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NEXT ISSUE

POLICY AFTER NOVEMBER: WHAT THE WINNERS WILL DO

How Sarbanes-Oxley Creates a Management Dilemma

Q&A with David Wingfield

David R. Wingfield is a partner at WeirFoulds LLP, Toronto, and a senior member of WeirFoulds' litigation practice. He has been lead counsel on many high profile cases in Canada and has acted as co-ordinating counsel on major global litigation. He represented The Ravelston Corporation Limited (the parent company of the Hollinger Group) in its Canadian and U.S. litigation. He is a member of the Executive Counsel Editorial Advisory Board.

The U.S. case against Hollinger had its origins when the company's directors ordered an investigation of money paid to Lord Conrad M. Black, who controlled Hollinger. The directors, who'd been handpicked by Black, acted under threat of prosecution under the Sarbanes-Oxley statutes. They eventually sought repayment of money wrongly paid to Black and his associates.

Executive Counsel recently interviewed Wingfield about Sarbanes-Oxley and related matters.

Executive Counsel: Sarbanes-Oxley has been on the books for five years now, and you've had some personal experience in a case in which that law played a central role. What lessons have we learned about Sarbanes-Oxley?

David R. Wingfield: It was enacted to improve financial reporting and corporate governance, and to make non-compliance more onerous. Worthy goals, certainly. Nevertheless, it creates problems for corporations that want to do things right, because it achieves its regulatory objectives by limiting choice.

For example, the 404 reporting requirements call for the CEO and the CFO to certify that there are no material errors in the financial reports, and the internal controls are such that if there were they'd be discovered. At the same time, the auditors are required to tell the SEC if they have reason to believe there's a problem with the company's controls.

So if management has legitimate questions about its own control standards that it wants to direct to its professional advisors, they are raising those questions with someone who is required to blow the whistle. The simple act of examining procedures with an eye to improving them can result in an adverse report, and a whole host of liability problems.

EC: Who decides whether the internal controls are adequate?

Wingfield: That's another challenge. Sarbanes-Oxley itself doesn't establish any rules. In practice, the rules that management selects are the ones that the auditors use. But the audit function and the control function within a corporation are very different things.

Control is designed to insure that corporate money is accounted for internally, that the people who handle money are not engaged in anything improper – fraud for example – and that the financial reports the corporation regularly produces to keep track of itself are accurate. The auditor's job is to certify to investors that the financial statements the company releases publicly are accurate. They do that by testing the veracity of the numbers management gives them.

Sarbanes-Oxley heightens the managers' duty to make sure their numbers are good, and it heightens the auditors' duty to report any problems they see with the control system and the numbers it yields. In many cases what has happened is that auditors' reports have led to significant restatements, which have led to lawsuits.

As a manager, if you have real questions, you're put in the position of either not asking or putting in motion a process that leads to a lawsuit. That's a major challenge created by the law.

EC: Is the certification of the financials by senior executives that we hear so much about couched in some required form or do the companies write it themselves?

Wingfield: It isn't a form in the sense that the government has provided the language, but the statements are more or less identical because they address the concepts that are imposed under Sarbanes-Oxley.

EC: So you can't fudge it? You can't say, for example, "We're doing our best, but our internal standards are a work in progress and some of these securities we're holding might not be worth what the ratings companies said they were"?

Wingfield: No, you don't have that choice.

EC: We often hear that Sarbanes-Oxley puts a greater burden on small publicly traded companies relative to large ones. Do you think that's true?

Wingfield: Yes. Look at something as evident as the concept that self-dealing is bad, no matter what size the company. That's certainly true, but in small corporations it's difficult to make a decision without having someone with a stake in that decision being in on it.

EC: What other challenges does the law pose for corporations that may not be engaged in wrong-doing?

Wingfield: It's made it difficult for officers and directors to fulfill their normal corporate mandates. For example, the law requires publicly traded corporations to have an audit committee composed mostly of independent directors, and gives that committee special powers to hire auditors and supervise them.

So it has an enhanced set of powers and obligations, and it needs a budget to hire auditors, and to get legal advice as well. The corporate laws in the United States and in Canada put the board of directors in charge of the managers, but Sarbanes-Oxley sets the audit committee up as in effect a super-board. It functions in many ways like the management it is supposed to supervise. That puts them in a very difficult position.

EC: Of course you know there is a perception among many investors, and in the general public, that the laws aren't tough enough, because Wall Street always finds a way to game the system.

Wingfield: Well, in a sense that observation is correct. There is a long list of public companies that engaged in significant malfeasance in the past decade: Tyco, Qwest, WorldCom, HealthSouth, Hollinger, Enron and many others. On top of that you have the problems at the brokerages, and the backdating of options.

So there's certainly a problem, and Sarbanes-Oxley as a matter of principle is not a bad thing. Something like it was required to maintain confidence in the capital markets. But that doesn't alter the fact that if you are the manager of a company it creates some real problems, and it makes it difficult to get the kind of outside professional advice you need without making more problems.

EC: What difficulties does it create if the problems are criminal?

Wingfield: Serious ones. They arise out of chapter eight of the federal sentencing guidelines for organizations and Section 304 of Sarbanes-Oxley. Chapter eight rewards companies that have committed criminal wrongdoing for self-reporting and for cooperation.

The DOJ circulated two memos about those provisions. The Thompson memo was interpreted to mean that unless corporations waive privilege and refuse to honor indemnity obligations for employees accused of wrongdoing they will be deemed uncooperative. McNulty softened that but didn't eliminate it, so it puts officers and directors in a bind. It will be in the corporation's interest to cut them loose if they are accused of wrongdoing, so it seriously affects the kind of contractual protections that they can rely on when they make tough decisions.

Right now it's very difficult for a company not to mollify the shareholders by throwing executives overboard. There's a conflict between the duty to maximize value for shareholders and the duty to honor contractual obligations made to officers, directors and managers.

EC: We're now going through the so-called liquidity crisis. Is that another regulatory failure?

Wingfield: People seem to look at it as either that or a failure of governance. I don't see it that way. I think it is mainly a market failure. Global economics has operated to reduce the risk premium that ought to be paid for financial investments. There is a lot of money chasing places to invest, and that has driven down the premium the money demands.

Now, real risk has come to light, but that is a macro-economic phenomenon that won't be solved by additional regulation. People borrowed money at relatively low interest and put assets up as collateral. Mortgages and real estate, for example. Those asset-backed paper obligations were packaged up and sold to people who want the underlying income stream those borrowers pay. Each of them is making the assumption that the risk-adjusted rate of return is better with that investment than it is in a T-Bill. It's a bet, really, that the interest premium is worth the risk of default.

Over the past decade the amount of interest demanded over that of a T-Bill has been very low, but the risk they're assuming for that slight increase is great. In my opinion that happened because the world economy is growing, a good thing, and the flow of capital is so free – another good thing – and there are huge sums of money in China and the oil producing countries looking for a place to invest. Money supply is great, demand is low. Thus low interest, generally, and a low risk premium.

EC: Wasn't there some error in valuation?

Wingfield: Yes, the rating agencies seem to have overstated the underlying quality of some of these investments. The whole thing, after all, is dependent on an accurate risk assessment. If people want to go ahead and take a chance even if they know the risk is high, that's one thing. If they're told the risk is low it's another.

That's a source of potential liability, because there is something troubling about taking a whole lot of assets that are not investment grade, pooling them together, and presto, they're investment grade. That is where you might find a regulatory failure or possible malfeasance.

EC: In view of the things we've discussed, do you think the global economy is well-served by Wall Street?

Wingfield: Yes. The biggest challenge is the belief that there has to be greater restraints on the operation of the free market – more regulation if you will. The U.S. is rich because it has the world's freest economy. It's the best free-trading country. It has the world's freest capital markets. It has tried to have a light regulatory framework for these things.

Sarbanes Oxley probably is not a long term problem for the States because increasing the quality of financial reporting and the transparency of business organizations is a good thing. It makes people who have been a little skittish about parking their money in the United States more confident. The bigger issue is the attempt to control the market in which these companies operate. Wall Street dominates that market and it needs to have the freedom to operate successfully.

“Sarbanes Oxley sets the audit committee up as in effect a super-board.”

EC: Do you think the repeal of Glass-Steagall was a good thing?

Wingfield: I do. The U.S. merchant banks are really good at figuring out how to make money investing, the last two years notwithstanding.

The problem is that the global need for capital was greater than they could supply. They needed to go to the banks that were under the Glass-Steagall restraints to access that pool of capital. Before the Act was repealed they'd figured out many ways to do that, but they were inefficient ways. Repeal simply allowed that capital to be deployed efficiently.