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Sarbanes-Oxley's Subtle Disclosure Costs

Criticism of the high costs of the Sarbanes-Oxley Act of 2002 has focused primarily on its requirements related to internal controls over financial reporting. However, little attention has focused on the hidden costs of the Act, in particular the increased time and advisory sophistication required to comply with the complex, time-sensitive disclosure system it has brought about.

by Marc Morgenstern

The unexpectedly high expense of compliance with The Sarbanes-Oxley Act (Sarbanes-Oxley or SOX)[1] has generated considerable debate[2] about the cost-benefit of the legislation to public companies, investors, and the capital markets. The primary focus has been on direct, out-of-pocket, expenses such as accounting fees, Section 404[3] compliance expenses, and increases in directors' fees and D & O liability insurance premiums.[4] Concerns have also been expressed over increased costs that are less easily quantifiable (but that are nonetheless real and significant), including allocation of management time and resources, larger internal accounting staffs, and increasingly risk-averse boards whose time is spent avoiding liability rather than creating shareholder value.[5]

A more subtle cost in the new corporate governance environment is the rigor and sophistication required to comply with the increasingly "rapid and current" disclosures required by SOX and the SEC,[6] as reflected by the 2004 passage of the SEC's expanded, 8-K disclosure requirements (New 8-K Rules).[7] Taken together, SOX and the new rules have generally expanded the specific disclosures required to be made in periodic reports, press releases, and other disclosure documents. Significantly, the reforms have also accelerated the timeframe within which disclosure must be made. Faster response time (along with expanded reporting obligations) while arguably good for the overall market, also decreases the probability of successful compliance. Human error under time pressure increases the chance of disclosure error by a company, thereby increasing the risk of individual liability of its directors for failing to adequately oversee corporate disclosure.

Changing the Board Meeting Process to Respond to SOX

Further exacerbating the corporate pressures associated with expanded disclosure requirements and reduced timeframes for required disclosure, companies and boards have had to significantly modify their preparation for, and conduct and memorialization of, board meetings in order to meet the increased responsibilities and oversight demanded in today's markets.[8] A reasoned response to the changed environment is to improve the quality of the preparation period for board meetings, perform more extensive analyses, involve a broader range of the company's professional advisors in the planning and board process, and to document the resulting analyses and actions.

Overall, that's probably a good result. However, it also has the consequence of creating more disclosable information in a process whose importance is frequently minimized within traditional disclosure analysis. In other words, issuers and directors have not historically regarded board meetings as being a major precipitating event or link in the SEC *disclosure* chain. The intuitive legal view of board meetings and process is that the issue to focus on is corporate and director liability under substantive law (*i.e.*, Business Judgment Rule) rather than viewing this process as a key component immediately and dramatically impacting an issuer's public disclosure obligations.

The net impact of a changed role for the board process is increased costs for all public companies.

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Because of the real-time nature of this disclosure environment, there is a concern that only larger public companies can truly meet all their obligations. They generally have a deeper financial staff, and frequently employ an inside, disclosure-sensitive, general counsel who fits comfortably into an expanded disclosure environment and role. Smaller public companies, by their nature, frequently lack the internal (and sometimes external) legal and financial professional resources needed to meet expanded SEC and SOX obligations. They tend to rely on outside counsel for disclosure advice since they frequently do not have an inside general counsel.

The financial results of faster-growing, emerging growth, public companies, are often less predictable (and therefore more volatile) than for more mature public companies. The rate of change and growth may be less well-suited to satisfy a faster-moving, more-sophisticated, disclosure environment. Small changes in financial numbers can loom disproportionately large as percentages of revenues or profit, impacting materiality analyses. Less historical data, and smaller databases with which to compare the data, make trend analysis more difficult. Even relatively modest consequences (in terms of absolute dollars) of a customer sale being deferred from the end of one quarter to the beginning of the next requires a sensitive and thorough analysis and appropriate disclosure and can be more dramatic (and traumatic) for a smaller public company. As a consequence, disclosure analysis and costs are typically higher as a percentage of revenue than for a larger public company.

Board Meetings and the Disclosure Process

In the normal course, packages of corporate-specific information are compiled and distributed to directors to prepare for board meetings, including internal and third party documents (Board Package). They generally contain draft minutes of the immediately preceding meetings of the board and committees that have not yet been approved by the board, and that are still subject to revision and modification. They also contain operational data and other information often compiled from multiple sources and prepared with varying degrees of formality, conservatism, and knowledge of the legal environment. They are prepared by operating personnel and financial officers primarily from an operational perspective rather than from an SEC disclosure perspective. This information, collectively, however, can have significant disclosure ramifications.

In our integrated SEC disclosure system,[9] prior disclosure creates a base-line for ongoing disclosure obligations. The information and analyses contained in the current board package, other discoverable documents, and contemporaneous facts, together form the basis for new disclosures, particularly with respect to trend analysis and the corporate obligation to amend or modify prior disclosures by the issuer. Prepared with foresight and care, the board package can *minimize* liability; inadequately prepared it can *create* liability. Among other things, these documents reflect the degree of corporate awareness concerning developments in the issuer's business. Knowledge by the board of material facts and developments, can,

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in turn, be used in subsequent regulatory enforcement proceedings by the SEC and state attorneys general (as well as private class action lawsuits) to allege a failure to disclose known material trends or other information. Additionally, the same documents and analyses can demonstrate knowledge of material, non-public information, the possession of which should cause the company, directors, officers, and insiders to refrain from trading in the company's securities.

As an historical example, prior to Sarbanes-Oxley, in the well-publicized Caterpillar proceeding),[10] Board minutes were used to demonstrate that Caterpillar was aware of a trend (Brazilian currency fluctuations) that would negatively and materially impact its next fiscal quarter. The SEC alleged that the company failed to comply with its obligation to disclose these trends in the company's 10-Q report as required under Item 303 of Regulation S-K. In the post-Sarbanes-Oxley world, a similar problem would raise additional issues concerning the adequacy of a company's disclosure controls, the accuracy of the CEO and CFO certifications of Sections 302 and 906 of SOX accompanying the periodic report, and the adequacy of the board's oversight with respect to SEC disclosure compliance.[11] Sufficient board oversight and review will buttress a director's defenses in litigation alleging misleading disclosures. Proper procedures, including pre- and post-board meeting process and documentation, will establish and confirm the availability of the directors' business judgment rule defense.

Preparing for board meetings, creating the agenda, deciding what documentation should accompany the agenda, and documenting the meeting, must involve individuals who understand a public company's disclosure obligations and can appreciate and recognize the disclosure implications of facts, graphs, charts, analyses, and proposals distributed to directors. The recent SEC rules all dictate faster "real time" disclosure. That means that the same quality of corporate analysis and disclosure previously required (including applying the ever-illusive definition of "materiality") combined with compliance with an expanded universe of obligations and accountability, has to be made in less time. Public company disclosure obligations have always been time-constrained and pressure-producing. It's simply that the time available for compliance has been reduced, the disclosure obligations themselves are expanded and harder, and the systematic pressure created has increased.

Disclosure issues, unfortunately, do not always arise neatly identified as such in a board package or at a board meeting. It isn't always obvious that some disclosure is required, particularly if the current disclosure obligation is based only on a review of information *currently* provided and examined. Even more difficult to detect is the obligation to amend prior disclosure, and/or refrain from trading, based on how current information adds to previously known facts, alters their significance, or requires modification to originally correct disclosures. Less time to make the correct disclosure, and less time to decide what needs to be disclosed, means that thoughtful, forward-looking planning anticipating the disclosure questions becomes ever more important. The only way to know if current board discussions, documents, or access to facts require disclosure is for the board (along with management and counsel) to understand the current facts, documentation, and analysis, in the context of the existing public disclosure history of the individual company. If a director or a company doesn't know what corporate disclosures have already been made, then they can't recognize whether prior disclosure remains correct or requires modification. Do new facts alter the materiality of previously disclosed information or illuminate a previously unknown or inchoate trend?

For disclosure purposes, history is prologue. The ultimate condition precedent to making correct current disclosure is knowing and understanding prior

Coming Attractions

- **Consequences of untimely Exchange Act filings**
- **Electronic distribution of proxy material**
- **Boards in the age of investigations**

disclosure. Only viewed from that knowledge-base and perspective can the current facts and analyses be examined.

What Knowledge Should the Board and the Disclosure Team Have?

In order to provide the needed context, companies should consider including in each board package the following information:

- The company's most recent SEC filings;
- The company's recent press releases, particularly any releases containing forward-looking statements such as guidance;
- Minutes for recent board and committee meetings; and
- Recent and updated internal company projections.

Disclosure needs to be an integrated effort among management, inside counsel, outside lawyers, and auditors (Disclosure Team). The Disclosure Team should be composed of individuals with knowledge of: the SEC rules and case law relating to disclosure (including the New 8-K Rules), rules of the self-regulatory organization applicable to the issuer, Sarbanes-Oxley, and the corporate law (such as the Business Judgment Rule) of the issuer's state of incorporation. From a document perspective, they should also have the company's charter documents, industry peer metrics, and prior board and committee meeting minutes for reference during meetings. The industry peer group would permit analysis of whether company financial results were so aberrant to industry standard that they require analysis or comment. Knowledge of the board and committee mandates is required to know whether the Board or the applicable committee is remaining within the authority and jurisdictional limits of the company's governing documents. Qualified individuals, armed with facts, law, and insight, are the only basis for the rapid and extensive disclosures called for in our Brave New World of disclosure.

Board Packages Facilitate Disclosure Compliance

To avoid creating bad facts and liability similar to *Caterpillar*, the Board Package has to provide directors sufficient information to understand what has previously been disclosed, and more subtly, what has not yet been disclosed. Trends occur in context. Information is frequently not publicly disclosed because at the time of original analysis, the information was not material or disclosure was not otherwise mandated. At an earlier time, the probability of a potentially disclosable event occurring may have been too remote to warrant disclosure.

For example, at some point, early indications of softness in the sales channels may turn into a material downward revision in the revenue forecast. As the quarter progresses, highly prejudicial facts about the company's outlook are revealed, and what appeared to be a manageable problem unexpectedly seems serious. In short, evolving facts and circumstances continuously require disclosure analysis. Prior analysis cannot remain static.

Information provided to the board has to be prepared in a manner calculated not to overstate (or understate) risks. Care needs to be taken to distinguish between forecasts (what management believes *will* occur) from hypothetical calculations of future financial results based on alternative management assumptions (what *may* occur). If information discussed is hypothetical, it should be clearly indicated as such. To accomplish this, the Board Package should be prepared or reviewed by individuals who understand both a public company's disclosure obligations, as well as the pre-litigation nature of the documents and information presented. Generally, this information is discoverable in litigation (subject to exceptions such as attorney-client privilege) and is frequently used by enforcement agencies and private litigants with the benefit of hindsight. Language used informally and colloquially in information contained in board packages appears quite different under the harsh light of a litigator's precise examination of a witness and documents. Information presented to the board as "absolute," without qualifiers, modifiers, or footnotes, may appear to require immediate disclosure while a fuller explanation would clearly indicate that disclosure was either premature or merely one of several possible scenarios.

Individuals who are given responsibility for preparing or reviewing SEC reports, press releases, and other public disclosures must have access to, and take

into account, what is contained in board packages. This is particularly important for the Management Discussion and Analysis section of periodic reports. board members must be proactive in requiring the Disclosure Team to confirm that risks and developments identified in board materials have been, or will be, properly disclosed, or do not require disclosure. Significant inconsistencies between internal and external disclosures of risks, trends, and developments should immediately raise questions for the company's lawyers and financial officers concerning the company's disclosure obligations. At the conclusion of a board meeting, directors should be advised by counsel (or other members of the Disclosure Team present) whether any issues discussed, facts learned, or conclusions reached, have altered the adequacy of the company's prior disclosure or created new disclosure obligations.

As an over-arching principle, in order to comply with the Company's disclosure control and procedures, there should be a clear understanding of how, when, and by whom appropriate disclosures will be made. Only with that information can directors fully understand how to satisfy other of their obligations (including their individual obligations not to trade) as well as confirm that the company has taken adequate steps to prevent trading by others during prohibited periods. board packages, director notes, and other contemporaneous records may play a pivotal role in verifying that appropriate disclosure was timely made. This will also be crucial in regulatory enforcement proceedings (as exemplified by the SEC enforcement actions against Sony and Caterpillar), as well as in private securities class action litigation. Directors have statutory obligations to provide oversight to these management functions and avoid personal liability.

In addition to long-standing state enunciated duties, the responsibilities of boards of directors and their committees under Sarbanes-Oxley, as well as related SEC and self-regulatory organization's rulemaking have substantially increased in areas such as director independence determinations, the requirement to hold executive sessions, financial acumen assessments of audit committee members, general oversight of internal and disclosure control development, auditor oversight, and whistleblower investigations. Specific tasks and responsibilities of boards resulting from governance reform legislation and rulemaking (particularly for committees) should be considered in preparing board agenda and resolutions approving matters related to periodic reports and proxy statement filings.[12] Compliance with these responsibilities, and documenting compliance with these obligations, involves advance planning by management, the board, and counsel to see that the right issues are addressed in a timely fashion, and that directors have sufficient facts and information to meet their obligations.

The broadened list of 8-K disclosure events and the reduced time period in which to make such filings (from 5 or 15 business days, depending on the item, to four business days for most items) further exacerbates the need for coordination among the Disclosure Team and the board. Documentation for the meeting, particularly the official minutes, must be consistent with previous disclosure, and appropriately support disclosure conclusions reached during the meeting. It's not always easy in a lengthy Board meeting to precisely determine either the magnitude of an event that is mentioned, or the *probability* that a *possibility* discussed will occur, and, in either case, whether the information alters the company's disclosure mix. The degree of difficulty of the task, however, is significantly compounded if the appropriate planning doesn't occur prior to the meeting.

Conclusion

In the post Sarbanes-Oxley world, public companies must be better prepared for board meetings, take more time to prepare, involve more members of the company's internal and external disclosure team, meaningfully review prior disclosures, and anticipate resulting public disclosures. But no matter how well-prepared the company is, and what costs it expends or time that it takes, good board discussions often take completely unexpected and unanticipated turns. board meetings cannot be, and should not be, controlled laboratory environments in which management and directors play a pre-determined Kabuki role enacting previously agreed-to scripts. Interactive, challenging dialogue among board and management, a major goal of corporate governance, creates an ever-faster, real-time, disclosure environment.

Among the hidden costs of Sarbanes-Oxley is the increased time and advisory sophistication required to comply with an increasingly complex, time-sensitive, disclosure system.

NOTES

1. See *Sarbanes-Oxley Act of 2002*, P.L. 197-204, 116 Stat. 745 (codified at various sections of 11, 15, 18, 28, and 29 U.S.C.).

2. *See, e.g.*, Pamela Gaynor, "Execs Rip Sarbanes-Oxley Law's Costs Regulations," *Pittsburgh Post Gazette* (April 19, 2005) available at 2005 WL 6065892; Joe Hutnyan, "SEC Roundtable Weighing Pros and Cons of Sarbanes-Oxley May Ease Pressure On Congress," *Securities Week*, Volume 32, Section 16 (April 18, 2005); Marc Morgenstern and Peter Nealis, *The Impact of Sarbanes-Oxley on Mid-Cap Issuers*, SEC 23rd Annual Government-Business Forum on Small Business Capital Formation (Washington, DC), September 20, 2004 (text available at *http://www.sec.gov/info/smallbus/smallbus-toc.htm* (last visited June 20, 2006), and reprinted in *The Review of Securities & Commodities Regulation* (Vol. 37, No. 21, December, 2004); *but see* Jesse Eisinger, "Corporate Regulation Must Be Working—There's a Backlash," *The Wall Street Journal* (June 16, 2004), at 61 ("The absurd aspect of this backlash against [the Act] is that companies are finding out that tightening their internal controls is good for business.").

3. Section 404 of Sarbanes-Oxley and its accompanying regulations requires public companies to implement and periodically report on the effectiveness of their internal controls over financial reporting. *See* Pub. L. 107-204, 116 Stat. 745, § 404 (2002), *codified in* 15 U.S.C. § 7262; *see also* SEC Release Nos. 33-8392 (February 24, 2004) and 33-8238 (June 5, 2003), Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports.

4. *See* Financial Executives International, Special Survey on Sarbanes-Oxley Section 404 Implementation (August 11, 2004) available at *http://xvww.fei.org* (last visited June 20, 2006) (survey of companies with average revenues of $2.5 billion concluding that surveyed firms will spend an average of $3.14 million per year in costs to comply with Section 404 of SOX); Foley Lardner LLP, "The Costs of Being Public in the Era of Sarbanes-Oxley and Corporate Governance" (June 15, 2006) (concluding that, despite dropping by 16% in 2005, the average cost of being public for a company with annual revenue under $1 billion has increased by $1.8 million since the inception of SOX, to approximately $2.9 million). The Foley Lardner study also concluded that "[t]he results provide factual support for the perception that Section 404 disproportionately impacts smaller public companies". *See* "Executive Summary", p. 1.

5. *See, e.g.*, Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (September 26, 2004), presented as part of the New York University Law and Economic Series and available at *http:// papers.ssrn.com* (last visited June 20, 2006) (discussing SOX's "ill-conceived" corporate governance provisions); Marc Morgenstern, "Blocking the Boards: Sarbanes-Oxley Prevents Corporate Boards from Making Decisions Based on Solid Business Principles," *Inside Business* (March, 2005) (discussing SOX'S impact on the ability of corporate boards to function); *see also* Morgenstern and Nealis, *supra* n.2 (discussing costs of "lost productivity" associated with SOX).

6. *See* Pub. L. 107-204, 116 Stat. 745, § 409 (2002) *codified in* 17 U.S.C. 78m(l) (requiring issuers to disclose to the public on a "rapid and current basis" information on material changes in their financial condition or operations); *see also* SEC Release No. 33-8128 (November 15, 2002), "Acceleration of Periodic Report Filing Dates and Disclosures Concerning Website Access to Reports." In a recent amicus brief filed by a group of securities law professors in support of Regulation FD, the group rejected the assertion that the SEC lacked the statutory authority to adopt Regulation FD prior to the enactment of Section 409 of Sarbanes-Oxley. Instead, the amicus brief asserted that Section 409 merely affirmed the SEC's continuing effort to create a "more comprehensive system of disclosure." *See* Law Professors Brief as Amicus Curiae in Opposition to Motion to Dismiss at 14, *Securities and Exchange Commission v. Siebel Systems, Inc. et al.* No. 04 CV 5130 (S.D.N.Y. filed March 10, 2005).

7. Section 409 of Sarbanes-Oxley. *See* SEC Release No. 33-8176 (March 16, 2004), *Final Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Deadline.*

8. For an unpublished article challenging the current method of preparing and analyzing Board minutes and advocating change in the traditional methodology, see Marc Morgenstern and Steve Bochner, "Corporate Governance and the Business Judgment Rule: Rethinking Board Minutes After Sarbanes-Oxley."

9. Since 1980, the cornerstone of the federal securities philosophy has been integrated disclosure. Public companies have responsibility for their disclosures when the disclosures are made, as well as an ongoing obligation to amend or modify such disclosures under certain circumstances. Companies have a continuous obligation to disclose rule-mandated information (*i.e.*, 10-K, 10-Q, and 8-K compliance). *See* Carl Schneider, "Did Polaroid Invent the Instant Movie After All"? His thesis was that "disclosure" was *not* "a snapshot in time, it wasn't a frame in an ongoing movie, and it wasn't good policy to say that if you volunteered an accurate snapshot as of a given date" you had an ongoing duty to update it. His view is that "if a statement is clearly made that's supposed to have ongoing future effects, you *may* have a duty to update it. But if it's accurate when it's made, and it's just backward-looking and historical, there shouldn't be any duty to change it." [emphasis added]. SOX added a statutory provision mandating "real-time" disclosure. Mr. Schneider, among others, has questioned whether this is a genuine paradigm-shifting change, i.e. is there an actual evolution to a true continuous disclosure system where silence alone could be a breach of the issuer's duty to disclose. *See* SEC Historical Society Interview with Carl Schneider conducted on May 5, 2004 by Bill Morley, Justin Klein, and Mickey Beach, *www.sechistorical.org/collection/OralHistories/interviews/schneider.*

10. *In re Caterpillar, Inc.*, Release No. 34-30532, 51 SEC Docket (CCH) 147 (March 31, 1992). For a discussion of this enforcement action in the context

of the disclosure obligations in the Management's Discussion and Analysis section of an issuer's periodic reports, *see* Marc Morgenstern, "Off Balance Sheet Disclosures in MD&A," *The Review of Securities and Commodities Regulation* (January 28, 2004).

11. *See* Pub. L. 107-204, 116 Stat. 745, §§ 302 and 906 (2002), *codified in* 15 U.S.C. § 7241 and 18 U.S.C. § 1350, respectively.

12. For a good discussion of director oversight of management functions *see, Saito v. McCall* (Del. Ch. Dec. 2004) where the Court imputed knowledge to the board (as a whole) from knowledge possessed by individual directors. This involved analysis under *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2nd 959 (Del. Ch. 1996), which has been one of the seminal cases for director oversight obligations.