The CORPORATE COMPLIANCE & REGULATORY Newsletter ®

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ALM

Confidential Client Communications? Maybe Not

SOX Versus the Attorney-Client Privilege

By Steve Wheeless

Former SEC Chairman William H. Donaldson noted in a March 5, 2004 speech that SOX was needed to deal with "a general erosion of standards of *integrity and ethics* in the corporate and financial world … The acquiescence by the gatekeepers, like accountants, who turned their backs or actually condoned such accounting manipulation, combined with stock option incentives to management, fueled the short-term focus." (www.sec.gov/news/speech/spch030504whd.htm (emphasis added).) Ironically, the SEC and the Department of Justice, which enforce SOX's criminal provisions, appear ready to burden the traditional ethical obligations of corporate legal counselors to keep client communications confidential in an effort to police the integrity and ethics of other corporate gatekeepers. To that end, the SEC imposes certain reporting requirements on corporate counselors, attempts to preempt state ethics rules, and DOJ prosecutors routinely pressure "target" corporations to waive the attorney-client privilege to obtain "cooperation" points. Corporate counselors must be aware of those initiatives to properly balance their competing obligations.

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Special Issue
Ethics

Drafting a Practical and Useful Code of Ethics

By Jeffrey E. Jordan

Pursuant to Section 406(c) of the Sarbanes-Oxley Act (SOX), the Securities and Exchange Commission adopted Regulation S-K 406, which requires reporting companies to disclose whether the company has adopted a code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. In addition, New York Stock Exchange Rule 303A.10, American Stock Exchange Section 807 and Nasdaq Rule 4350(n) require listed companies to adopt and disclose a code of conduct for directors, officers and employees.

The SEC rule requires that the code include standards that are reasonably designed to deter wrongdoing, and to promote: 1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; 2) full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the SEC and in other public communications made by the registrant; 3) compliance with applicable governmental laws, rules and regulations; 4) the prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and 5) accountability for adherence to the code. The American Stock Exchange and Nasdaq require a code complying with the requirements of Section 406 and the regulations adopted thereunder by the SEC. The New York Stock Exchange adds requirements that the code also address: 1) corporate opportunities; 2) confidentiality; 3) fair dealing; and 4) protection and proper use of company assets.

In response to these requirements, public companies have adopted codes of conduct varying in length and complexity. Few precedents were available prior to the deadlines for adopting codes, and many companies adopted codes of conduct that stated code

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provisions as simple and strict commandments or merely paraphrased the text of the regulations. For example, some codes include a requirement to "at all times obey all applicable federal, state and local laws and regulations" or "not engage in any transaction involving a conflict of interest."

PROMOTING COMPLIANCE

The SEC rule states that the code must be designed to *deter* wrongdoing and *promote* several objectives, including honest and ethical conduct, ethical handing of actual or apparent conflicts of interest, and compliance with applicable governmental laws, rules and regulations. The New York Stock Exchange rule calls for the code to *focus* the board and management on areas of ethical risk, *provide guidance* to personnel to help them recognize and deal with ethical issues and *help foster* a culture of honesty and accountability. A code requirement written as a strict commandment, without more, does not effectively promote compliance.

Business operations are, of course, subject to many laws, and those laws may be difficult to understand or even be unknown to the employees subject to them. Accordingly, a code more effectively promotes compliance with law by not only stating the company's policy to comply with applicable laws but also including policies designed to promote employees learning of the law applicable to their responsibilities and understanding the application of the law to their responsibilities. For example, an effective code may include policies that provide that:

- employees whose duties specifically include compliance issues become familiar with the laws and regulations applicable to their duties; and
- the company will provide training opportunities on legal compliance topics and encourage employees to participate in them;
- employees consult with supervisors, the company's counsel and perhaps even the company's outside counsel in appropriate circumstances before proceeding in situations about which they are uncertain.

Similarly, business operations present many opportunities for conflicts of interest to arise. It is common for outside directors to serve on multiple boards, and their business expertise may result in their serving businesses with similar or sometimes even competing interests. Also, with many relationships, a director or officer may find him or herself the subject of an inadvertent or unanticipated conflict of interest. Although repeated conflicts of interest should be avoided, it is not unethical for a conflict of interest to arise. Indeed, a transaction including a conflict may still be beneficial to the business, and a business need not reject a conflict transaction out of hand, but may choose to pursue it while observing proper safeguards for addressing conflicts of interest.

Accordingly, a code provision forbidding conflicts of interest is not only naive but neglects the opportunity to promote compliance by stating a policy of seeking to avoid conflicts of interest but seeking to recognize when they arise and to properly address and resolve them when they do occur. These objectives may be accomplished by policies that encourage employees to be sensitive to the possible presence of conflicts of interest, that encourage disclosure of a conflict if one occurs and provide workable procedures for addressing conflicts, rather than just adopting a code provision condemning conflicts. Again, code provisions that provide that the company will provide training opportunities, encourage employees to participate in training opportunities and encourage employees to consult with supervisors, the company's counsel or perhaps even the company's outside counsel in appropriate circumstances are also sensible parts of a conflicts policy.

AVOIDING UNREASONABLE VIOLATIONS: SETTING REASONABLE STANDARDS

Item 5.05 of Form 8-K requires that a reporting company describe the approval of any material departure from the code of ethics adopted by the

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Compliance and Ethics Programs: Passivity Is Passé

By Steven A. Lauer

Corporate compliance and ethics programs have matured significantly from their humble beginnings. Since they appeared in the 70s in response to government investigations of overseas bribery in the aerospace, defense and armaments industries, leading to enactment of the Foreign Corrupt Practices Act, compliance programs have spread into most, if not all, other industries. Moreover, compliance programs have received official "endorsement" by the government through the Sentencing Guidelines for Organizational Defendants (Sentencing Guidelines), which appeared in their original form in 1991 as Chapter 8 of the Federal Sentencing Guideline Manual.

The adoption of corporate compliance and ethics programs throughout many industries led to the establishment of the Ethics Officer Association (EOA) in 1992 as "a professional association for ethics officers and the organizations for which they work, that provides for sharing of ideas and best practices, continuing education and professional development." From its 12 founding members, EOA has grown to over 1000.

What trends and developments in the field of corporate compliance and ethics programs justify the attention of practitioners in this field? How might those trends and developments affect such programs in the future?

One of the most significant developments consists of the changes to the Sentencing Guidelines that the United States Sentencing Commission (Sentencing Commission) adopted in 2004 (2004 Changes). The original Sentencing Guidelines have had considerable impact on the existence and form of corporate ethics and compliance programs. *See* Murphy: The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics. 87 *Iowa L. Rev.* 697, 710 (2002). I expect that the recent changes will similarly lead to considerable changes to existing compliance and ethics programs and provide greater definition to those that are still in the design stage.

What changes did the Sentencing Commission make last year? Several general themes emerge. First, the Sentencing Commission attempted to create responsibility and more direct accountability on the part of corporate management for the existence and operation of a compliance and ethics program. Second, the Sentencing Commission created some specific responsibilities, in respect of the compliance and ethics program, for the "governing authority" of the entity, which for a corporation is the board of directors. Third, the Sentencing Commission clarified that training is a mandatory means by which to "communicate … its standards and procedures" to all employees, including directors and management, and, as appropriate, third-party agents. Let's examine those themes in greater detail.

Management Responsibility and Accountability

The greater degree of accountability on the part of management emanates from several sources in the Guidelines as enhanced by the 2004 Changes.

- The organizational leadership of a firm "must ensure that the organization has an effective compliance and ethics program" (§ 8B2.1(b)(2)(B) which should be designed to "promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law." § 8B2.1(a)(2).
- The Sentencing Commission required that "[s]pecific individual(s) within high-level personnel shall be assigned overall responsibility for the compliance and ethics program" and that "[s]pecific individuals within the organization shall be delegated day-to-day operational responsibility for the compliance and ethics program."
- Those who have day-to-day operational authority "shall report periodically to high-level personnel and, as appropriate, to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program." §§ 8B2.1(b)(2)(B) and (C) of the Guidelines." High-level personnel of the organization" means "individuals who have substantial control over the organization or who have a substantial role in the making of policy within the organization." *See* § 8A1.2, Application Note 3(b).
- The Sentencing Commission even goes so far as to direct that "[t]he organization shall use reasonable efforts not to include within the substantial authority personnel … any individual whom the organization knew, or should have known through the exercise of due diligence, has engaged in illegal activities or other conduct inconsistent with an effective compliance and ethics program." § 8B2.1(b)(3). "Substantial authority personnel" includes "individuals who within the scope of their authority exercise a substantial measure of discretion in acting on behalf of an organization. § 8A1.2, Application Note 3(c).
- An organization shall "take reasonable steps … to ensure that the … compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct; … to evaluate periodically the effectiveness of … the program; and … to have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organizations employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation." § 8B2.1(b)(5).
- The "compliance and ethics program shall be promoted and enforced consistently … through (A) appropriate incentives to perform in accordance with the compliance and ethics program; and (B) appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct." § 8B2.1(b)(6).

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One cannot fail to see the implications of those changes. The Sentencing Commission wanted to assure that, in a company with a compliance and ethics program it wishes to earn the title "effective," specific individuals in the hierarchy must have specific responsibilities for that program and for its operation. "Plausible deniability" by senior management (remember the defense put on by Bernie Ebbers?) should disappear as an excuse on the part of high corporate officials.

Ultimately, the Sentencing Commission hoped that a business organization that creates and operates a compliance and ethics program to meet the standards set out in the 2004 Changes would be one that "promote[s] an organizational culture that encourages ethical conduct and a commitment to compliance with the law." To fulfill that goal, managers and corporate executives must understand the purpose of the compliance and ethics program, its constituent elements and how they can and should demonstrate ethical leadership.

When those corporate leaders demonstrate ethical leadership, they also satisfy the standards set out by Congress in Sarbanes-Oxley (SOX) that a publicly traded corporation adopt a code of ethics that promotes "honest and ethical conduct" and "compliance with applicable governmental rules and regulations," which code of conduct must apply to the behavior of firm's senior financial officers. *See* § 406(c) of SOX. Ethical leadership now constitutes the legal standard of behavior for corporate America.

A Proactive Governing Authority

The Sentencing Commission had a great deal to say about the role of a governing authority of an organization. Generally speaking, that body "shall be knowledgeable about the content and operation … and shall exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program." § 8B2.1(b)(2)(A). The firm's employees who have day-to-day operational responsibility for the operation of the program "shall be given … direct access to the governing authority or an appropriate subgroup of the governing authority." § 8B2.1(b)(2)(C).

The 2004 Changes require that a firm establish "a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organizations employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation." Such a mechanism closely resembles the requirement recently enacted by Congress in § 301 of SOX that the audit committee of the board of directors of a publicly held corporation "establish 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." Elsewhere in that statute, Congress added to the criminal statutes provisions that protect whistleblowers, further buttressing reporting mechanisms from attack from within the organization. *See* § 1107.

With such information-gathering processes in place, management and the board of directors likely will learn more frequently about issues and concerns that come to the attention of employees throughout the organization. In essence, such a mechanism creates a network within the organization of sensors (not censors) in respect to compliance or ethical failures or potential failures. An effective program will include follow-up steps that assure the reporting individuals that their concerns result in some sort of action by the organization. Those follow-up steps should include action (even if only recognition in its oversight role) by the governing authority. Expectations that a board of directors will take a more proactive approach to its role in the corporation reverberates throughout the recent corporate reforms, including the Guidelines, the 2004 Changes, SOX and SEC rulemakings.

This contrasts with the results that directors might have seen under the more traditional standards of court review of their actions or failures to act: "when director liability is predicated on ignorance of liability creating activities only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists — will establish the lack of good faith that is a necessary condition to liability." *See McCall* v. *Scott*, 239 F. 3d 808 (CA6 2001). That traditional approach suggests a very reactive role for the board, whereas the Sentencing Commission, Congress and others hope to push it into a more proactive stance.

Under the 2004 Changes, not only must the board of directors ascertain that the company has a compliance and ethics program, but it must "exercise reasonable oversight with respect to the implementation and effectiveness" of that program. *See* § 8B2.1 (b)(2)(A). What does that requirement mean? Directors must "be knowledgeable about the content and operation" of the program. They must ensure that those to whom they delegate responsibility for the operation of that program have "adequate resources" for that purpose. The directors must provide those individuals with "direct access" to the board, or a subgroup of the board, for reporting purposes.

In order to fulfill those expectations of the Sentencing Commission, a company's directors require information. They need to understand the purpose of the compliance and ethics program. Why does an "effective compliance and ethics program" matter? What components comprise an effective program and what are the existing best practices in that regard?

Training for All

This brings us to the third theme of the 2004 Changes. That theme relates to training on compliance and ethics topics. The Sentencing Guidelines had highlighted the importance of communication by an organization of its standards and procedures relative to compliance and ethics to its employees. In the 2004 Changes, the Sentencing Commission specified that training is a mandatory method by which to do so. *See* § 8.B2.1(b)(4)(A). Inasmuch as government officials have previously described "a system of effective organization-wide training on compliance standards and procedures" as a "critical element of an effective compliance

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program" (*see* page 8 of Corporate Responsibility and Corporate Compliance: A Resource for Health Care Boards of Directors, which is posted at oig.hhs.gov/fraud/docs/complianceguidance/040203CorpRespRsceGuide.pdf), the Sentencing Commission's view should surprise nobody. The Sentencing Commission based the 2004 Changes on recommendations made by an Ad Hoc Group on the Organizational Sentencing Guidelines, which indicated its view "that all organizations should engage in some form of active compliance training." *See* "Report of the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines" (October 7, 2003), p. 71.

Not only must an organization provide training on subjects related to compliance and ethics to all employees, including directors, executives and even third-party agents (as appropriate); that organization should design that training to convey "information appropriate to … individuals' respective roles and responsibilities." § 8B2.1(b)(4)(A). Merely providing the exact same training to everyone — executives, clerks, accountants and shop-floor workers — will not satisfy the standards detailed in the 2004 Changes. In fact, such an untailored approach might suggest to prosecutors that the organization has created a mere "paper" program unworthy of the benefits available in the Sentencing Guidelines. *See* the memorandum dated Jan. 20, 2003, by Larry D. Thompson, Deputy Attorney General, entitled "Principles of Federal Prosecution of Business Organizations" (Thompson Memo): "Prosecutors … should attempt to determine whether a corporation's compliance program is merely a 'paper program' or whether it was designed and implemented in an effective manner."

Finally, an important consideration, in the eyes of prosecutors and courts, as to whether a program is effective is whether and when a firm voluntarily discloses to regulators and prosecutors instances of illegal conduct that it discovers as a result of the program. The 2004 Changes incorporate this factor in that an organization that "delay[s] reporting the offense to appropriate governmental authorities" may not qualify for the sentencing reductions otherwise available for an effective program. *See* § 8B2.1(f)(2). The entire organization must take proactive steps to: 1) identify noncompliant behavior; 2) correct such behavior when found; and 3) tell the government when it uncovers such behavior and the corrective steps it has taken.

Conclusion

Since promulgation of the Sentencing Guidelines in 1991, corporate compliance and ethics programs have multiplied and matured. Much of that growth resulted from those Guidelines and other related developments, such as the *Caremark* decision. The 2004 Changes promise to further instigate change and development of those programs. Much of that development likely will follow along the lines laid out by the Sentencing Commission. Some boards of directors have already begun to demonstrate a more proactive attitude. The need for greater accountability for the creation and operation of compliance and ethics programs and the deployment of effective compliance training among business organizations likely will continue.

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Attorney-Client Privilege

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Attorney Reporting Requirements

Mandatory Reports

An attorney "appearing and practicing before the" SEC must report any material violation of any federal or state law or any breach of fiduciary duty "up the ladder" to the chief legal officer or CEO, and, if an "appropriate response" from the CLO or CEO is not forthcoming "within a reasonable time," to the company's audit committee or Board of Directors, if there is no committee of independent directors. SOX § 307; 17 C.F.R. § 205.3. Attorneys failing to comply with SOX's reporting requirements face civil penalties and discipline by the SEC (but there is no private right of action). 17 C.F.R. §§ 205.6, 205.7. The SEC reported in late-2004 that it had named more than 30 lawyers as respondents in enforcement actions in the prior two years. (*See* The Securities Reporter, Vol. 9, Issue 3, Fall 2004, at 23.)

An attorney retained or directed by an issuer to investigate or defend a SOX complaint is most likely "appearing and practicing before the Commission." 17 C.F.R. § 205.3(b)(5). If the attorney is retained by the company's CLO to investigate or defend a SOX complaint, the attorney must report any material violations he or she discovers to the CLO *and* confirm that the CLO has forwarded the information to appropriate representatives of the Board of Directors. 17 C.F.R. § 205.3(b)(6). The attorney would be well advised to get that confirmation in writing. Once that confirmation is received, the attorney has no further reporting obligations. 17 C.F.R. § 205.3(b)(8). If the attorney does not receive such confirmation, or has reason to believe that the CLO has not reported the evidence of material violation to the Board of Directors, the attorney presumably should do so. 17 C.F.R. § 205.3(b)(9). An attorney retained by a "qualified legal compliance committee" to investigate or defend a SOX complaint has no reporting obligations. 17 C.F.R. § 205.3(b)(7).

Permissive Reports

If a retained attorney (appearing and practicing before the Commission) reasonably believes that his or her relationship with the company was terminated because he or she reported a material violation, the attorney may report that information to the Board of Directors. 17 C.F.R. § 205.3(b)(10).

Likewise, a covered attorney may report to the Commission, *without the client's consent*, "confidential information related to the representation to the

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extent the attorney reasonably believes is necessary" to: 1) prevent the company from committing a material violation that is likely to cause substantial injury to the financial interests or property of the company or investors; 2) prevent the company from committing perjury or fraud before the Commission; or 3) rectify the consequences of a material violation by the company that caused or might cause substantial injury to the financial interests or property of the company or investors in the furtherance of which the attorney's services were used. 17 C.F.R. § 205.3(d). Those permissive reports are much broader in many respects than those allowed under state ethics rules.

ATTEMPTED PREEMPTION OF STATE ETHICS RULES.

According to the SEC, its permissive attorney-reporting rules preempt conflicting state rules or laws. 17 C.F.R. § 201.1. Likewise, according to the SEC, "an attorney who complies in good faith with the [reporting] provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices." 17 C.F.R. § 205.6(c). Accordingly, the SEC takes the position that a covered attorney may make permissive reports of confidential client information that might or would violate state ethics rules. At least two state bar associations (California and Washington) have indicated that their attorneys should comply with state ethics rules and would not be protected from discipline by the SEC's "good faith" defense regulation. (*See* California State Bar Comments On Proposed SEC Rules, dated April 4 and Dec. 16, 2002, and April 4 and 7, 2003; Interim Formal Ethics Opinion Re the Effect of the SEC's Sarbanes-Oxley Regulations on Washington Attorneys' Obligations Under The RPCs; Letter from Washington Bar Association to SEC General Counsel, dated Aug. 11, 2003.) The SEC has indicated that it might pursue injunctive relief in federal court on behalf of reporting attorneys should a state bar association attempt to discipline an attorney who reported client confidences under the SEC's permissive reporting rules.

AUDIT LETTERS

Attorneys often provide input to or prepare "audit letters" for publicly traded companies. As such, they are covered by SOX and subject to SEC Rule 13b2-2(b)(1), which makes it unlawful to "mislead" a public auditor. (*See The Securities Reporter,* Vol. 9, Issue 3, Fall 2004, at 23-31 (suggesting that a negligence standard will apply).) At the same time, public auditors are under much greater pressure (and liability) because of SOX to ensure that their audits are completely accurate in all material respects. *Id.* Consequently, public auditors have begun putting significant pressure on attorneys responding to audit inquiries to give much more information than has been traditionally required under the 1975 ABA/AICPA "Treaty." *Id.* Careful practitioners should comply with the minimum requirements of the Treaty and resist the temptation or client pressure to "brainstorm" with auditors or discuss facts or legal authority in support of an attorney's assessment, as such information could: 1) ultimately be found to be inconsistent with other internal communications or assessments; 2) be deemed a waiver of the attorney-client or work product privileges; or 3) become an admission by a party-agent. *Id.*

NOISY WITHDRAWAL PROPOSAL

The SEC has proposed a "noisy withdrawal" regulation that would: 1) allow a covered attorney to report the attorney's withdrawal from a representation if the attorney reasonably believed that a publicly-traded client had not remedied a material violation; or 2) require a publicly-traded company to immediately report to investors the withdrawal of any covered attorney and the circumstances of the withdrawal. (*See* SEC 2003-13 News Release, dated Jan. 23, 2003.) Due to the great controversy created by the proposal, the SEC has not yet promulgated the regulation. However, the SEC has not withdrawn the proposal either.

PRESSURE TO WAIVE THE ATTORNEY-CLIENT PRIVILEGE

Attorneys must consider carefully what is said or written to the client and outside counsel regarding a SOX investigation. Should the SEC pursue civil or criminal penalties for either the alleged SOX violation or for an underlying alleged securities violation, the SEC and DOJ may pressure the company to waive its attorney-client and work product privileges to demonstrate "cooperation." Both agencies weigh "cooperation points" heavily when determining what sanctions to seek for SOX violations. (*See* Memorandum of Deputy Attorney General Larry Thompson, *Principles of Federal Prosecution of Business Organization*, at 7 (Jan. 20, 2003) (www.usdoj.gov/dag/cftf/corporate_guidelines.htm) ("One factor the prosecutor may weigh in assessing the adequacy of a corporation's cooperation is the completeness of its disclosure including, if necessary, a waiver of the attorney-client and work product protections, both with respect to its internal investigation and with respect to communications between specific officers, directors, and employees and counsel.").)

In addition, while the Thompson Memo suggests that waiver of the attorney-client privilege is not an absolute requirement as a theoretical matter, the reality on the ground may be quite different. For example, in 2003, Shirah Neiman, General Counsel in the U.S. Attorney's Office in the Southern District of New York, stated that a corporation must turn over information to the government when that information is relevant to an alleged securities violation and, if the corporation cannot turn over that information without waiving the attorney-client privilege, the corporation "need[s] to waive the privilege." (*See* John M. Callagy, *The Attorney-Client Privilege: A Casualty of Post-Enron Enforcement*, Andrews Sec. Litig. and Regulation Reporter (December 15, 2004) (citing Susan Kavanagh, *What Prosecutors Look for in a Compliance Program*, Federal Ethics Report (July 2003)) (www.eoa.org/EOA_Resources/FER_July03.pdf). Notably, Ms. Neiman stated that she did not understand what the "big hullabaloo" was about on the waiver issue.

Because prosecutors may view invocation of the attorney-client privilege as an admission of wrongdoing, corporate executives are often quick to waive the privilege to reduce the risk of indictment or sanction. The SEC promotes that perspective. For

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example, *In the Matter of Gisela de Leon-Meredith*, Exchange Act Release No. 44970 (Oct. 23, 2001), a controller confessed to manipulating a subsidiary's assets and expenses, and the parent company, Seaboard, immediately launched its own investigation and then fully cooperated with the prosecution of the controller. That cooperation included waiving the corporation's attorney-client privilege and work product protections. Ultimately, the controller was sanctioned, but the SEC noted that it was "not taking action against [Seaboard], given the nature of the conduct and the company's responses," which the SEC noted included not invoking the attorney-client privilege or the work product protection. (*See* U.S. Securities and Exchange Commission, Release No. 44969 (Oct. 23, 2001) (www.sec.gov/litigation/investreport/34-44969.htm).) The SEC and DOJ have continued to stress such waivers as those agencies pursue SOX investigations and related indictments. Consequently, corporate counselors investigating potential SOX violations should view every oral and written communication as one that might one day be disclosed to the SEC or DOJ in an effort by a corporate client to gain favor and avoid any threat (real or imagined) of criminal or civil penalties.

A complicating factor is that initial corporate communications related to a SOX investigation may occur months or years before the SEC or DOJ asks for a waiver and the waiver decision may be made by corporate officers who have replaced those who were involved in the initial investigation or underlying events. Additionally, potential SOX violations may be investigated by different internal teams representing different perspectives. For example, a company may commission an employment-law investigation to evaluate whistleblower allegations, a securities-law investigation to evaluate accounting allegations, and an audit-committee investigation to evaluate internal control processes. Those investigations may be conducted in parallel or serially over time. Confidential communications in each investigation may ultimately be subject to disclosure through a corporate waiver. Consequently, corporate counselors should view SOX investigations as having a long and convoluted "life cycle," and should be exceedingly circumspect in their own communications and in advising others on when and how to communicate.

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company pursuant to S-K 406, either in a report on that form or by disclosure on the company's Web site. Although the materiality qualification of the requirement may provide some relief, overly strict and overly broad code requirements increase the likelihood of the need for otherwise unnecessary disclosures or even the inadvertent violation of this reporting requirement.

For example, a code requirement that commands compliance with "all laws" creates numerous opportunities for problems. Does such a provision extend to conduct unrelated to the company or its business? Does it extend to minor violations, especially if it does not carry with it any implication of intentional wrongdoing or wrongful intent? Does a director, officer or employee violate the code if he or she is involved in a violation at another company? Does a director, officer or employee violate the code if he or she receives a traffic ticket while pursuing company business? Does a director, officer or employee violate the code if he or she makes a material error on his or her personal income tax return? Similarly, the New York Stock Exchange requires that the code include a provision with respect to protection of corporate assets. Some codes merely repeat this obligation verbatim, not even limiting it to material property or property in the employee's possession or control. Do officers or employees violate this provision if their laptop computer or PDA is stolen from their office?

These issues and similar policy issues should be addressed by careful code drafting that sets reasonable standards. For example, in preparing draft code provisions, consider whether the provisions:

- effectively and realistically promote or encourage compliance but do not call upon the directors, officers or employees to "ensure" compliance;
- require reasonable actions or efforts, rather than all actions or efforts;
- cover material or significant matters and not any matter, no matter how small; and
- cover circumstances reasonably related to business and not all circumstances.

Although not all matters lend themselves to specific guidelines, some do. Specific guidelines, where drafting is possible, may directly promote compliance or deter violation. For example, it may be possible to provide specific guidelines in an area such as conflicts of interest, where a code could specifically provide that it is inappropriate for an employee to accept outside employment in a business that might require disclosure of company confidential information or to accept outside compensation or other benefits in exchange for favorable decisions or actions in performance of their job. Similarly, it may be possible to provide specific guidelines in an area such as insider trading, where a code could specifically provide guidance on "trading windows" and specifically prohibited trading practices.

Defining Persons Subject

Section 406, as implemented by Regulation S-K 406, only requires compliance by the principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. The rules adopted by the New York Stock Exchange, American Stock Exchange and Nasdaq expanded the requirement to apply to all directors, officers and employees. The active duties of officers and employees differ significantly from the supervisory duties of outside directors. Accordingly, code provisions may not apply to

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Code of Ethics

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officers and employees in the same manner as outside directors, and code drafters should consider whether alternate provisions are required or whether a separate code should be adopted for outside directors.

For example, although a reporting company may appropriately restrict its employees from exposing themselves to the conflicts inherent in having more than one employer, it is unrealistic to expect that an outside director will have no other business activities. This, at the very least, may present conflicting demands for the director's time and could present other conflicts between the multiple businesses the director serves. Accordingly, it may be appropriate for a director conflict of interest policy to be more focused on identification, reporting and resolution of conflicts, rather than describing prohibited relationships. As another example, the New York Stock Exchange rule requires that the code address the protection and proper use of company assets. The access to, and duties with respect to, company assets will differ between employees and outside directors. Employees may have access and control over funds and tangible assets while a director may have access to intangible assets, such as corporate opportunities. Accordingly, code provisions that only command directors, officers and employees to "protect assets" without distinguishing among assets and duties may fail to address meaningful concerns and cannot effectively promote compliance.

Establishing Procedures

Section 406 requires that the code promote the prompt internal reporting of violations of the code to an appropriate person or persons identified in the code and accountability for adherence to the code. Codes typically address the reporting requirement by providing procedures for reporting perceived violations, including identifying multiple or alternate persons designated to receive reports. The reporting provisions often overlap with § 301 of SOX, which requires that audit committees establish procedures for the receipt of complaints regarding accounting matters, including a procedures for the submission of confidential, anonymous submissions. Codes also often include a provision overlapping with § 806 of SOX, assuring no retaliation for reporting violations. Finally, codes typically respond to the accountability requirement by including statements that the code will be enforced by actions up to and including termination of employment.

These provisions, while responsive to the minimum requirements of § 406, are essentially reactive, and while perhaps providing some deterrent to wrongdoing, do nothing to actively promote compliance. Code drafters should consider whether procedures should be included to promote compliance. For example, it appears that many codes have been adopted, published on the company's web page and disclosed in the company's proxy statement, but with little being done to familiarize employees with the code or otherwise to encourage compliance. In order for a code to be useful, and not just a response to a regulatory requirement, it is important that the code include procedures to educate existing and new employees about the code, its requirements and procedures. Also, though confidential reporting procedures are helpful to enforcement, perhaps some consideration should also be given to a "help line" as well, where employees with questions or concerns could seek guidance, when necessary, outside their supervisory structure and in confidence when necessary.

Conclusion

Drafting short, general and mandatory code provisions arguably does not comply with § 406 and Regulation S-K 406, causes unnecessary risks of code violations (potentially triggering mandatory 8-K disclosures) and misses the opportunity to adopt a practical code that actually establishes a meaningful tone, rather than merely fulfills a regulatory requirement. Code drafters should attempt to construct code provisions that provide meaningful guidance and that establish procedures that promote compliance. Audit committee members or others charged with administering or enforcing a code of conduct, having adopted a code, should not permit it to become merely a seldom visited file in the company's Web site, but should seek to regularly promote code compliance and refine the code as necessary, in order to make it practical, useful and ultimately effective component of corporate governance.

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