Corporate Compliance: Casting A Wide Net

McKenna Long & Aldridge LLP
Attorneys at Law

METROPOLITAN CORPORATE COUNSEL
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BY THOMAS WARDELL

Editor: "Compliance readiness" is a term that was unknown to most of our readers just a few years ago. As one of the leading practitioners in the field of corporate governance, what do *you* mean by the term?
Wardell: In attempting to define compliance readiness, I ask myself two questions. First, is a compliance program – compliance with the law and with the regulatory environment in which the company conducts its activities – installed and in operation? And, second and more importantly, is that program preventative in addition to investigative? Many programs are strong on investigation, but not so strong on preventative practices. That is, they are reactive, as opposed to pro active. In addition to positioning the company to be in compliance with the external rules and regulations, a good program reflects compliance with the company's own business practices and culture.

One of the signals I look for when trying to figure out what readiness means in a particular corporate context is how the whistleblower program is built. Is the first report to an external third party? One with strong experience? Does the program provide a choice for anonymity? Does it encourage people to find a way to report even frivolous things? Eighty percent of what is reported has to do with frivolous issues. The other 20 percent, however, can include things of crucial importance. If, in the interest of efficiency, the seemingly unimportant issues are ignored, the dampening effect this has on employees will hinder the reporting of things that do matter.

Even where the preventative aspect of compliance is given its due – and education and training on a continuing basis are in place – it is important to see where this function is located and who has responsibility for it. It should include, for instance, a soft controls feature. By that I mean an examination of the important risks that the company is facing at that moment, as well as those that are anticipated for the future. That feature is something that requires the ongoing attention of people at the highest level of the organization chart.

Another signal has to do with the company's code of conduct. If it is not only reaffirmed but actively reviewed on a regular basis, it can serve to reaffirm the corporate culture that the company is seeking to promote. Every company is going to claim that its code of conduct is promulgated throughout the organization as a matter of course; a few may require that each person with supervisory responsibility understand the code and walk a senior manager through the steps that he or she has taken to ensure that the employees understand it as well. There is a subjective feature to this, of course, but it represents the difference between effective compliance and lip service.

Editor: With the spotlight now on corporate compliance, how has the role of general counsel changed in recent years?
Wardell: General counsel has wound up with more responsibilities. In some corporate environments, that increased responsibility has been coupled with enhanced authority, which is important. While everyone expects general counsel to be on top of the compliance issues, if general counsel is to fulfill those expectations he or she must have sufficient authority to ensure that the compliance program is properly implemented, monitored and enforced.

Editor: Please tell us about tone at the top, and its role in meeting the challenges of compliance.
Wardell: "Tone at the top" is a concept that has been used frequently in today' environment. The Sentencing Guidelines reference it, and there is widespread agreement that unless the support of senior management is present, the company will not possess the cultural norms necessary for effective compliance.

General counsel is a member of the senior management group from which the requisite tone emanates. But she or he cannot drive the cultural norms that underlie compliance alone. The most important person, in this regard, is the CEO. While general counsel is perceived as the person who makes the call on what should be investigated, it is the CEO whose assumption of responsibility for the company's commitment to be in compliance with the law and with its own stated business practices really undergirds the norms.

Tone at the top must also involve the board of directors. When the CEO speaks with the authority of the board, that should reflect the fact that the board has been part of the compliance discussion, has reviewed the compliance issues and is on record with its support.

Editor: There are instances when encouraging good behavior might be undermined by self-interest. I am thinking of one of the current issues under discussion in the corporate governance arena, that of backdated options. What is the problem here?
Wardell: At its core, the problem of backdated options is having one date for the granting of options and another date for determining the exercise price for those options. This is referred to as a backdating problem because the usual abuse entails making the grant on, say, August l5, at a time when the stock has a value of $20, and giving the grantee the exercise price of $10, which was the price on June l5.

The principle behind using stock options as an incentive is to give *on a date certain* a number of options with an exercise price that is identical to the price on the date of the grant. That provides an incentive to increase profits and thereby the value of the options because, of course, when issued at the then-current stock price the value of the options is zero. I would suggest that any stock option program that involves a second look at prices is really in the danger zone.

Editor: Is this something that might have been anticipated if general counsel's resources, and reach, were more extensive?
Wardell: I do not think that this problem was anticipated. When the issue first arose, I did not believe it constituted a serious problem. These plans are very specific – as are the tax laws – and I could not imagine anyone would stray as far out of line as the business press appeared to believe. For instance, by giving an employee a windfall through backdated options, the compensation has occurred and the employee has a tax obligation. The company must issue a W- 2 on that income, and the grant changes what the company reports as employment expense deductions. If the numbers are large enough, the company's financial statements are affected.

The real scandal lies in the pretense that these options were issued in the normal way, when in fact they were granted without proper accounting and, if appropriate, disclosure. In a number of cases the grants have skewed the company's financials significantly enough to require restatements over several years.

Editor: And the consequences?
Wardell: At a minimum, there would be tax consequences in any situation where the company issued these options. Whether the issuance entailed financial disclosure consequences as well is a question of materiality.

I hasten to add, however, that the investor and public relations consequences are very serious *irrespective* of materiality. The clear implication is that the compensation committee of the board of directors has disregarded the pricing mechanism specified in the plan document for a discretionary pricing mechanism– which they are usually entitled to invoke under the plan – to benefit a few key employees. The issuance of backdated options, at the very least, suggests that management has set about in a very deliberate way to manipulate the accounting rules and the tax laws to benefit these employees at the expense of the shareholders. That will have an impact on the confidence of investors and of the general public. If the company's behavior in this respect leads to financial restatements as well, management's own norms of conduct are called into question. What might have been implied then

becomes much more of a certainty, and investor and public confidence are further eroded. And it may well mean fraud.

Editor: General counsel may be in a difficult situation, even a direct conflict situation. What steps should general counsel take if he or she thinks there may be a problem?
Wardell: If general counsel is uncertain whether a problem exists but is uncomfortable with the situation, a review is certainly in order. In the situation where general counsel is a recipient of the options in question, he or she should step aside and have outside counsel handle the review. The fact that they may not be aware of the process by which options are granted is not at all unusual. In many corporate settings, this is the province of the HR professionals and the compensation committee of the board of directors, not corporate counsel. But, if general counsel is a beneficiary of the process, the only thing for that person to do is to hand over responsibility for the review to a disinterested and objective party. That usually means outside counsel.

Editor: What about the future? What do you see emerging as the principal compliance issues?
Wardell: I think the discussion on backdated options is well underway, but I do not see it leading to legislation or a new regulatory scheme. I believe it will be dealt with through processes already in existence – the executive compensation rules require further disclosure and the SEC can use the comment letter. Following Enron, for example, the SEC added off balance sheet transactions to its areas of focus, and I think that is the way this particular issue will be handled going forward.

Executive compensation has been an important issue for some time, and it will continue to be so. The first lawsuits on appropriate executive compensation have occurred, and between media attention and the new disclosure regulations I believe that much attention will continue to be focused on this area.

Enterprise risk management is increasingly important, and I mean operational and strategic risks, not just insurable risks. This is an emerging issue.

The issue of majority election of directors is still with us. Stockholders are not concerned about this issue because they wish to run the corporations they invest in, but rather they wish to ensure that the people who are so engaged are doing a good job. This injects a level of accountability into the board room that may not have been there in the past. And it serves to keep the spotlight on corporate compliance.

Increased attention is going to be paid to the quality of financial statements over the near term. This is a direct consequence of a great deal of recent investigatory attention given to compliance issues that can impact financial statements.

The market has improved over the last three years and mergers are on the rise. That leads to increased pressure from people trying to get material information that is not public. The terrain has changed. Private equity money is differently placed from other forms of private investment, and companies attempting to attract it have an increasing need to know what is disclosable and when a confidentiality agreement is in order.

In recent years, the field of corporate compliance has become increasingly complex and has extended to places within the corporate arena where it had not appeared in the past. Practice in this area has also attained a certain momentum. I do not see any of this changing any time soon.