Corporate Compliance Programs in the Aftermath of Sarbanes-Oxley:

- or –

“The Time has Come, the Walrus Said…”

Program of the Ad Hoc Committee on Corporate Compliance

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I. The Framework for Corporate Self Governance
THE FRAMEWORK FOR CORPORATE SELF-GOVERNANCE:
AN EFFECTIVE ETHICS AND COMPLIANCE PROGRAM

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I. Introduction

Until very recently, corporations had become increasingly willing voluntarily to accept responsibility for monitoring their own activities. This trend, in part, was induced by the promotion and encouragement of corporate self-governance by government law enforcement authorities and regulators as well as by corporations' realization that their economic self-interest is served by preventing and detecting employee misconduct. 

With the recent proliferation of corporate scandals, however, Congress and the Securities and Exchange Commission (“SEC”) have imposed a variety of reforms, most notably the Sarbanes-Oxley Act of 2002 and its implementing regulations, to ensure that corporations strengthen their commitment to ethical conduct and improve their corporate governance practices and their financial and other public disclosures.

Yet despite the rash of new regulatory requirements, self-governance remains critical to a corporation’s successful operations. Self-governance is designed to ensure that a corporation aspires to and insists on uncompromising ethical behavior in its activities. Self-governance at its core involves the development of a "corporate ethic" or "corporate culture" of ethical conduct. A vigorous and effective ethics and compliance program provides two critical components of corporate self-governance: it causes a corporation to conduct its business in strict accordance with all applicable laws, rules, and regulations and it persuades corporate employees at all levels

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that operating within the bounds of the law is in the corporation's interest and, more importantly, in the interest of all of the corporation's employees.

This paper will discuss corporate ethics and compliance programs in three respects. First, it will identify the benefits and potential problems associated with developing and implementing a corporate ethics and compliance program. Second, it will outline the minimum elements necessary for an effective ethics and compliance program. Third, it will discuss the experience that Lockheed Martin Corporation has had with the development and implementation of its self-governance program.

II. Benefits and Potential Problems Associated With An Ethics and Compliance Program

A. Benefits of an Ethics and Compliance Program

The development and implementation of an effective ethics and compliance program offers a corporation a number of advantages. As a fundamental matter, the true value of an ethics and compliance program lies in its ability to detect and prevent criminal and other improper activity by corporate employees. In other words, an effective ethics and compliance program will foster and encourage ethical conduct by employees in all aspects of the corporation's business. Constant reminders (and examples) to employees that it is the corporation's policy to abide by the law and to punish violators discourage and deter criminal behavior and other unethical conduct, discourage employee tolerance of improper activity, and

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encourage employees to report misconduct to management. The early detection of misconduct maximizes a corporation's ability proactively to respond to and address the causes of wrongdoing and to minimize its consequences. 4

The financial savings resulting from the prevention or early detection of criminal and other improper conduct are substantial. A corporation can avoid criminal, civil, and administrative fines, penalties, offsets, civil judgments in *qui tam* and class action private securities lawsuits, and the significant legal fees associated with litigation with either the government or private parties. Moreover, an effective ethics and compliance program may prevent the loss of business which will result from suspension or debarment from government contracting, denial of export licenses, the loss of customer confidence, or a damaged reputation. In addition, prevention or early detection of misconduct will avoid the employee morale and productivity disruptions that often accompany an investigation of, or legal action involving, allegations of corporate impropriety.

One of the more significant advantages of a corporate ethics and compliance program is avoiding altogether prosecution for the criminal acts of corporate employees. While an effective ethics and compliance program will not absolve a corporation from criminal liability, the existence of an effective compliance program is a factor upon which a Federal prosecutor may base his or her decision not to bring criminal charges against a corporation. In a memorandum dated January 20, 2003, Deputy Attorney General Larry D. Thompson includes corporate

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4 See "Programs for Employees Keep Companies on Track Ethically," *BNA Corporate Counsel Weekly*, Dec. 9, 1998 at 5 (reporting view that business professionals behave unethically due to pressure to achieve management objectives, with top pressures including: (1) meeting overly aggressive financial priorities; (2) meeting schedule priorities; (3) helping the organization to survive; and (4) rationalizing other peoples' often unethical behavior).
compliance programs among a variety of factors Federal prosecutors should consider in deciding whether to pursue criminal charges against corporations (the “Thompson Memo”). After noting that the Department encourages the “corporate self-policing” inherent in compliance programs, the Thompson Memo points out that “. . . the existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for criminal conduct undertaken by its officers, directors, employees, or agents.” The Thompson Memo acknowledges that “no compliance program can ever prevent all criminal activity by a corporation’s employees” but advises prosecutors that the fundamental questions they should ask are: is the compliance program well-designed and does it work?

To answer those questions, the Thompson Memo identifies indicia of an effective compliance program: its comprehensiveness; the extent and pervasiveness of the criminal conduct; the number and level of the corporate employee involved; the seriousness, duration, and frequency of the misconduct; and any remedial action taken by the corporation including restitution, disciplinary action, and revisions to the compliance program. The Thompson Memo identifies the promptness of a corporation’s disclosure of wrongdoing to the government and its cooperation with the government’s investigation as important factors. High level involvement

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5 Memorandum dated January 20, 2003, To: Heads of Department Components and United States Attorneys, From: Larry D. Thompson, Deputy Attorney General, Subject: Principles of Federal Prosecution of Business Organizations, posted at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm Other factors identified by the Thompson Memo include: the nature and the seriousness of the offense, including harm to the public; the pervasiveness of the wrongdoing within the corporation, including the complicity in, or condonation of, the wrongdoing by corporate management; the corporation’s history of similar conduct; the corporation’s timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation, including, if necessary, the waive of corporate attorney-client and work product protection; the corporation’s remedial actions; collateral consequences, including disproportionate harm to shareholders, pension holders, and employees not proven personally culpable and impact on the public arising from the prosecution; the adequacy of the prosecution of individuals responsible for the corporation’s malfeasance; and the adequacy of remedies such as civil or regulatory enforcement actions.
by the corporation’s directors is viewed as critical to the effectiveness of a compliance program, as the Thompson Memo advises prosecutors to evaluate a corporation’s compliance program in light of the seminal Caremark decision by the Delaware Chancery Court: “. . . have the directors established an information and reporting system in the organization reasonable [sic] designed to provide management and the board of directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization’s compliance with the law.” Finally, the Thompson Memo directs prosecutors to determine whether a corporation has provided for “a staff sufficient to audit, document, analyze and utilize the results of the corporation’s compliance efforts . . . and whether the corporation’s employees are adequately informed about the compliance program and are convinced of the corporation’s commitment to it.”

Even if an effective ethics and compliance program does not prevent prosecution, it can minimize the severity of a corporation's sentence upon conviction. The Organizational Sentencing Guidelines reduce a corporation's "culpability score" by three points if an offense occurred "despite an effective program to prevent and detect violations of the law." This reduction can result in substantial mitigation of the sentencing fine range and the corporation's sentencing exposure (in some instances up to eighty percent).  

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6 In Re Caremark International, Inc. Derivative Litigation, 698 A.2d 959 (Del.Ch. 1996); see text at notes 11-12, infra.

7 U.S.S.G. § 8C2.5(f). The three-point reduction is lost if a "high level individual" or an "individual responsible for administration or enforcement" of the compliance program participated in, condoned, or was willfully ignorant of the offense.” Id.

8 See U.S.S.G. §§ 8C2.6 and 8C2.7.
and compliance program may prevent imposition of a burdensome and intrusive sentence to a
term of organizational probation.9

Aside from having a role in avoiding or mitigating criminal prosecution, an effective
ethics and compliance program will reduce the potential for suspension or debarment from
government contracting, a serious administrative action that poses a substantial threat to the
economic viability of a corporation. The Federal Acquisition Regulation ("FAR") provides, and
experience shows, that suspension and debarment authorities will favorably consider an ethics
and compliance program in assessing the present responsibility of a corporation.10

Finally, the creation and implementation of an effective ethics and compliance program
may shield company directors from personal liability arising from the wrongdoing of employees.
The Delaware Court of Chancery in In re Caremark International Inc. Derivative Litigation, in
the context of approving a settlement of a derivative action, held that Caremark's directors did
not breach their duties to shareholders because they took steps to ensure that the corporation had
a compliance system (an "information and reporting system") to assure the board that appropriate
information would come to its attention in a timely manner as a matter of ordinary operations.11
Some of these steps include naming the chief financial officer as the corporate compliance

9 See U.S.S.G. § 8D1.1(a)(3). In 1996, 96 companies were placed on probation, nearly twice as many as in 1993.
"Corporate Monitors Form a New Industry," The Wall Street Journal (December 1, 1997) at B12. In some
instances, companies have found particularly onerous and disruptive, the conduct of outside monitors appointed by
the sentencing court as a condition of probation in order to provide the court with continuing authority over the day
to day operations of the corporation.

available at http://www.arnet.gov/far

before the court arose from a 1994 federal indictment of Caremark, which led in 1995 to Caremark pleading guilty
to a single felony charge and its payment of $250 million in criminal fines, civil penalties, and civil damages.
officer, creation of an internal audit plan monitored by a board committee designed to assure compliance with business and ethics policies, and the compilation of an employee ethics handbook concerning compliance policies (including the requirement for all employees to report illegal conduct to a toll-free confidential ethics hotline). The court made two interesting observations. First, it noted that any corporate self-governance effort must take into account the requirements of the organizational sentencing guidelines. Second, it pointed out that no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law.

B. Potential Problems Associated with an Ethics and Compliance Program

Although outweighed by the benefits, there are potential problems associated with the implementation of an ethics and compliance program. Once a corporation establishes compliance standards, it must devote the necessary resources to ensure that the standards are met or risk having the compliance program deemed "non-effective" due to lack of enforcement. In some instances, a corporate ethics and compliance program may be used as a sword against the corporation. For example, a prosecutor or plaintiff's counsel may try to use a corporation's ethics and compliance program as the standard by which employee conduct should be judged in a civil case.

12 Caremark at 970.
13 Id.
or criminal trial, arguing that any failure to meet the program's requirements is indicative of fraudulent intent, a knowing act, or negligence.\footnote{Id., citing Pitt & Groskaufmanis, "Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct," 78 Geo.L.J. 1559, 1605-14 (1990).}

An ethics and compliance program may generate through reporting procedures and an internal investigation damaging evidence that, if obtained by government investigators or private litigants, will assist in the development of a criminal or civil case against the corporation and could ultimately lead to the corporation's prosecution. Reporting procedures or an internal investigation may also alert corporate employees to suspected wrongdoing and these employees may take advantage of such information and file lawsuits against the corporation under the \textit{qui tam} provisions of the Civil False Claims Act. In that regard, taking disciplinary action against employees may not only cause them to become \textit{qui tam} relators, but can serve as a "roadmap" for government investigators by providing insight into the corporation's assessment of relative culpability among sanctioned employees through a comparison of the varying severity of discipline imposed.

Although the results of an internal investigation are normally protected by the attorney-client privilege, prosecutors and private litigants in some instances nonetheless may obtain access to the information. A corporation may elect to disclose to the government portions of an internal investigation's findings in an effort to avoid indictment, mitigate sentencing exposure or avoid suspension or debarment. Such disclosure, however limited, creates a substantial risk that
the corporation will waive the attorney-client or work product privileges, not only with respect to
the internal investigation's findings, but to all information related to the same subject matter.\textsuperscript{16}

\textbf{III. Elements Of An Effective Ethics and Compliance Program}

Aside from the substantial volume of literature and websites generated by law firms, consultants, and commentators discussing ethics and compliance programs,\textsuperscript{17} corporations can look to several sources from which to derive the essential elements of an effective ethics and compliance program. The first is the Sarbanes-Oxley Act of 2002 (the “Act”) and its implementing regulations promulgated by the SEC. The Act and the SEC regulations provide a mandatory, albeit limited, compliance baseline, at least for public companies that are issuers under the Securities Exchange Act of 1934. However, an effective compliance program includes many elements not mandated by the Act or the SEC. The principal source of those elements are the Organizational Sentencing Guidelines at Chapter 8 of the United States Sentencing Guidelines. Other sources exist, however, particularly for corporations doing business with the Department of Defense ("DoD"). The Defense Federal Acquisition Regulation Supplement ("DFARS") establishes for DoD contractors the general requirement for ethical conduct, defines broad program elements, and provides examples of what a system of management controls


should include. The Defense Industry Initiative on Business Ethics and Conduct ("DII") principles provide another source for ethics and compliance program elements. Yet another source for the elements of a compliance program for those companies in the health care industry may be found at a website published by the Department of Health and Human Services, Office of the Inspector General ("HHS OIG").

**A. Sarbanes-Oxley Act of 2002**

The Act generally addresses securities and public accounting issues raised by the financial reporting scandals involving publicly held companies and their accountants such as Enron, Arthur Andersen, Adelphia, WorldCom, and Tyco. The Act’s stated purpose is to improve corporate governance, public auditing, and SEC oversight so that the investing public will be adequately protected. Several of the Act’s provisions are relevant to a corporation’s self-governance efforts.

Section 406 of the Act requires the SEC to issue rules requiring public companies to disclose whether they have a code of ethics for senior financial officers and that any change to or waiver of a corporation’s code be disclosed in a Form 8-K. The Act does not require that a public company have a code of ethics, although the reason for not having one must be disclosed. On January 23, 2003, the SEC released its final rules implementing Section 406 of the Act. The SEC rules require a public company to disclose in its annual report on Form 10-K whether

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19 The DII homepage is at [http://www.dii.org](http://www.dii.org)

20 [http://oig.hhs.gov/fraud/complianceguidance.html](http://oig.hhs.gov/fraud/complianceguidance.html)

the company has adopted a code of ethics for its principal executive officer, senior financial officer, principal financial officer, principal accounting officer or controller, or persons with similar functions. If it has not, the SEC rule requires the company to explain why. The SEC rule defines “code of ethics” as a “codification of such standards as 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 the company files with or submits to the SEC; (3) compliance with applicable governmental laws, rules, and regulations; (4) prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and (5) accountability for adherence to the code. The SEC declined to set forth specific language, procedures, or sanctions required for a code, noting that companies must have the freedom to establish codes of ethics that suit their particular needs and structures.

Section 301 of the Act, among other things, requires that the audit committee of a public company establish procedures for: (1) the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters; and (2) the confidential, anonymous submission by employees of the company of concerns regarding questionable accounting or auditing matters. In its proposed rule implementing Section 301 issued on January 8, 2003, the SEC did not amplify the statutory language and advised that it would not mandate specific procedures in order to provide companies and their audit committees with the flexibility to develop and utilize procedures appropriate for their

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22 SEC Release 34-47137 (http://www.sec.gov/rules/proposed/34-47137.htm)
unique circumstances. The SEC appears to contemplate a reporting system using a hotline designed to ensure and protect the confidentiality of internal whistleblowers. The SEC rule notes that the establishment of formal procedures for receiving and handling complaints could serve to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems before they have serious consequences. The SEC believes that since the audit committee is dependent to a degree on the information provided to it by management and internal and outside auditors, it is imperative for the committee to cultivate open and effective channels of information. The SEC rule further explains that management may not have the appropriate incentives to self-report all questionable practices and a company employee or other individual may be reticent to report concerns regarding questionable accounting or other matters for fear of management reprisal.

Although not explicitly addressing elements of a compliance program, the certification requirements of Sections 302 and 906 of the Act, as implemented by the SEC, will necessarily encourage senior managers to make internal corporate disclosure processes – the so-called “disclosure controls” – subject to or an integral part of the corporation’s compliance program. Sections 302 and 906 of the Act require the chief executive officer and chief financial officer of a public company to certify that their company’s annual and quarterly reports to the SEC “fairly present,” in all material respects, the company’s financial condition and results of operations. The SEC rule also requires the chief executive and financial officers to certify that: (1) they are responsible for establishing, maintaining and regularly evaluating the effectiveness of disclosure

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controls and procedures; (2) they have disclosed to the company’s outside auditors and to the audit committee: (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the company’s ability to record, process, summarize and report financial data; (b) any material weakness in internal controls; and (c) any fraud, whether or not material, that involves management or other employees who have a significant role in the internal controls; and (3) they have included information in the quarterly and annual reports about their evaluation and whether there have been significant changes in the internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation. 24

The SEC rule defines “disclosure controls and procedures” as controls and other procedures of a corporation that are designed to ensure that information required to be disclosed by the corporation in its periodic reports filed with the SEC is recorded, processed, summarized and reported in an accurate and timely manner to the corporation’s management, including the chief executive and chief financial officers. There is a remarkable similarity between this requirement and the touchstone of an effective compliance program identified by the Caremark decision: an "information and reporting system" designed to assure the board of directors that appropriate information will come to its attention in a timely manner as a matter of ordinary operations.

24 As used in the rule, the SEC’s concept of internal controls addresses a company’s controls and procedures for financial reporting purposes that are currently required to be in place under Section 13(b) of the Securities Exchange Act of 1934 and that are addressed in AICPA Auditing Standard § 319 as follows:

   Internal controls is a process . . . designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting; (b) effectiveness and efficiency of operations; and (c) compliance with applicable laws and regulations.

On the other hand, the SEC rule intends the concept of disclosure controls and procedures “to cover a broader range of information than is covered by an issuer’s internal controls related to financial reporting.”
B. Organizational Sentencing Guidelines

The Organizational Sentencing Guidelines specify the type of corporate compliance effort that is required for mitigation of a corporation's sentence upon conviction.\(^{25}\) As a practical matter, however, the real benefit to corporations of instituting an effective ethics and compliance program will not be at sentencing, but will be in its role in preventing crime in the first place.

The Guidelines provide that an "effective program to prevent and detect violations of law" means a program that has been reasonably designed, implemented, and enforced so that it generally will be effective in preventing and detecting criminal conduct.\(^{26}\) The hallmark of an effective program to prevent and detect violations of law, according to the Guidelines, is that the organization exercised due diligence in seeking to prevent and detect criminal conduct by its employees and other agents.\(^{27}\)

The Guidelines articulate the minimum steps that the organization must take to establish that it exercised due diligence:\(^{28}\)

1. The organization must establish compliance standards and procedures to be followed by its employees and other agents that are reasonably capable of reducing the prospect of criminal conduct.

2. High-level individuals within the organization must have been assigned overall responsibility to oversee compliance with such standards and procedures.

3. The organization must use due care not to delegate substantial discretionary authority to individuals whom the organization knew,
or should have known through the exercise of due diligence, had a propensity to engage in illegal activities.

(4) The organization must take steps to communicate effectively its standards and procedures to all employees and other agents, e.g., by requiring participation in training programs or by disseminating publications that explain in a practical manner what is required.

(5) The organization must have taken reasonable steps to achieve compliance with its standards, e.g., by utilizing monitoring and auditing systems reasonably designed to detect criminal conduct by its employees and other agents and by having in place and publicizing a reporting system whereby employees and other agents could report criminal conduct by others within the organization without fear of retribution.

(6) The standards must be consistently enforced through appropriate disciplinary measures, including, as appropriate, discipline of individuals responsible for failure to detect an offense. Adequate discipline of individuals responsible for an offense is a necessary component of enforcement; however the form of discipline that will be appropriate will be case specific.

(7) After an offense has been detected, the organization must take all reasonable steps to respond appropriately to the offense and to prevent further similar offenses -- including any necessary modifications to its program to prevent and detect violations of law.

The Guidelines explain that the precise actions necessary for an effective program to prevent and detect violations of law will depend upon a number of factors:

(1) Size of the organization -- The formality of a compliance program will vary with the size of the organization. Larger organizations must have more formal programs with established written policies defining the standards and procedures to be followed by its employees and other agents.

(2) Likelihood that certain offenses may occur because of the nature of its business -- If the nature of an organization's business engenders

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29 U.S.S.G. § 8A1.2. (n.3(k)).
a substantial risk that certain types of offenses may occur, the program must focus on those offenses.

(3) Prior history of the organization -- An organization's prior history may indicate types of offenses that it should take actions to prevent.

(4) An organization must incorporate and follow applicable industry practice or the standards called for by any applicable governmental regulation.

The Guidelines reward self-reporting and cooperation by sentence mitigation.\textsuperscript{30} The Guidelines urge an organization to take responsibility for its actions as soon as it detects an offense. The organization must disclose wrongdoing to government authorities and its cooperation must be both timely and thorough. The Guidelines require that the organization must begin cooperating at the time it receives notice of an investigation and the organization must disclose all pertinent information sufficient for law enforcement officials to identify the nature and extent of the offenses and the responsible individuals.

B. DFARS Subpart 203.70

DFARS Subpart 203.70 articulates policy and procedures applicable to government contractor ethics programs that are directly relevant to establishing and implementing a compliance program and, in general terms, complement the compliance requirements established by the Organizational Sentencing Guidelines. The DFARS policy statement is straightforward: government contractors must conduct themselves with the highest degree of integrity and

\textsuperscript{30} U.S.S.G. § 8C2.5(g).
To meet this goal, the DFARS requires that contractors have standards and internal control systems that:

1. Are suitable to the size of the company and the extent of their involvement in government contracting.
2. Promote such standards.
3. Facilitate the timely discovery and disclosure of improper conduct in connection with government contracts.
4. Ensure corrective measures are promptly instituted and carried out.

The DFARS identifies elements that a contractor's system of management controls should provide for:

1. A written code of business ethics and conduct and an ethics training program for all employees.
2. Periodic reviews of company business practices, procedures, policies, and internal controls for compliance with standards of conduct and the special requirements of government contracting.
3. A mechanism, such as a hotline, by which employees may report suspected instances of improper conduct, and instructions that encourage employees to make such reports.
4. Internal and/or external audits as appropriate.
5. Disciplinary action for improper conduct.
6. Timely reporting to appropriate government officials of any suspected or possible violation of law in connection with government contracts or any other irregularities in connection with such contracts.
7. Full cooperation with any government agencies responsible for either investigation or corrective actions.

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31 DFARS Subpart 203.7000; 48 C.F.R. § 203.7000.

32 Id.

33 DFARS Subpart 203.7001; 48 C.F.R. § 203.7001.
C. DII Principles

In 1986, representatives of eighteen defense contractors drafted six key principles of business ethics and conduct. The principles, which became known as the DII principles, pledge the signatory companies to implement policies, procedures, and programs in six areas.

1. Company codes of ethics.
2. Ethics training for employees.
3. Internal reporting of alleged misconduct.
4. Self-governance through the implementation of systems to monitor compliance with federal procurement laws and the adoption of procedures for voluntary disclosure of violations to the appropriate authorities.
5. Responsibility to the industry through attendance at Best Practices Forums.
6. Accountability to the public.

The DII principles generally reflect the policies and procedures of corporate self-governance and effective ethics and compliance programs articulated by the Organizational Sentencing Guidelines and the DFARS.

D. Healthcare Compliance Guidelines

The creation of compliance program guidance is a major initiative of the HHS OIG. The HHS OIG believes that development of compliance program guidance will assist a health care provider in using internal controls more efficiently to monitor adherence to applicable statutes, regulations and program requirements and thereby reduce waste, fraud and abuse.34 HHS OIG

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has issued compliance guidance on a variety of specific areas including the hospital industry, home health agencies, clinical laboratories, third-party medical billing companies, and hospices.

In general, HHS OIG has identified the following as elements for an effective compliance program:

1. Implementing written policies, procedures and standards of conduct;
2. Designating a compliance officer and a compliance committee;
3. Conducting effective training and education;
4. Developing effective lines of communication;
5. Enforcing standards through well-publicized disciplinary guidelines and developing policies addressing dealings with sanctioned individuals;
6. Conducting internal monitoring and auditing; and
7. Responding promptly to detected offenses, developing corrective action, and reporting to the Government.  

IV. Lockheed Martin's Self-Governance Program

Lockheed Martin Corporation was formed on March 15, 1995, through the merger of Lockheed Corporation and Martin Marietta Corporation. While each company brought with it a commitment to ethical conduct and compliance programs, the merger afforded Lockheed Martin Corporation a unique opportunity to emphasize core ethical principles central to the new corporation and a self-governance program designed to ensure that those core ethical principles became an integral part of doing business throughout the corporation.

Fundamental to Lockheed Martin's self-governance program is the establishment and promulgation of a strong corporate culture of ethical conduct. In a videotape shown to all new employees:

35 Id.
employees, the President and Chief Operating Officer of Lockheed Martin makes it clear that the Corporation is committed to the highest standards of ethical conduct in every aspect of its dealings with all its constituencies: employees, customers, communities, suppliers, and shareholders. The videotape highlights the Corporation's guiding ethical principles:

(1) Honesty: to be truthful in all our endeavors; to be honest and forthright with one another and our constituencies.

(2) Integrity: to say what we mean, to deliver what we promise, and to stand for what is right.

(3) Respect: to treat one another with dignity and fairness, appreciating the diversity of our workforce and the uniqueness of each employee.

(4) Trust: to build confidence through teamwork and open, candid communication.

(5) Responsibility: to speak up -- without fear of retribution - and report concerns in the workplace, including violations of laws, regulations and company policies, and seek clarification and guidance whenever there is doubt.

(6) Citizenship: to obey all the laws of the United States and the foreign countries in which Lockheed Martin does business and to do our part to make the communities in which we live a better place to be.

A key element of Lockheed Martin's ethics and compliance program is high-level program management. To develop and implement its self-governance program, the Corporation established the Office of Ethics and Business Conduct and the position of Vice President of Ethics and Business Conduct. The Vice President of Ethics and Business Conduct reports directly to the Office of the Chairman and to the Audit and Ethics Committee of the Board of Directors. The Vice President of Ethics and Business Conduct attends meetings of and has
unrestricted access to the Audit and Ethics Committee of the Board of Directors and reports on matters of ethics, compliance, and business conduct.

The Corporation has also created the Corporate Ethics and Business Conduct Steering Committee. The Committee is chaired by the Corporation's President and Chief Operating Officer, and is further comprised of senior corporate officers including the Vice President of Ethics and Business Conduct, the Senior Vice President and Chief Financial Officer, Senior Vice President and General Counsel, Senior Vice President of Human Resources, Vice President of Internal Audit, Vice President of Business Development and, on a rotating basis, one Business Area Executive Vice President and four Business Unit Presidents representing the other business areas of the Corporation. The Committee meets quarterly to provide guidance, counsel, and strategic direction on the Corporation's ethics and business conduct programs to include monitoring compliance with applicable laws, regulations, and business practices policies, oversight of corporate-wide ethics education and awareness programs, reviewing ethics and compliance program performance of business units (including foreign locations), and reviewing ethics helpline statistics, trends, and survey data.

Each business unit within Lockheed Martin has established a steering committee with similar responsibility for management and oversight of its ethics and business conduct program. A business unit committee is chaired by the business unit president and includes, at a minimum, the senior human resources, legal, internal audit, and finance executives, and the business unit ethics officer.

The Corporation has developed and distributed to each of its more than 125,000 employees a code of conduct designed to ensure that every employee understands and adheres to
the Corporation's principles of integrity and ethical behavior as well as its policies and procedures. Lockheed Martin's Code of Ethics and Business Conduct, entitled "Setting the Standard," updated in 2003 to incorporate the requirements of Sections 301 and 406 of the Sarbanes-Oxley Act, provides a common source of reference for general ethical guidance for all employees at every level of the corporation. The code initially was distributed to each employee individually by his or her immediate supervisor during annual live ethics training and is provided to all new employees. All employees must acknowledge receipt of the code in writing or via electronic acknowledgment. The code, published in English and 13 other languages, is a pocket-sized, spiral-bound booklet, which articulates the Corporation's core ethics principles of honesty, integrity, respect, trust, citizenship, and responsibility, as well as general standards of conduct and principles to guide employees in their daily activity. The code is also available for viewing by all employees, suppliers, or any other interested party at the Ethics Home Page at the Corporation's website: www.lockheedmartin.com/about/ethics/code_of_ethics.html. Those general standards of conduct include:

(1) Treat in an ethical manner all those to whom Lockheed Martin has an obligation.

(2) Obey the law - Compliance with the law does not comprise our entire ethical responsibility, it is a minimum, absolutely essential condition for performance of our duties.

(3) Promote a positive work environment.

(4) Work safely.

(5) Keep accurate and complete records.

(6) Record costs properly.

(7) Strictly adhere to all antitrust laws.
(8) Know and follow the law when involved in international business.

(9) Follow the rules in using or working with former government personnel.

(10) Follow the law and use common sense in political contributions and activities.

(11) Carefully bid, negotiate, and perform contracts.

(12) Avoid illegal and questionable gifts or favors.

(13) Steer clear of conflicts of interest.

(14) Maintain the integrity of consultants, agents, and representatives.

(15) Protect proprietary information.

(16) Obtain and use company and customer assets wisely.

(17) Do not engage in speculative or insider trading.

To ensure complete and effective implementation of its ethics and compliance program, Lockheed Martin has created a corporate-wide ethics and business conduct organization. The Office of Ethics and Business Conduct is responsible for the overall administration of the Corporation's ethics and business conduct program. The Vice President of Ethics and Business Conduct and business area executive vice presidents have appointed business area ethics directors while business unit ethics officers have been appointed by their respective business unit presidents in consultation with the Office of Ethics and Business Conduct. The business unit ethics officers report directly to their business unit presidents. Ethics officers are responsible for coordination and oversight of ethics programs and processes and serve as primary points of contact between the business unit and the Office of Ethics and Business to assure effective implementation of ethics awareness and reporting processes. The ethics officers advise and
support business area executive vice presidents and business unit presidents in evaluating ethics issues and establishing and enforcing ethics policies and practices. In addition, ethics officers initiate investigations into allegations of misconduct and assure appropriate review and disposition, to include coordination necessary for discipline or corrective action.

Important components of the Corporation's self-governance program are its reporting and information hotlines, or "HelpLines." Ethics officers and confidential ethics helplines are available to all employees at both the operating business units and corporate level. Employees are urged via training, in the code of conduct, and by poster to use these resources without fear of retribution whenever they have a question or concern that cannot be readily addressed within their work group or through their supervisor. It is Lockheed Martin policy to foster a free and open atmosphere that allows and encourages employees to make inquiries, express work-related concerns regarding ethics issues, and to report business ethics violations or violations of law, regulations, policies, or procedures without fear of retribution or retaliation for making such reports or inquiries. Posters placed on bulletin boards throughout the Corporation identify the appropriate ethics officer by name, provide a photograph, and include his or her telephone number, as well as toll-free Helpline numbers.

Ethics awareness and compliance training of each employee is an essential element of the Corporation's self-governance program. Training programs are centrally developed and locally administered and are designed to ensure that all employees are sensitive to ethical issues and standards. Moreover, the training programs are designed to ensure that all employees are aware of applicable laws, regulations, and standards of business conduct both in general and as they
pertain to the employee's specific job function, as well as the consequences both to the employee and the company that may result from violations.

A key element of Lockheed Martin's ethics and business conduct program is a requirement that each employee receive live ethics awareness training from his or her supervisor on an annual basis. In 2000 and 2001, the training tool was *Ethic Daily*, a *USA Today*-style newspaper. *Ethics Daily* training focused on the application at work of the ethics principles of honesty, trust, respect, integrity, responsibility and citizenship. During the training, employee teams analyzed selected scenarios, styled as newspaper articles, and patterned on real workplace situations that occurred in the Corporation. Employees developed appropriate actions based on an article’s facts, identified the applicable ethical principles that these actions entailed, and created headlines to describe the article. In 2002, the training tool was called “Perspectives – Lockheed Martin Ethics Challenge.” Employee teams were presented with different fact situations in which each team was assigned a separate role. The training was designed to emphasize the different perspectives people bring to a situation, the different conclusions that result, and that different conclusions do not necessarily imply unethical behavior. Managers and supervisors, who personally conduct the training for their employees, facilitate ethics awareness training sessions. The training begins with the Lockheed Martin Chairman and Chief Executive Office conducting training with his senior staff. Ethics awareness training then cascades from the top down to the business areas and business units throughout the Corporation.

The Corporation believes that for its ethics program to be effective, supervisors and managers must link their dialogues on performance to reminders about the Corporation's values emphasizing mission success, teamwork, and a commitment to the highest standards of ethical
business conduct. All employees at Lockheed Martin are part of the ethics program, and supervisors and managers are responsible for leading the annual ethics awareness training sessions.

Compliance training related to business conduct is the complement of ethics awareness training in the Corporation's self-governance program. Compliance training is developed and implemented locally based on broad guidance from corporate elements. Designated corporate staff ("responsible executives") is charged with ascertaining training needs in their areas of responsibility, ensuring that compliance areas are identified, and that appropriate training materials and curricula are developed and implemented. The corporate responsible executives name corporate subject matter experts to support the compliance effort.

Every three years, corporate elements as well as business areas and business units, develop or update a compliance training plan tailored to their respective organizations, consistent with guidance from the Office of Ethics and Business Conduct. Each business unit names its own responsible officials and subject-matter experts for each area identified for training. To ensure that each employee is knowledgeable about applicable laws, regulations, and standards of business conduct pertinent to his or her particular job function, the plans include a training matrix detailing the training to be provided, how it will be conducted, who will receive the training, and how it will be tracked and reported.

Compliance training is provided locally at business units through a number of delivery options, including: web-based interactive multimedia and CD ROM's, hand-held mobile learning (PDA’s), linear videos, all-hands meetings, staff meeting discussions, classroom training, training bulletins, and pamphlets. Business units have the flexibility to determine which
combination of delivery options offers the most effective and efficient manner in which to conduct compliance training. Web-based training available includes, among others, Antitrust, Diversity, Domestic Consultants, Environment Safety and Health, Ethics, Ex-Government Employees, Export Control, Foreign Corrupt Practices Act, Harassment in the Workplace, Insider Trading, International Consultants, Kickbacks and Gratuities, Labor Charging, Material Cost, Organizational Conflicts of Interest, Procurement, Procurement Integrity, Product Substitution, Protecting Classified Information, Records Retention, Sensitive Information Protection, and Truth-in-Negotiations. The web-based training and its record management is completely automated. Employees can view their own training records, automatic email notification of training completion are sent to employees and their supervisors, and management has instant access to employee training records and can assign required training.

In an effort to increase the efficiency and lower the costs of compliance training, the Corporation has implemented a web-based tool called Qwizard. Qwizard allows employees to take compliance training quizzes, the same quizzes taken at the end of a training module, on-line at their desks. Qwizard enables employees who know the material in the training modules to reduce significantly the amount of time they spend on recertification compliance training without compromising the Corporation's ability to say with absolute certainty that employees demonstrate the compliance knowledge and competency they need.

The Corporation believes that continuous reinforcement of the commitment to ethical business conduct is an essential component of its self-governance efforts. To that end, there are frequent ethics columns in *Lockheed Martin TODAY*, the corporate-wide newspaper. Each *TODAY* ethics column focuses on current activities of the Office of Ethics and Business Conduct.
or addresses issues of general interest. A periodic guest ethics column by corporate executives is published as tangible evidence of senior management's involvement in and support of the ethics process at the Corporation. Moreover, current ethics and compliance related materials and items of interest, together with links to other ethics sites, are available to employees not only on the Corporate Business and Ethics Conduct Office's website, but on a variety of websites maintained or supported by Lockheed Martin company ethics offices across the Corporation.

Three final elements are essential to Lockheed Martin's self-governance program. First, internal audit each year creates an audit plan for and audits the Corporation's operations for compliance with its ethics and compliance program. This audit effort is in addition to internal audit's more traditional compliance-related focus on internal controls and compliance. Included in this audit coverage is a review of the Corporation’s progress in completing compliance training requirements. Second, all Lockheed Martin employees are surveyed bi-annually on a voluntary and confidential basis. The surveys are done on-line and on paper and the findings assist management in understanding the ethics perspectives of its employees and identifying adjustments necessary to ensure the continued effectiveness of the ethics and business conduct program. Third, as part of its self-governance program, Lockheed Martin has adopted a policy of voluntarily disclosing to responsible governmental authorities violations of law or significant employee misconduct. Lockheed Martin has found that employee awareness and appreciation of the Corporation's policy to disclose improper behavior to the government is an extremely
effective method of communicating to employees the unequivocal nature of the Corporation's commitment to ethical behavior and is a powerful deterrent against improper behavior.  

V. Conclusion

Like many corporations, Lockheed Martin Corporation has taken responsibility for self-governance because it is the right thing to do and because ethics and compliance programs are a good business practice. Lockheed Martin's self-governance program goes beyond a mere focus on rules that is associated with many compliance programs, to a broader focus on ethical values and conduct as a way of business. In doing so, Lockheed Martin seeks to prevent employee misconduct before it happens and thereby successfully measure up to the intense scrutiny and high standards to which the government, shareholders, industry, and the public hold Lockheed Martin in all its operations.

Lockheed Martin's efforts in that regard were formally recognized on September 8, 1998, when the American Society of Chartered Life Underwriters & Chartered Financial Consultants announced that it had awarded to Lockheed Martin Corporation its 1998 American Business Ethics Award ("ABEA") in the public company category. Awarded annually since 1994, the ABEA recognizes companies from three categories -- public company, private company, and

36 The Organizational Sentencing Guidelines reward self-reporting and cooperation, U.S.S.G. § 8C2.5(g), and require, as part of an effective program to prevent and detect violations of law, that a corporation adequately discipline an employee responsible for a violation of the law. U.S.S.G. §8A1.2. (n.3(k)(6)). Companies confronted with employee misconduct are becoming increasingly willing to disclose that misconduct to government law enforcement agencies and to cooperate with the government's investigation of the employee. See "Pollution Case Highlights Trend To Let Employees Take the Rap," The Wall Street Journal (October 9, 1997) at B8. In response to The Wall Street Journal's article, one commentator has advised that turning against an employee may not always be the optimal course of action for a company, as the company may need the cooperation of such employees for its defense and casting individual employees aside may hasten their turning against the company. Richard M. Cooper, "Is It Always Smart for a Company to Let Employees Take the Rap?" Business Crimes Bulletin, Vol. 4, No. 9 (October 1997) at 1.
small business -- that demonstrate a firm commitment to ethical business practices in everyday operations, management philosophies, and response to crisis or challenges.
II. Codes, Waivers and Whistleblowers
Codes, Waivers And Whistleblowers

I. Sarbanes Oxley—An Act to improve "accuracy and reliability of corporate disclosures made pursuant to the securities laws..."

A. Within this purpose are four objectives affecting compliance. The Act seeks, inter alia, to:

i. Strengthen application of codes of ethics for financial officers;
ii. Discourage waivers of codes for financial officers by requiring disclosure of waivers;
iii. Strengthen handling of complaints and concerns re: accounting and auditing, by requiring Audit Committee to establish procedures; and
iv. Protect whistleblowers in matters involving fraud on shareholders.

II. The Enron Influence. Like many provisions of the Act, the provisions designed to carry out these objectives have roots in the Enron scandal.

A. Enron Board's agreement to waive code of ethics.
   i. Enron Board agreed to waive code of ethics prohibition on conflicts to accommodate CFO Fastow's dual roles as CFO of the company and as principal of special purpose entities engaging in material transactions with Enron
   ii. Board set up monitoring that proved empty and ineffectual
   iii. Board, accountant and management officials signed off on particular transactions involving conflicts thinking others had given substantive scrutiny—apparently no one had.

B. Whistleblower letter side-tracked.
   i. Sherron Watkins letter to CEO Ken Lay in August, 2001, raised accounting and financial reporting concerns that were unquestionably material.
      1. Not immediately reported to Board:
2. Investigation skewed for result apparently desired by management;
3. CEO and GC instructed regular outside counsel not to second guess accounting treatment and advice of outside auditors; and
4. Regular outside counsel concluded Enron had done nothing wrong, and no further investigation required.

III. SOX Section 406—Codes of Ethics for Senior Financial Officers

A. Issuers to disclose whether or not they have adopted codes of ethics for Senior Financial Officers, and if not, why not. [Section 406(a) requires SEC to issue rules]

B. Immediate disclosure in 8-K or by internet of changes in or waivers of the code for senior financial officers [Section 406(b)]

C. Code of Ethics defined [Section 406(c)]
   i. To promote—three elements:
      1. Honest and ethical conduct, proper handling of conflicts
      2. "full, fair, accurate, timely, and understandable disclosure..."
      3. Compliance with governmental rules and regulations

IV. SEC Issues Final Rules Implementing Section 406

A. Final Rule "17 CFR Section 229.406 (Item 406) Code of Ethics"\(^1\)
   i. Issuers must disclose code's applicability to
      1. principal executive officer (new, not in Section 406 itself)
      2. principal financial officer, principal accounting officer or controller, or persons performing similar functions; and
      3. If no code for such officers, explain why

B. Code defined—expanded, now five elements

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\(^1\) The Final Rules' effective date is March 3, 2003. (See Release No. 33-8177, as revised January 24, 2003.) Companies must comply in their annual reports for fiscal years ending on or after July 15, 2003. They must disclose amendments to and waivers of their codes on or after the date of the first annual report in which disclosure of the code is required.
i. Written standards "reasonably designed to deter wrongdoing and to promote:"

1. Honest and ethical conduct and ethical handling of actual or apparent conflicts;
2. "full, fair, accurate, timely, and understandable disclosure"
3. Compliance with governmental laws, rules, and regulations;
4. "prompt internal reporting of violations of the code to an appropriate person or persons identified in the code" [appropriate person must, not be involved in the issue, have sufficient status in the company, and have adequate authority to deal with the issue] and
5. Accountability for adherence to the code

ii. Each of the above elements can be seen in a recently adopted code of ethics—discussion and illustration by reference to a recently adopted code.
1. Encouraging employees to "speak up"
2. Considerations for system of anonymous telephone submission of complaints and concerns
3. Transparency and accuracy of financial information
4. How much detail should be in a code of ethics
5. Government regulations
6. Other considerations for content of codes of ethics

iii. Instructions to Item 406 permit possibility of separate codes of ethics for different types of officers

iv. The required Code can be part of broader document

C. Disclosure of the Code
i. Issuer must
1. File copy with Commission as exhibit to annual report; or
2. Post on website and disclose website address in annual report and fact code is posted on website; or
3. Undertake in annual report to provide on request and explain manner of making such requests.

ii. Disclose whether intend to disclose changes or waivers by means of internet website and if so provide internet address.

iii. Disclosure of Changes and Waivers
1. Item 10 of Form 8-k requires disclosure within five business days of

   a. *Changes* to the code affecting the CEO and senior financial officers
      i. Technical, administrative or non-substantive changes need not be disclosed

   b. *Waivers* of the code as applied to the CEO and senior financial officers that constitute "material departures" from the code

   c. *Implicit waivers*, i.e., the failure to act within a reasonable time regarding a known material departure from the code

   iv. Alternative disclosure of changes and waivers by means of internet website.

V. Handling of Complaints and Concerns Regarding Accounting and Auditing—Section 301

   A. Under Section 301, the SEC is required to issue rules requiring SRO's (securities exchanges and securities associations) to adopt listing requirements concerning Audit Committee standards, among which is the requirement that:

      i. Audit Committee must establish procedures for
         1. receipt, retention, and treatment of complaints regarding accounting, internal auditing controls, or auditing matters; and
         2. the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

   B. Release No. 34-47137, January 8, 2003, proposes a rule for listing requirements which simply repeats the language of the statute.²

      i. The SEC states: "We do not propose to mandate specific procedures that the audit committee must establish."

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² The new rule must become effective April 23, 2003, and it must be operative by the national securities exchanges and national securities associations not later than one year after publication of the new rule in the Federal Register.
1. The SEC states: "The establishment of formal procedures for receiving and handling complaints could serve to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems before they have serious consequences."

2. This obviously contemplates that the Audit Committee's work is not finished once the procedures are established. It is apparent the SEC envisions that the Audit Committee receive some information—e.g., reports from the chief of compliance, but SEC's release does not imply the necessity to establish procedures providing for direct submission of complaints and concerns to the Audit Committee.

   ii. Text—What is meant by "complaints" vs. "concerns?" What degree of anonymity satisfies the requirement of "confidential, anonymous submission"

   iii. Discussion of Hotline
      a. Special attention to accounting and auditing matters.

   iv. Reports to Audit Committee.

VI. Whistleblowers—Protected.

   A. The Act provides substantial remedies to whistleblowers. In fact, under the Act, legitimate whistleblowers are untouchable by aggrieved management.

   B. Under Section 806, whistleblowers who provide information to law enforcement officials, their superiors in the workplace, or to Congress or in the course of various types of proceedings, concerning fraudulent conduct by the company or its employees or officers, or its directors or its agents, contractors or subcontractors are to receive some very broad and potent protections. Whistleblowers may not be discharged, demoted, suspended, threatened, harassed, or in any manner discriminated against.

   C. The aggrieved whistleblower may file a complaint at the Department of Labor or if after 180 days no decision is rendered, file suit in the US District Court.

   D. The whistleblower may receive relief including:
i. Reinstatement without loss of seniority;
ii. Back pay with interest;
iii. Special damages including attorneys' fees, expert witness fees, etc.
III. Nuts & Bolts: S.E.C. Attorney Conduct Rules
I. Introduction

Section 307 of Sarbanes-Oxley directs the Securities and Exchange Commission to establish minimum standards of professional conduct for attorneys practicing before the Commission,\(^1\) including a rule requiring lawyers to report to the CEO or chief legal officer of the company (or the equivalent) evidence of a material violation of the securities laws, breach of fiduciary ‘duty or similar violation by the company or its agents.\(^2\) If the CEO or chief legal officer fails to respond appropriately, the lawyer must report the evidence to the audit committee, independent directors or full board.\(^3\)

Senator John Edwards, a Section 307 sponsor, decided that it was time for Congress to mandate an “up the ladder” reporting requirement on attorneys representing public companies.\(^4\) Senate speeches suggest the other sponsors shared this goal.\(^5\)

On November 6, 2002, the Commission proposed standards of professional conduct for attorneys practicing before the Commission in a new Part 205 of 17 CFR.\(^6\) On January 23, 2003, the Commission adopted final rules to implement Section 307.\(^7\)

The final rules adopted by the Commission, implementing Section 307 of Sarbanes-

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Oxley, are noticeably “softer” than the proposed rules. The new rules nevertheless impose detailed and stringent requirements on attorneys who represent issuers.

We discuss below the most important new attorney conduct rules, including the proposed “noisy withdrawal” provision of the rules, which has not been adopted, and for which the Commission seeks additional comments. We also summarize the widespread criticism of the “noisy withdrawal” provision. Finally, we provide an “attorney conduct checklist” to aid in deciding precisely what must be done to respond to a client’s perceived noncompliance.

II. **Final Rule – Implementation of Standards of Professional Conduct for Attorneys**

The final rules adopted by the Commission to implement Section 307 are a “softened” version of the rules initially proposed by the Commission. Most significantly, the proposed rules would have required a so-called “noisy withdrawal,” i.e., they would have required lawyers to notify the Commission of a failure to persuade managers to correct potential securities law violations. However, as Jonathan D. Glater, of the New York Times put it, “some of the toughest proposals appear to be dead, watered down or postponed.” This appears suspiciously like the result of heavy lobbying by law firms, bar associations and other trade groups. Nevertheless, the final rules continue to impose many new requirements on lawyers who practice before the Commission.

A. **To whom do the rules apply?**

The new Section 307 rules cover attorneys who have an attorney-client relationship with an issuer, and who have notice that documents they are preparing or
assisting in preparing will be filed with or submitted to the Commission.\textsuperscript{12} They emphasize that the client must be an issuer with whom the attorney regularly interacts, rather than an officer or employee of the issuer.\textsuperscript{13} Section 205.3(a) provides:

\begin{quote}
\textbf{Representing an Issuer.} An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer’s officers, directors, or employees in the course of representing the issuer does not make such individuals the attorneys’ clients.
\end{quote}

The Commission recognized that although “it is the client issuer, acting through its management, who chooses the objectives the lawyer must pursue, even when unwise, so long as they are not illegal or unethical,” the lawyer still owes his or her ethical duties to the issuer as an organization.\textsuperscript{14} The Commission also commented that the rules do not create a new fiduciary duty to shareholders, or a new private right of action against attorneys or anyone else.\textsuperscript{15}

\section*{B. Reporting Requirement}

The new rules provide that an attorney who appears or practices before the Commission has a duty to report evidence of a “material violation” of a securities law, “up-the-ladder” within the issuer, i.e., to its chief legal counsel, chief executive officer or the equivalent.\textsuperscript{16} The term “evidence of a material violation” is defined as “credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.”\textsuperscript{17} The Commission chose to incorporate an objective standard – “unreasonable under the circumstances for a prudent and competent attorney” – rather than a subjective standard, to “facilitate the effective operation of the rule and to encourage the reporting of evidence of material violations.”\textsuperscript{18}
This objective standard, however, also recognizes a range of conduct regarding which reasonable minds may differ. The “circumstances” mentioned in the definition are measured at the time the attorney decides whether to report the information, potentially including: the attorney’s professional skills, background and experience, the time constraints under which the attorney is acting, the attorney’s previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer must consult.

If an attorney becomes aware of such evidence, he or she must report it to the issuer’s Chief Legal Officer (“CLO”) or its Chief Executive Officer (“CEO”). The rule specifically states that reporting such information to the CLO or the CEO “does not reveal client confidences or secrets.” This provision underscores an attorney’s duty to protect the interests of the issuer by reporting – internally – evidence of a material violation by anyone, including the issuer’s officers, directors, employees, and agents.

Section 205.3(b)(2), describes the CLO’s responsibilities in handling violation reports. The CLO “shall cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report, has occurred, is ongoing, or is about to occur.” Upon finding that such a violation has occurred, a CLO must “take all reasonable steps to cause the issuer to adopt an appropriate response, and shall advise the reporting attorney thereof.” Likewise, the CLO is required to notify the reporting attorney of a determination that no material violation has occurred is ongoing or about to occur.

The new rules allow an issuer to establish a “qualified legal compliance committee” (QLCC) as an alternative procedure for reporting evidence of material
violations. A QLCC must include at least one member of the audit committee or equivalent committee of independent directors) and two or more independent board members. A QLCC would have the responsibility to recommend the response to evidence of a material violation.

An issuer is not necessarily required to form a new QLCC as long as another committee meets all of the requirements for a QLCC and agrees to assume that additional role. For instance, an audit or other committee may serve as a QLCC as long as that committee has at least two or more independent directors and board members.

A QLCC (or its equivalent) presents an alternative avenue for reporting evidence of a material violation. Additionally, section 205.3(b)(2) permits a CLO to refer such reports to a QLCC rather than initiating an inquiry under section 205.3(b)(2). In that case, the CLO shall inform the reporting attorney of the referral.

An attorney who reports a violation to a QLCC is relieved of all further reporting obligations. The QLCC becomes responsible for fulfilling the notification requirements, including notifying the CLO, initiating an investigation where appropriate, determining the appropriate remedial measures, reporting the results of the investigation to management and the board, and notifying the Commission if the issuer fails to take any of the designated remedial measures.

The rules also require an attorney to report evidence of a “material violation” to the audit committee or the full board if the CLO or the CEO does not respond appropriately to the evidence. The rules further provide that an attorney who believes it “futile” to report a material violation to the issuer’s CLO or CEO may report such evidence directly to the audit committee or other similar committee.
The proposed (unadopted) rules contained a provision requiring that reports and responses to evidence of material violations be documented and maintained for a reasonable period. The Commission failed to include this proposal in the final rules.

Under the proposed rule, a lawyer would have been required to document his or her report of evidence of a material violation...the CLO would have been required to document any inquiry in response to a report...a reporting attorney would have been required to document when he or she received an appropriate response to a report...and an attorney who believed he or she did not receive an appropriate response to a report would have been required to document that response.

Almost all of the comments regarding the proposed documentation requirement opposed inclusion in the final rule. Many expressed concern that the requirement could impede open and candid discussions between attorneys and issuer clients. Others suggested the potential for conflicts of interest between lawyer and client. Still others speculated that this requirement might increase the issuer’s vulnerability in litigation.

An attorney’s obligation to report evidence of a material violation is modified, and perhaps even relaxed, where the circumstances otherwise assure that a QLCC or other comparable committee will receive appropriate information. First, there is a lesser reporting obligation if the attorney was investigating such evidence at the direction of, and reports to, the CLO. In that case, the reporting obligation is satisfied if either (1) the CLO reports the results of the investigation to a QLCC or comparable committee, or (2) the attorney and CLO each reasonably believe that no material violation has occurred or is about to occur.

An attorney retained to defend the issuer in an investigation or judicial or administrative proceeding may also decline to report evidence of a material violation if the CLO assumes responsibility for reporting to the QLCC or other similar committee.
Similarly, an attorney directed or retained by a QLCC to investigate evidence of a material violation, or to defend the issuer, has no independent reporting obligation. An attorney’s reporting obligation is satisfied upon receipt of an appropriate and timely response to a violation report. If management fails to respond appropriately, the attorney must notify the CLO, CEO, and directors to whom the attorney originally reported the evidence of a material violation.

The new rules also provide a reporting avenue for an attorney who may have been discharged for being a whistleblower. To prevent the CLO from blocking violation reports, an attorney who reasonably believes he or she has been fired because of a violation report may notify the board or any board committee.

C. Disclosure of Confidential Issuer Information

The rules permit an attorney, without the issuer’s consent, to reveal confidential information to the extent reasonably necessary (1) to prevent the issuer from committing a material violation likely to cause substantial financial injury to the financial interests or property of the issuer or investors; (2) to prevent the issuer from committing an illegal act; or (3) to rectify the consequences of a material violation or illegal act in which the attorney’s services have been used.

Under § 205.3(d), an attorney may also use records created to fulfill Sarbanes-Oxley reporting obligations to defend against charges of misconduct. This rule is similar to the ABA’s Model Rule 1.6(b)(3) and numerous state law “self-defense” exceptions to client confidentiality rules.

It should be noted that the attorney conduct standards set forth in the final rules both supplant inconsistent rules and supplement applicable standards of any jurisdiction.
where an attorney is admitted or practices. They are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part.47 A mandatory disclosure requirement imposed by a state would therefore be an additional requirement consistent with the Commission's permissive disclosure rule.48 In other words, where a state’s ethical standards conflict with the attorney conduct rules, the Commission’s rules govern.49

D. Responsibilities of Supervising and Subordinate Attorneys

Section 205.4, which prescribes the responsibilities of supervisory attorneys, is based in part upon ABA Model Rule 5.1.50 That rule does two things: (1) requires supervisory attorneys to make reasonable efforts to ensure that subordinate attorneys adhere to the Rules of Professional Conduct; and (2) provides that supervisory attorneys may be liable for ratifying or the culpable failure to remedy violations by subordinate attorneys.

The definition of “supervisory attorney” is fairly narrow. Only a senior attorney who actually directs or supervises subordinate attorneys appearing and practicing before the Commission is a supervisory attorney under the rule. A senior attorney who supervises or directs a subordinate on other, unrelated matters is not considered to be a supervisory attorney. Under section 205.4, a supervisory attorney to whom a subordinate attorney reports evidence of a material violation is responsible for carrying out the reporting requirements prescribed under the rule.

Section 205.5, on the other hand, deals with the responsibilities of a “subordinate attorney.” This section is based on rule 5.2 of the ABA’s Model Rules (which provides that subordinate attorneys remain bound by the Model Rules even when they act at the
direction of another). Under section 205.5, a subordinate attorney is responsible for complying with this rule – i.e., a subordinate attorney is not exempt from the rule merely because he or she operates under the supervision or at the direction of another person.

E. Sanctions and Discipline

A violation of Sarbanes-Oxley Act or the rules promulgated thereunder also constitutes a violation of the Exchange Act. Such violations subject an attorney to Commission discipline even though the attorney may also be punished for the same conduct in another jurisdiction. This may include censure, or temporary or permanent denial of the privilege of appearing or practicing before the Commission. In other words, “the Commission intends to proceed against individuals violating Part 205 as it would against other violators of the federal securities laws and, when appropriate, to initiate proceedings under this rule seeking appropriate disciplinary sanction.” Good faith compliance with the rules is, however, a defense.

F. No Private Cause of Action

The new rules state that they do not create a new private right of action. The authority to enforce the rules rests exclusively with the Commission.

III. Noisy Withdrawal Provisions

Because of the controversy surrounding the proposed “noisy withdrawal” provision of the new rules – requiring an issuer’s attorney in some circumstances to notify the Commission of concern over the issuer’s conduct – the Commission extended the comment period on this and related provisions that were originally included in proposed Part 205. The Commission found it necessary to continue to seek comment
because of the significance and complexity of the issues involved. The “noisy withdrawal” provision, proposed section 205.3(d), applies where an attorney reasonably believes an issuer has not responded appropriately to a material violation report.

The Commission has also proposed an alternative to the “noisy withdrawal” that would still require withdrawal, but would require the issuer, rather than the attorney, to disclose the situation publicly. Under this proposal, an issuer that has been notified of an attorney’s withdrawal must report the notice and the related circumstances on form 8-K, 20-F or 40-F, as applicable, within two days of receiving the attorney’s notice. (This proposal also proposes concomitant amendments to forms 8-K, 20-F, and 40-F.) The Commission also seeks comment on whether there are circumstances in which an issuer should be allowed to refrain from disclose an attorney’s written notice.

The Commission intends its proposals regarding “noisy withdrawal” to further the objectives of the up-the-ladder reporting requirement, and enhance investor confidence in the financial reporting process. The proposals are intended to deter attorney and issuer misconduct, and reduce its effect on issuers and shareholders. The Commission emphasizes, however, that the rule is not intended to discourage “zealous advocacy,” nor to discourage issuers from obtaining appropriate and effective legal advice.

A. **Noisy Withdrawal Procedures**

Proposed Section 205.3(d)(1) requires specific actions by an attorney who has not received an appropriate response to a material violation report, and who believes that such a violation is ongoing or about to occur. Under such circumstances, an attorney “retained by the issuer,” i.e., outside counsel, must:

1. Withdraw from representing the issuer, and indicate that the withdrawal is based on “professional considerations;”
2. Within one business day of withdrawing, notify the Commission in writing of the withdrawal, including that it was based on “professional considerations.”

3. Promptly disaffirm to the Commission any opinion, document, affirmation, representation or characterization, in a document filed with or submitted to the Commission, which the attorney has prepared or assisted in preparing, and which the attorney reasonably believes is or may be materially false or misleading.

Under such circumstances, an attorney “employed by the issuer,” i.e., in-house counsel, must do the following:

1. Within one business day, notify the Commission in writing of an intention to disaffirm an opinion, document, affirmation, representation or characterization, in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading; and

2. Promptly disaffirm to the Commission, in writing, the specific opinion, document, affirmation, representation, characterization, or the like.

Additionally, the CLO is required to inform any replacement attorney that predecessor counsel’s withdrawal was based on “professional considerations.”

An attorney is required to take similar steps when the reported material violation has already occurred.

B. Alternative Proposal to “Noisy Withdrawal”

As noted above, the Commission has proposed an alternative which omits the “noisy withdrawal” and disaffirmation requirements, and requires an issuer’s attorney to act only where the attorney reasonably finds substantial evidence that a material violation is ongoing or about to occur and is likely to cause substantial injury to the issuer.

Most significantly, section 205.3(e) of the alternative proposal requires an issuer – not its attorney – to notify the Commission within two business days of an attorney’s
withdrawal or failure to receive an appropriate response.\textsuperscript{70} (The Commission has proposed concomitant amendments to Forms 8-K, 20-F, and 40-F to enable such disclosures.)\textsuperscript{71} This alternative proposal requires an attorney to inform the Commission of his or her withdrawal if the issuer fails to do so.\textsuperscript{72}

Alternative proposed section 205.3(d) requires an outside attorney who has reported evidence of a material violation but not received an appropriate response to withdraw, and notify the issuer – not the Commission – in writing, that the withdrawal is based on “professional considerations.” An in-house attorney is similarly required to cease participation in any matter concerning the violation, and to notify the issuer, in writing, of the absence of an appropriate response.\textsuperscript{73} This alternative proposal does \textit{not} require a withdrawing attorney to notify, or disaffirm documents filed with, the Commission.\textsuperscript{74}

\textbf{C. Comments and Criticisms regarding the “noisy withdrawal provision”}

Most of the comments submitted on the “noisy withdrawal” provisions strongly oppose it. They argue that provision goes “beyond the mandate of Sarbanes-Oxley,”\textsuperscript{75} and express a general concern that the “noisy withdrawal” provision will negatively affect the attorney-client relationship.\textsuperscript{76}

The American Bar Association’s comment provides the most thorough and instructive criticism:

Providing notice to the SEC that the attorney has withdrawn "for professional considerations" and disaffirming specific documents will have a similar effect as a violation of client confidences, and may itself be a violation of the attorney's duties to the client under state court rules, because it will promptly trigger an enforcement investigation and potentially civil lawsuits. As a consequence, some issuers might not even consult qualified attorneys regarding close issues of whether or not to disclose information in a filing or otherwise because the attorney might engage in a noisy withdrawal even though all that may have been involved was a matter of business judgment as to the materiality of certain information.
Moreover, mandating withdrawal and disaffirmance removes the flexibility that lawyers need in order to have time to counsel their corporate clients effectively. In some instances, premature withdrawal and disaffirmance of documents might seriously and unfairly harm the issuer and its shareholders or create disruption in the market for issuer's securities, when more time spent with managers or expert advisers might have avoided the need for the attorney to employ so extreme a measure. Such consultations also may prove the attorney to be wrong in believing any material violation will occur. Indeed, one wonders whether noisy withdrawal is not an undesirable, costly and unnecessary supplement to reporting up-the-ladder as specifically required by Section 307 of the Act.

The proposed Section 307 rules provide that they preempt the professional conduct rules of the states. The proposed withdrawal/disclosure standards are, however, sure to increase the attorney's exposure to civil liability if the attorney discloses client confidences or otherwise violates a duty to the client under the state court's rules in the mistaken belief that noisy withdrawal is mandated or permitted under the standards of the Section 307 rules. We discuss the issues regarding attorney-client privilege and confidentiality in more detail in Part VII below.

The noisy withdrawal proposal focuses principally (although not entirely) on the conduct of individual attorneys. Unclear, however, is how the noisy withdrawal rules would operate when either the same firm handles many matters for the issuer or when a large multinational corporation is represented on multiple matters by many lawyers in a firm from offices in several states and foreign jurisdictions. For example, must the firm withdraw from representing the multinational corporation in all the different matters it is currently handling for the large multinational corporation when the rules call for noisy withdrawal in one matter? Even if the Section 307 rules do not so require, the applicable rules of professional conduct may require withdrawal from all matters because the noisy withdrawal and disaffirmance and its consequences might create such adversity between the law firm and its clients as to result in an impermissible conflict of interest. The problems law firms may face is discussed in greater detail in Part XI below.

Under these circumstances, we urge that the Section 307 rules omit any standards for either mandatory or permissive withdrawal. They should instead on the lawyer conduct rules adopted by the applicable state courts to govern proper lawyer conduct before the SEC. 77

Commentators also argue that the “noisy withdrawal” provision is unnecessary because the “up the ladder” rules ensure that material violation reports will be adequately disseminated. 78 Other comments observe that a noisy withdrawal will be ineffective
when the CEO and the Board of Directors go along with one another’s decisions, and when the corporate attorneys are “being paid to look for loopholes in the law” to effectuate the Board’s requests. Another commentator proposed that the Commission issue a simple rule, requiring issuers’ attorneys to make quarterly certifications that no advice has been given on any matter that might create a conflict of interest between management and stockholders.

Judging by the sheer number of negative comments regarding the “noisy withdrawal” provisions and the strong language used in these comments to oppose the provisions, it seems unlikely that the Commission will require a true noisy withdrawal, but will more likely adopt less stringent measures. In any event, attorneys who practice before the Commission should stay tuned in awaiting the Commission’s final decision regarding “noisy withdrawal.”

IV. Attorney Conduct Checklist

✓ Remember – your client is the corporate entity, not the officers, directors, or employees with whom you regularly work.

✓ Set up a QLCC, or designate an existing committee as the corporation’s QLCC. The QLCC must consist of at least one member of the audit committee or an equivalent committee of independent directors, and two or more independent board members. They are responsible for recommending that the corporation implement an appropriate response to evidence of a material violation.

✓ Report evidence of a material violation to the CLO. The CLO (or the CEO) must then investigate and determine whether a material violation has occurred, is ongoing, or is about to occur. If the CLO finds a material violation, he or she must adopt an appropriate response and must advise the reporting attorney of the intended response. Alternatively, the CLO can refer a report of evidence of a material violation to a QLCC instead of investigating personally. In that case, the CLO must inform the reporting attorney that the matter has been referred to the QLCC.
Preferably, report evidence of a material violation to the QLCC. Instead of reporting evidence of a material violation to the CLO or the CEO, an attorney may also report to the QLCC or other similar committee. An attorney who chooses this method is relieved of all further reporting obligations. The QLCC becomes responsible for notifying the CLO, investigating, determining what remedial measures are appropriate, reporting the results of the investigation to the CLO, the CEO and the full Board of Directors, and notifying the Commission if the corporation fails to take any of the appropriate remedial measures.

Report evidence of a material violation to the audit committee or the full board of directors if the CLO or the CEO does not respond. Additionally, if the attorney believes it would be futile to report to the CLO or CEO, the attorney may go directly to the audit committee or the full board of directors.

An attorney does not have to report evidence of a material violation if:

- The attorney was retained by the corporation’s CLO to investigate evidence of a material violation, the attorney reports the results of the investigation to the CLO and the CLO reports the results to the QLCC or some other similar committee.
- The attorney was retained to assert a defense on behalf of the corporation in an investigation or other formal proceeding, if the CLO reports to the QLCC on the progress and outcome of the proceeding.
- The attorney was directed or retained by a QLCC to investigate evidence of a material violation, or to assert a defense on behalf of the corporation.

Once an attorney receives an appropriate response to a report of evidence of a material violation, he or she has no further obligation with respect to that report.

Reveal information related to the corporate representation when necessary to prevent the issuer from committing a material violation likely to injure the issuer or investors, to prevent the corporation from committing an illegal act, and to rectify the consequences of a material violation or illegal act in which the attorney took part. The attorney may also reveal such information to defend against charges of attorney misconduct.

Supervising attorneys must comply with the reporting requirements when a subordinate attorney reports evidence of a material violation to the supervising attorney.

Subordinate attorneys must similarly comply with the reporting requirements.

Under “noisy withdrawal” (outside counsel) – if an outside attorney does not receive an appropriate response to a material violation report and believes that such a violation is ongoing or about to occur, that attorney must:
Under “noisy withdrawal” (in-house attorneys) – under the above circumstances, an attorney “employed by” the corporation must:

- Notify the Commission in writing that he or she intends to disaffirm some opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission; and
- Promptly disaffirm such opinion, document, affirmation, representation, characterization, or the like.

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2 Id.

3 Id.


5 Id., citing remarks by Senator John Edwards, 148 Cong. Rec. S6552 (July 10, 2002) (“This amendment is about making sure those lawyers, in addition to the accountants and executives in the company, don’t violate the law and, in fact, more importantly, ensure that the law is being followed. ***If you find out that them managers are breaking the law, you must tell them to stop. If they won’t stop, you got to the board of directors, which represents the shareholders, and tell them what is going on. If they won’t act responsibly and in compliance with the law, then you go to the board and say something has to be done; there is a violation of the law occurring. It is basically going up the ladder, up the chain of command. ***This amendment acts in a very simple way. It basically instructs the SEC to start doing exactly what they were doing 20 years ago, to start enforcing this up-the-ladder principle.” See also id. at S6555 (comments by Senator Enzi) (“When their counsel and advise is sought, attorneys should have an explicit, not just an implied, duty to advise the primary officer and then, if necessary, the auditing committee or the board of directors of any serious legal violation of the law by a corporate agent. Currently, there is no explicit mandate requiring this kind of conduct. It is clearly in the best interest of their client to disclose this type of information”) and S6556 (comments by Senator Corzine) (“The bottom line is this. Lawyers can and should play an important role in preventing and addressing corporate fraud. Our amendment seeks to ensure that. It seeks to go back to the old way: when lawyers know of illegal actions by a corporate agent, they should be required to report the violation to the corporation.”).

6 Id.


Id.

Id.

Id.

Id.

Id.

Id. (to be codified at 17 C.F.R. pt. 205.2(e)).

Id.

Id.

Id. (to be codified at 17 C.F.R. pt. 205.3(b)(1)).

Id.

Id.

Id. (to be codified at 17 C.F.R. pt. 205.3(b)(2)).

Id.

Id.

Id.

Id.

Id. (to be codified at 17 C.F.R. pt. § 205.3(c)).

Id. (to be codified at 17 C.F.R. pt. 205.3(b)(2), (c)).

Id.

Id.

Id. (to be codified at 17 C.F.R. pt. 205.3(b)(3)).

This is true for both the final rules and the proposed and alternative “noisy withdrawal” provisions.

61 Id.

62 Id.

63 Id.

64 Id.

65 Id.

66 Id. (to be codified at 17 C.F.R. pt. 205.3(d)(1)).

67 Id.

68 Id. (to be codified at 17 C.F.R. pt. 205.3(d)(2)).

69 Id.

70 Id.

71 Id.

72 Id.

73 Id.

74 Id.

75 See e.g., Comment submitted by Cynthia A. Glassman, Commissioner of Securities Industry Association ("SIA"), regarding Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys.

76 See e.g., Comment submitted by Skadden, Arps, Slate, Meagher & Flom LLP, regarding Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys.


IV. Developing Trends in the Organizational Guidelines
V. The Criminal Provisions of the Sarbanes-Oxley Act

A. The Act’s criminal provisions may be found at:

1. Title VIII – Corporate and Criminal Fraud Accountability Act of 2002
3. Title XI – Corporate Fraud Accountability Act of 2002

B. The criminal provisions of the Act have three purposes:

1. Creating new federal criminal offenses;
2. Increasing penalties for existing criminal offenses; and
3. Mandating that the U.S. Sentencing Commission review and amend the Sentencing Guidelines to ensure that penalties and enhancements are sufficient to deter and punish the criminal activity addressed by the Act.

II. New Provisions

A. Title VIII, § 802 created 18 U.S.C. § 1519, “Destruction, alteration, or falsification of records in Federal investigations and bankruptcy.”

1. 18 U.S.C. § 1519 provides: Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object 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, or in relation to or
contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.

2. While document destruction with the intent to impede an investigation is already an offense under 18 U.S.C. § 1505, the new statute extends to “contemplated” investigations. The language is broad enough potentially to cover the destruction of a company’s documents years before a civil or even administrative investigation occurs as long as the company’s activities are “administered” in some way by an agency of the federal government.

3. The statute does not appear to require any specific intent or knowledge by the defendant that the “investigation” or “administration” being influenced was within a particular, or any, department’s or agency’s jurisdiction.

4. The statute does not require a willful or corrupt state of mind thereby relieving prosecutors from proving that the defendant violated a known legal duty.

B. Title IX, § 1102 created “Tampering with a record or otherwise impeding an official proceeding.

1. Inserted at 18 U.S.C. § 1512(c), the offense provides that:

   (c) Whoever corruptly –

   (1) alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object’s integrity or availability for use in an official proceeding; or

   (2) otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so,

   shall be fined under this title or imprisoned not more than 20 years, or both.

2. The amendment expands the existing statute by eliminating the requirement that one who obstructs or impedes an official proceeding or alters documents must corruptly persuade another person to do so.
3. Neither the amendment nor the current statute requires that an official proceeding be pending or about to be instituted at the time of the obstructive conduct.

C. Title VIII, § 802 created a new statute, 18 U.S.C. § 1520, entitled “Destruction of corporate audit records.”

1. 18 U.S.C. § 1520 provides:

(a)(1) Any accountant who conducts an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j-1(a)) applies, shall maintain all audit or review workpapers for a period of 5 years from the end of the fiscal period in which the audit or review was concluded.

(2) The Securities and Exchange Commission shall promulgate, within 180 days, after adequate notice and an opportunity for comment, such rules and regulations, as are reasonably necessary, relating to the retention of relevant records, such as workpapers, documents that form the basis of an audit or review, memoranda, correspondence, communications, other documents, and records (including electronic records) which are created, sent, or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit or review, which is conducted by any accountant who conducts an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j-1(a)) applies. . .

(b) Whoever knowingly and willfully violates subsection (a)(1), or any rule or regulation promulgated by the Securities and Exchange Commission under subsection (a)(2), shall be fined under this title, imprisoned not more than 10 years, or both.

(c) Nothing in this section shall be deemed to diminish or relieve any person of any other duty or obligation imposed by Federal or State law or regulation to maintain, or refrain from destroying, any document.

2. While the statute provides that audit and review workpapers must be maintained for five years regardless of any other provision of law, the SEC rule implementing the statute extends the retention period to seven years.
3. The willfulness requirement requires proof of an intentional violation of a known legal duty.

4. In Release No.'s 33-8180 and 34-47241, the SEC promulgated the final rule implementing in Release No.'s 33-8180 and 34-47241 802 at 17 C.F.R. Part 210, by adding Rule 2-06 to Regulation S-X. The rule is effective March 3, 2003, and compliance is required for audits and reviews completed on or after October 31, 2003.

5. The final rule requires that the auditor retain records relevant to the audit or review, including workpapers and other documents that form the basis of the audit or review of an issuer's financial statements, and memoranda, correspondence, communications, other documents, and records (including electronic records) that meet two criteria: (1) are created, sent or received in connection with the audit or review, and (2) contain conclusions, opinions, analyses, or financial data related to the audit or review.

6. The rule explains that "workpapers" means "documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement, as required by standards established or adopted by the Commission or by the Public Company Accounting Oversight Board."

7. The rule states that non-substantive materials that are not part of the workpapers, such as administrative records, and other documents that do not contain relevant financial data or the auditor's conclusions, opinions or analyses would not meet the second of the criteria and would not have to be retained. The following records generally would not fall within the scope of the rule provided they do not contain information or data, relating to a significant matter, that is inconsistent with the auditor's final conclusions, opinions or analyses on that matter or the audit or review: (a) superseded drafts of memoranda, financial statements or regulatory filings; (b) notes on superseded drafts of memoranda, financial statements or regulatory filings that reflect incomplete or preliminary thinking; (c) previous copies of workpapers that have been corrected for typographical errors or errors due to training of new employees; (d) duplicates of documents, or (e) voice-mail messages. However, the rule requires the retention of an
item in this list if that item documented a consultation or resolution of differences of professional judgment.

D. Title VIII, § 807 created a new general securities fraud statute, 18 U.S.C. § 1348, entitled “Securities fraud,” which provides that:

1. Whoever knowingly executes, or attempts to execute, a scheme or artifice –

   (1) to defraud any person in connection with any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. § 78l) or that is required to file reports under Section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. § 78o(d)); or

   (2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. § 78l) or that is required to file reports under Section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. § 78o(d)); shall be fined under this title, or imprisoned not more than 25 years, or both.

2. Securities fraud has long been an offense under the Securities Exchange Act, but § 1348 eliminates the requirements that a securities law violation be willful and “in connection with the purchase or sale” of securities. Thus § 1348 dispenses with the cumbersome requirement to explain in an indictment or in the prosecutor’s case-in-chief the entire federal securities regulatory regime.

3. § 1348 requires proof of a knowing execution of a scheme to defraud and a specific intent to defraud. The statute reaches defrauding of investors as well as regulators.

E. Title IX, § 902 created 18 U.S.C. § 1349, entitled, “Attempt and conspiracy,” which provides:

1. Any person who attempts or conspires to commit any offense under this chapter shall be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy.
2. Chapter 63 of Title 18 now covers mail (30), wire (30), bank (30), healthcare (10) and securities fraud (25). The maximum sentence for a conspiracy to violate each offense is now pegged to the maximum sentence for each underlying offense, as reflected by the parenthetical numbers above.

F. Title IX, § 906 created a new statute, 18 U.S.C. § 1350, covering “Failure of corporate officers to certify financial reports.”

1. The statute provides:  
   (a) Certification of Periodic Financial Reports – Each periodic report containing financial statements filed by an issuer with the Securities Exchange Commission pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. § 78m(a) or § 78o(d)) shall be accompanied by a written statement by the chief executive officer and chief financial officer (or equivalent thereof) of the issuer.

   (b) Content – The statement required under subsection (a) shall certify that the periodic report containing the financial statement fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. § 78m(a) or § 78o(d)) and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

   (c) Criminal Penalties – Whoever – (1) certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $1,000,000 or imprisoned not more than 10 years, or both; or (2) willfully certifies any statement set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $5,000,000, or imprisoned not more than 20 years, or both.

2. Prior to creation of this statute, no federal criminal provision explicitly covered false certifications to the SEC by a CEO or CFO. §1350 does not require any actual or
intended effect on stock prices or any actual or intended pecuniary gain by the CEO or CFO.

3. Whether charged with a knowing or willful violation, a CEO or CFO may still argue that he or she committed no crime because he or she was misled and deceived by others in making his certification, although the more detailed certification required by the Act’s § 302, particularly the certification regarding disclosure controls, may make such a defense tenuous.


1. 18 U.S.C. § 1513(e), provides:

   (e) Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.

2. The statute requires that the whistleblower provide “truthful” information to a “law enforcement officer” suggesting that it does not include within its scope retaliation against a whistleblower who provides information to a regulatory official, or merely threatens to go to law enforcement authorities.

3. The statute requires that the whistleblower’s information be truthful. Consequently, it may be a defense to the statute that the defendant reasonably believed that the whistleblower’s information was untruthful. On the other hand, it is unlikely that a prosecutor must prove as an element of the offense that the information was truthful.

4. § 1513(e) should not be confused with Title VIII, § 806 of the Act, 18 U.S.C. § 1514A, which provides certain civil protections for whistleblowers in publicly traded companies. Under § 806, as long as the whistleblower reasonably believes that the corporate conduct at issue violates securities laws or regulations or federal fraud-related criminal statutes, he or she cannot be subject to
III. Amendments to Existing Provisions

A. Title IX, § 904 amended 29 U.S.C. § 1131, which prohibits willfully violating the reporting and disclosure requirements concerning employee benefit plans under the Employee Retirement Income Security Act (ERISA).

1. Under 18 U.S.C. § 1131, the maximum prison sentence is increased from one to ten years, the maximum individual fine is increased from $5,000 to $100,000, and the maximum fine for entities is increased from $100,000 to $500,000.

2. Violation of § 1131 is now a felony rather than a misdemeanor, implicating the alternative fine provision of 18 U.S.C. § 3571, which makes an individual liable for a maximum fine of $250,000 and an entity for a maximum fine of $500,000, and makes both an individual and entity liable for the maximum fine or twice the pecuniary gain or loss caused by the crime, whichever is greater.

B. Title XI, § 1106 amended the Securities Exchange Act of 1934 by increasing the maximum term of imprisonment for individuals from 10 years to 20 years and the maximum fine for individuals from $1,000,000 to $5,000,000 and for entities from $2,500,000 to $25,000,000.

IV. Enhancing Federal Sentencing Guidelines

A. In §§ 805, 905 and 1104, the Act mandates the United States Sentencing Commission to review and amend, as appropriate, the federal sentencing guidelines and related policy statements concerning certain offenses to ensure that penalties and enhancements are adequate to deter and punish the conduct addressed in the Act.

1. Offenses examined include: obstruction of justice, including the newly created offenses in § 802 relating to destruction of documents; fraud endangering the financial security of a “substantial number of victims”; certain white-collar offenses discussed in Title IX of the Act; and securities and accounting fraud, including fraud by officers and directors of publicly traded companies.
2. The Sentencing Commission was also directed to examine sentencing guidelines applicable to organizations.

B. On January 8, 2003, the Sentencing Commission approved an emergency amendment to the Sentencing Guidelines that implements the various congressional directives and significantly increased penalties for corporate crime and serious fraud and obstruction of justice offenses. The effective date of the emergency amendment was January 25, 2003. The temporary amendment expires on November 1, 2003, when a permanent amendment becomes effective. The Sentencing Commission plans to submit the permanent amendment for congressional review on or before May 1, 2003.

C. A detailed description of the emergency amendment and the factors considered by the Commission may be found in the U.S. Sentencing Commission Report to Congress (January 2003) at <http://www.ussc.gov/r_congress/S-Oreport.pdf>.

D. Sentencing Commission Emergency Amendment

1. Expanded the existing enhancement at §2B1.1(b)(2) (covering theft, property destruction, and fraud) by providing an additional two level increase, for a total of six levels, if an offense involved 250 or more victims. A six level enhancement approximately doubles the term of imprisonment under the guidelines.

2. Expanded the existing enhancement at §2B1.1(b)(12)(B) by adding two additional prongs that would trigger the four level enhancement and a minimum offense level of 24 if an offense substantially jeopardized the safety and soundness of a financial institution.

a. One new prong applies to offenses that substantially endanger the solvency or financial security of an organization that at any time during the offense was a publicly traded company or had 1,000 or more employees, including filing for bankruptcy, substantially reducing the value of the company’s stock, and substantially reducing the company’s workforce.
b. The second new prong applies to offenses that substantially endanger the solvency or financial security of 100 or more victims, regardless of whether a publicly traded company was affected by the offense.

3. Provided a new four level enhancement at §2B1.1(b)(13) that applies if the offense involved a violation of securities law and, at the time of the offense, the defendant was an officer or director of a publicly traded company.

4. Expanded the loss table at §2B1.1(b)(1) to punish more severely offenses that cause catastrophic losses of magnitudes such as the recent corporate scandals. The amendment adds two additional loss amount categories to the table: an increase of 28 levels for offenses in which the loss exceeded $200 million, and an increase of 30 levels for offenses in which the loss exceeded $400 million. The impact on a defendant’s sentence is significant. A defendant who causes a loss more than $400 million sees his or her sentence rise from 121 to 151 months to 188 to 235 months.

5. The sentencing enhancements added to §2B1.1 result in significantly increased fines for many corporate and other organizational defendants, as those enhancements are used to calculate the base fine for an organization under Chapter Eight.

6. Two significant modifications were made to §2J1.2 (Obstruction of Justice).

   a. Increases the base offense level applicable to all defendants sentenced under §2J1.2 from level 12 to 14.

   b. Adds a two-level enhancement if the offense involved (1) the destruction, alteration, or fabrication of a substantial number of records, documents or tangible objects; (2) the selection of any essential or especially probative record, document or tangible object to destroy or alter; or (3) otherwise extensive in scope, planning or preparation.
7. Modified §2E5.3 (False statements and Concealment of Facts in Relation to Documents Required by ERISA; Failure to Maintain and Falsification of Records Required by the Labor Management Reporting and Disclosure Act).

a. The Commission determined that the base offense level of six provided by §2E5.3 is insufficient in cases in which document destruction was intended to facilitate an obstruction of justice offense and in such cases cross-references §2J1.2.

b. Although §2E5.3 references the ERISA violations referenced in § 904 of the Act, the Commission determined that criminal violations of ERISA that are committed to facilitate a fraud are more appropriately sentenced under §2B1.1, which provides significantly greater penalties. The cross reference to §2B1.1 also includes cases involving a bribe or gratuity by including §2E5.1 (Offering, Accepting, or Soliciting a Bribe or Gratuity Affecting the Operation of an Employee Welfare or Pension Plan; Prohibited Payments or Lending of Money by Employer or Agent to Employees, Representatives, or Labor Organizations).

E. Organizational Guidelines

1. Section 805 of the Act directed the Commission to “review and amend, as appropriate, the Federal Sentencing Guidelines and related policy statements to ensure … the guidelines that apply to organizations in United States Sentencing Guidelines, chapter 8, are sufficient to deter and punish organizational criminal misconduct.”

2. In its report to Congress, the Commission notes that “Substantial fine penalties comprise an important component of the punishment of organizational misconduct under Chapter Eight” and that the emergency amendment to the Guidelines pursuant to the Act “are expected to result in significantly increased fines for organizational misconduct because of the longstanding operational relationship between Chapter Two and the Chapter Eight fine calculations.” This is particularly the case for fraud and related offenses. For example, prior to the
amendment a publicly traded company convicted of securities fraud which involved more than 250 victims and $1.2 million in loss, and which was committed by an officer or director of the company, would receive a base fine under §8C2.4 of at least $3.7 million. Under the amendment, the base fine would be increased to at least $17.5 million.

3. The Commission’s Report states that the general criminal fine statute, 18 U.S.C. § 3751, which provides a maximum fine for organizations of $500,000 or twice the gross gain or loss resulting from the offense, unless a greater fine is specified by the particular statute of conviction, was not increased by the Act. As a result, the Commission declined to amend the guideline fine provisions for organizations beyond the increases provided by the operation of the underlying Chapter Two guideline.
VI. Speaker Biographies
David Axelrod

Mr. Axelrod is a partner in the White Collar Defense Group of Vorys, Sater, Seymour and Pease LLP, with offices throughout Ohio and in Washington, D.C. He practices in the areas of corporate compliance, and the representation of corporations and individuals in complex civil and criminal cases. Mr. Axelrod is a former Assistant U.S. Attorney and Trial Attorney for the Tax Division of the U.S. Department of Justice, and has served as a special prosecutor for the State of Ohio. Mr. Axelrod has frequently served on the faculties of the ABA National Institutes on White Collar Crime and Criminal Tax Fraud. He is a member of the Practitioners Advisory Group to the U.S. Sentencing Commission, has testified before the Commission, and is the immediate past chair of the ABA Tax Section Committee on Civil and Criminal Tax Penalties. He is the author of many published articles on topics related to his practice, and is listed in Who’s Who in American Law.
Anthony Boone

Anthony Boone was named Associate General Counsel – Compliance and Regulatory Matters, Sears, Roebuck and Co. in December 1999. His day-to-day duties and responsibilities include overseeing regulatory complaints and inquiries from federal, state and local agencies for this Fortune 500 company. Anthony joined Sears in 1974, assuming the responsibility for Workers’ Compensation and Public Liability matters for Sears’ Midwest Territory Law Department in Skokie, Illinois. In 1981, Anthony transferred to Sears’ headquarters at Sears Tower, Chicago, Illinois and worked in a variety of assignments including Litigation (products liability defense) and Transactional Matters. Sears relocated its current Headquarters to Hoffman Estates, Illinois in 1992. Anthony’s primary focus remained transactional matters until 1996 when he was named Vice President/General Counsel and Secretary for Western Auto Supply Company, a Sears’ subsidiary located in Kansas City, Missouri. He graduated from The Ohio State University College of Law, Columbus, Ohio in 1974 and holds his B.A. from Elmhurst College in Elmhurst, Illinois.
Kenneth V. Handal
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Altria Corporate Services, Inc.
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Mr. Handal currently serves as counsel to the enterprise-wide Compliance and Integrity program at Altria Group, Inc. Altria is the parent company of Kraft Foods, Inc., Philip Morris International and Philip Morris U.S.A. He joined the company in 1996 as Associate General Counsel in litigation.

Prior to joining the company, Mr. Handal was a partner in the New York office of Arnold & Porter, where his practice consisted primarily of litigation and white-collar defense. Before that, Mr. Handal was an Assistant United States Attorney in the Criminal Division of the U.S. Attorney for the Southern District of New York.

Mr. Handal received an A.B. from Georgetown University in 1970 and his J.D. from The University of Chicago Law School, where he was the Managing Editor of the Law Review. After law school, he was a law clerk for Judge Robert A. Ainsworth of the U.S. Court of Appeals for the Fifth Circuit, in New Orleans, Louisiana.
Lisa A. Kuca is the Director of Corporate Compliance for Corporate Integrity Services (CIS). She is responsible for the development and implementation of corporate compliance programs, compliance software and web-based compliance solutions. Additionally, Ms. Kuca coordinates and manages compliance-related audits, reviews and internal investigations. Due to her extensive experience with the Federal Sentencing Guidelines, she also assists white-collar defense attorneys with criminal sentencing matters.

Prior to joining CIS, Ms. Kuca was a Manager in Ernst & Young’s Litigation Advisory Services, where she specialized in the design and execution of compliance programs, as well as conducted traditional litigation support services. Before joining Ernst & Young, she was the President of Sentencing Specialists, Inc. and offered consulting services on the Federal Sentencing Guidelines to white collar defense attorneys. Formerly a U.S. Probation Officer in the Southern District of Florida for nearly a decade, she acquired comprehensive knowledge of the Federal Sentencing Guidelines, which impose stringent corporate compliance requirements that apply to every industry.

Ms. Kuca has applied the Federal Sentencing Guidelines in over 400 complex cases, including healthcare, securities, insurance, bank, government procurement, and tax frauds. She has also participated in cases involving antitrust, environmental offenses, money laundering and public corruption, and has experience with criminal violations of the customs and labor laws.

Ms. Kuca served on the faculties of the American Bar Association’s 1997, 2000 and 2001 National Institutes on White Collar Crime, participated in programs dealing with corporate compliance, and co-authored a related article about the Organizational Guidelines. Her published articles include:


Ms. Kuca is one of 16 members of the U.S. Sentencing Commission's Ad Hoc Advisory Group on Organization Guidelines and its Practitioners Advisory Group. She received a Bachelor's in Sociology from Villanova University in 1987, with a concentration and certification in Criminal Justice, and is the recipient of the 1987 U.S. Achievement Academy Leadership Award.
SCOTT W. MACKAY

Scott W. MacKay is the Associate General Counsel for Litigation and Compliance at Lockheed Martin Corporation in Bethesda, Maryland. He is responsible for managing and conducting corporate litigation, including commercial litigation, as well as criminal and civil fraud matters, coordinating the Corporation's response to government investigations and requests for information, conducting internal investigations, and handling corporate compliance issues. Prior to joining Lockheed Martin in July 1995, Mr. MacKay was a senior trial attorney in the Fraud Section of the Department of Justice in Washington, D.C. At the Justice Department, Mr. MacKay investigated and prosecuted cases involving procurement fraud, violations of the Foreign Corrupt Practices Act, perjury before a grand jury, telemarketing fraud, public corruption, and fraud relating to classified contracts.
Developing Trends in the Organizational Guidelines

April 3 - 6, 2003

Lisa A. Kuca

Director of Corporate Compliance
CORPORATE INTEGRITY SERVICES LLC
Legal Compliance vs. Ethics Based Programs
Oversight

- “high-level oversight”
- “overall responsibility to oversee compliance”
Responsibility

- Board of Directors
- Governance
- Committees
Communication and Training

- Codes of Conduct
- Policies and Procedures
- Training
- Other communication
Reporting Systems

- anonymity vs. confidentiality
- Ombudsman vs. Compliance Officer
- fear of retribution
Audits

- financial vs. other
- independence
- frequency
Corrective Action

- internal investigations
- self reporting
Legislative and regulatory trends

- Sarbanes-Oxley
- NYSE
- Industry “best practices”
Balancing the “carrots and sticks”

- incentives for doing the right thing vs. enhancements for doing nothing