COMPLIANCE WEEK
The leading resource on corporate compliance and governance for U.S. public companies.

Summertime Compliance: Responding To Changes In Climate And Enforcement

By Harvey L. Pitt, Compliance Week Columnist—July 25, 2005

As thoughts turn toward summer vacations, and then the ultimate re-emersion into "office normalcy," this may seem like a good time to take a break from compliance cares, litigation woes and regulatory and prosecutorial initiatives. But, alas, that might be short-sighted. While business men and women can take vacations, and relegate their problems to the proverbial "back burner," their critical business issues and problems won't be taking a vacation from them. This makes it critical to plan ahead, and also to consider what lies ahead.

About three decades ago, in *Ernst & Ernst v. Hochfelder*, the Supreme Court considered the fraudulent "mail rule" used by Leston B. Nay—head of infamous First Securities Co. of Chicago—to defraud his unwary clients. Nay imposed a simple "mail rule": No mail addressed to him was to be opened whenever he was away from the office. The Nay "mail rule" provided a lesson in what not to do when senior executives go off on vacation: shut down important corporate policies, procedures and regimens. Conversely, the annals of SEC enforcement actions are replete with cases of chief executives who return from vacation and divulge material, nonpublic information, perhaps because their newly-mellowed states also mean their defenses are down.

Here are some rules of thumb for vacationing corporate officials to consider *before* departing and *immediately after* returning:

- **Address the "Alexander Haig" issue.** When senior executives go away, the question always is: "Who's in charge?" The answer to that question should come before officials go off on holiday. Companies do well to assign responsibilities for corporate policies, practices and procedures to cover any absences, no matter how brief.
- **Securing contact information *before* officials depart is not optional.** Vacations provide critical and necessary respite from the day-to-day traumas and travails of corporate life, and therefore should not be interrupted except in an emergency. Nonetheless, emergencies have absolutely no respect for anyone's vacation, so it's useful if critical personnel can be contacted on a moment's notice. In particular, those who plan their vacations to avoid being able to be contacted should be required to call in at regularly-scheduled intervals.
- **Maintain up-to-date calendars.** It's important to know what project milestones are likely to arise *before* officials take off on vacation. Many promised deadlines or milestones can be moved or rescheduled. Alternatively, other arrangements can be made for fulfilling obligations.
- **It's useful, if not essential, to keep a calendar of vacations to avoid overlaps of vacations for critical human resources.** However, the pecking order is established, there

really should be some semblance of order as to who takes vacations for how long, and when. The absence of this kind of fundamental planning is sure to result in significant corporate dislocations when—not if—a crisis hits.

- **Apply similar rules to vacations of outside directors.** Given the increasingly important role outside directors perform, they should adhere to the same general philosophy that applies to senior managers. Takeover bids, corporate raids, litigation, crises and worse all have a nasty way of arising when folks are scattered to the four winds (both literally and figuratively). Advance planning can minimize the damage that arises if outside directors can't be found.

Acclimating To Change

Recent personnel changes, litigation outcomes, and the spirit of optimism induced by the summer solstice's onset all engender a good deal of speculation about the future, and the current regulatory and litigation environment. With President Bush's nomination of Representative Christopher Cox to chair the Securities and Exchange Commission, for example, many are predicting a sea change. But a radical and abrupt departure from established norms is unlikely. That's especially true with respect to the twin fantasies of many—the repeal of most regulatory requirements enacted to date, and a significant slowdown in the SEC's enforcement program. After all, Chairman-Designate Cox served as the first Chairman of the House Committee on Homeland Security. Nor is the Agency likely to go "soft" on law enforcement. The Commission undoubtedly will continue to pursue misconduct aggressively and expeditiously through its "real-time" enforcement program.

My expectation is that Chairman-Designate Cox will use regulation as a tool to assist *both* investors and those who must comply with the law's strictures, rather than as a weapon against the private sector. When Sarbanes-Oxley was overwhelmingly enacted, the private sector hadn't really taken the initiative to solve some of the ugliness seen in corporate governance and transparency. That, perhaps more than anything, contributed to the public's actual loss of confidence and the creation of a groundswell favoring legislation. SOX ensured that excuses, ambiguities, oversights, inattentiveness and venality had even less justification.

Lest that seems hokey, just look at the conviction of former WorldCom CEO Bernie Ebbers. He was a hands-on executive, very knowledgeable about the intricacies and nuances of the company's business, yet he tried to absolve himself from any liability by offering up the "four monkey" defense:

- I didn't do anything;
- I didn't see anything;
- I didn't know anything; and
- I certainly didn't understand anything.

Of course, the implied corollary is that CEOs can profess ignorance of—and totally delegate responsibility for—terrible things that happen on their watch. SOX was enacted specifically to preclude the successful assertion of that defense and will continue to do so, even though Richard Scrushy—who led HealthSouth for years—ultimately prevailed with the same "four monkey" defense (probably because he was tried in a city in which he has acted as a patron and televangelist, and because he didn't testify under oath, only on courthouse steps).

So where does that leave us? Exactly where we've been: To avoid the excesses of government regulation and litigation, the private sector needs to assume the initiative in promoting corporate governance and transparency, and routing out corruptive practices.

- **Marketplace forces now *require* companies to pursue full transparency and good compliance policies.** Companies that don't set, then meet, higher standards, will be abandoned or turned on by investment banks, accounting firms, insurance companies, commercial banks, and rating agencies, and will find it hard to attract quality directors. This means that, one way or another, wittingly or not, corporations and financial institutions will be compelled to meet new governance standards in order to survive and prosper. More than any government regulation or prosecution, these are the factors that will drive the push toward better governance, more accountability, and greater transparency.
- **Lead rather than follow.** Adopt standards and policies that promote transparency and investor confidence. American businesses should hunker down and think about the problems some have inflicted. It's well and good to say the scandals we've seen are the product of a few rotten apples. But, what difference does it make to *your* shareholders, *your* employees, or *your* directors (when they're sued)? None. The time for industry initiatives is when there aren't any current problems. It's so much easier to solve problems that haven't arisen than it is to solve those that have surfaced and are biting companies in places they don't want to be bitten.
- **Businesses should continue to assume the initiative in cleaning up their own acts.** Companies that wait for prosecutors to uncover, pursue or recommend solutions for potential misconduct are certain to be dissatisfied with the results. There are three discrete time frames in which internal corporate investigations are prudent: (1) when a problem hasn't yet reached government's radar screen; (2) when a company learns of a government concern or inquiry; and (3) when a company wants to satisfy itself that significant potential wrongdoing hasn't occurred.

  From the government's perspective, internal inquiries undertaken in the first and third time frames have the greatest credibility. That doesn't undercut the potential value or need for an inquiry undertaken once a company learns of some government concern. While some companies assume the wisdom of the old saw, "if it ain't broken, don't fix it," that's just plain wrong in today's regulatory and prosecutorial environment.

- **A good place to start is with better press releases.** Despite all the recent turmoil and litigation, for many companies it looks as if it's still business as usual. Every morning, the financial press carries stories about companies under investigation. A typical article goes something like this:

  "Pitt Company today reported that it had received subpoenas from the Department of Justice and the SEC. Harvey Pitt, Pitt Company's CEO, said, 'we're cooperating fully with these government inquiries.'"

  What's wrong with that picture is that it indicates a company that doesn't understand what's really been going on over these past four years, or what's about to happen to it now. When mythical Pitt Company says it's cooperating with government inquiries, that means absolutely nothing: Companies *must* comply with subpoenas they receive. It also means the

company is asleep at the switch; it's waiting for regulators and prosecutors to tell it what it did wrong, and how it has to be fixed. By then it's too late. When a company learns of potential misconduct, its first thought should be: "How do we get control of this situation, and turn this into an opportunity?"

Instead of the release just hypothesized, suppose our mythical Pitt Company issued a very different press release that was marked by the following attributes:

- Clear disclosure of the receipt and substance of the subpoenas;
- An indication of the nature of activities the subpoenas suggest may have occurred, and the company's candid recognition whether it had any advance knowledge of the validity of these government concerns;
- The company's reaction to these events, if in fact they did occur;
- Whether conduct of this nature is consistent with, or inconsistent with corporate policies and standards;
- What the company intends to do to find out if the government's concerns are valid;
- A statement directed to company customers, shareholders and the public reaffirming the fact that the company won't tolerate this kind of conduct, if it in fact occurred;
- A commitment to work to satisfy the government's information needs;
- A commitment to develop improvements in corporate standards and practices as recommended by an independent review of applicable company practices;
- A pledge to share the results of the company's review with the government and the public, and to announce the remedial steps it will take in response to any concerns uncovered;

During a crisis, the operative window is short. Waiting for things to get better—or more defined—before making appropriate disclosure is like waiting for Godot. The key is to disclose, disclose, disclose—before the window snaps shut. And stay away from litigators—they want to win the case, while managers and directors want to salvage the company.

- **Self-police, self-report, remediate and cooperate.** Like your own physical health, you need to take care of your company's health. You can't wait for doctors—also known as prosecutors or regulators, or others outside of your company—to tell you that, indeed, you have a problem. In this regard, it's salutary to revisit the SEC's 21(a) Report and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, released in October 2001 (often referred to as the Seaboard Release). It sets forth criteria the Commission and its staff will consider in determining whether and how much to credit self-policing, self-reporting, remediation and cooperation. In brief, it requires businesses to be on top of all the issues when misconduct comes to light. The Report, which reflects long-standing tenets of the SEC, is likely to be given much more attention and implementation in the newly reconstituted Commission.
- **Make quality use of downtime.** Summer is typically a time when overlooked projects are addressed—for example, updating procedure and control manuals, preparing for the yearly

audit, and understanding the dimensions of unreconciled accounts. These projects are often relegated to middle management, with little direction from senior managers, since this has been a traditional summer assignment. With the advent of Section 404 and other changes wrought by SOX, it's worth the effort for senior managers to draft a list of concerns and prioritize summer projects, so new concerns aren't overlooked in the clean-up process of summer.

In a complex environment, it's always nice to dream about changes in the way government will approach businesses and their foibles, somewhat akin to a form of corporate charity. But, as we all learned long ago, "Charity begins at home." This is one place where practicing that aphorism is sure to produce the results for which so many hope.

The column solely reflects the views of its author, and should not be regarded as legal advice. It is for general information and discussion only, and is not a full analysis of the matters presented.