting regularly with the corporate officers responsible for internal controls, codes of ethics, and compliance policies.

In addition to the recommended mandatory standards listed above, the Task Force endorses a number of corporate governance best practices:

- Boards should appoint a lead independent director or an independent director to serve as chair of the board of directors.
- Boards should adopt processes for setting agendas and distributing information.
- Boards should consider policies establishing term limits for directors and rotation requirements among the independent committees of the board.
- Training and education programs should be maintained for all directors, particularly independent ones.
- The board should adopt procedures for evaluating the effectiveness of meetings, information flow, diversity of director experience, and contributions of individual directors.

The Task Force sees its preliminary report as serving as a vehicle for eliciting comments from interested observers through a written comment process and public hearings to be scheduled in the fall. The Task Force intends to issue a final report before the end of 2002, which most likely will be submitted to the ABA House of Delegates next February. Because the report has not been approved by the ABA House of Delegates or Board of Governors, it should not be taken as ABA policy.

IN ADDITION TO AMENDING THE MODEL RULES, THE TASK FORCE RECOMMENDS THE ADOPTION OF TWO CORPORATE GOVERNANCE POLICIES THAT IT BELIEVES WOULD FACILITATE AND ENCOURAGE INDEPENDENT OVERSIGHT OF POTENTIAL VIOLATIONS OF LAW AND BREACHES OF DUTY.

NOTES

1. Richard B. Schmitt et al., *Corporate-Oversight Bill Passes, Eases Path for Investor Lawsuits*, WALL ST. J., July 26, 2002, at A1.
2. A "person associated with a public accounting firm" includes a "professional employee of a public accounting firm, or any other independent contractor or entity that, in connection with the preparation or issuance of any audit report . . . receives compensation . . . from, that firm . . . or participates as agent or otherwise on behalf of such accounting firm in any activity of that firm." The ABA strongly but unsuccessfully objected to this broad definition as appearing to give the Board jurisdiction to regulate both in-house attorneys and outside law firms hired by accounting firms. In the ABA's view, "[r]egulation of lawyers should remain the province of the judiciary, not the executive, and any attempt to grant the accounting oversight board or the SEC the power to adopt a set of national rules would violate separation of powers principles." Letter from Robert D. Evans to Hon. Paul S. Sarbanes (July 19, 2002).
3. The ABA unsuccessfully opposed this provision. The ABA objected both because this provision could interfere with the attorney client relationship and because this provision could superimpose national ethics rules that might be inconsistent with current state ethics rules.
4. *See* Preliminary Report of the American Bar Association Task Force on Corporate Responsibility (July 16, 2002), available at www.abanet.org/buslaw/corporateresponsibility/.
5. The Task Force would also amend Rule 1.13(b) to emphasize in the text of the rule that the potential remedial actions do not need to be pursued in any particular order. This amendment would mean that, in situations involving potentially serious misconduct with significant risk to the corporation, a lawyer could go directly to the board of directors if the lawyer believed that an effort to seek reconsideration by a particular officer or employee would be futile.
6. Both Rules 1.2(d) and 4.1 refer to "knowing conduct." Rule 1.2(d) provides that a lawyer "shall not counsel a client to engage, or assist a client, in conduct the lawyer knows is criminal or fraudulent." Rule 4.1 provides that a lawyer "shall not knowingly . . . make a false statement of material fact or law to a third person" in representing a client. Rule 4.1 also provides that a lawyer shall not knowingly fail to disclose material facts when necessary to avoid assisting a criminal or fraudulent act. Similarly, the requirements of Rule 1.13 apply only if a lawyer knows that an officer, employee, or agent of a corporation is engaging or intends to engage in misconduct. The Model Rules define "knows" as "actual knowledge of the fact in question."