LEGAL & POLITICAL RISKS

Section Objective:

This section provides participants with information designed to help self-assessment users avoid serious negative consequences that can occur from the dramatic increase in the amount of "sensitive" risk status information and the number of people in decision making roles who are aware of the organization's risk status.

PARTICIPANTS SHOULD SEEK EXPERT LEGAL ADVICE IN THEIR RESPECTIVE COUNTRIES. THIS SECTION PROVIDES GENERAL GUIDANCE ON THE PRIMARY LEGAL ISSUES FROM A CANADIAN LEGAL PERSPECTIVE. IT IS NOT A SUBSTITUTE FOR PROFESSIONAL, COUNTRY SPECIFIC, LEGAL ADVICE.

WHAT IS DUE DILIGENCE?

Reference Source: Selected excerpts from *Regulatory Offences in Canada: Liability and Defences*, John Swaigen, Published by Carswell, 1992. Excerpts reproduced with permission of the Publisher.

THE DEFENCE OF REASONABLE CARE

"The individual and/or company took all reasonable steps to avoid the particular event." (p.75)

EXAMPLES OF AREAS WHERE DUE DILIGENCE ISSUES CAN ARISE

ENVIRONMENTAL ISSUES
SAFETY/HEALTH
FRAUD PREVENTION AND DETECTION
FINANCIAL DISCLOSURES
REGULATORY COMPLIANCE IN NUMEROUS AREAS
EXECUTION OF CONTRACT TERMS
PHYSICAL SECURITY

THE FIRST BRANCH OF REASONABLE CARE: MISTAKE OF FACT

"To show that a mistake of fact was reasonable, the accused must establish that he or she took all reasonable steps and made all reasonable inquiries to find out the correct information." (p.81)

"A perfunctory inquiry is not sufficient. Moreover an employer cannot rely solely on the fact that employees have led him/her to believe in incorrect facts." (p.81)

THE SECOND BRANCH OF REASONABLE CARE: DUE DILIGENCE

"Liability rests on control and the opportunity to prevent the event." (p.85)

"control may be exercised by "supervision or inspection, by improvement of business methods or by exhorting those whom [employers and principals] may be expected to influence or control." (p. 85)

[A due diligence system] "will involve creation of a corporate culture that fosters concern and compliance and discourages non-compliance, and the inculcation of attitudes conducive to such care and concern at all levels within the corporation." (p. 86)

"Finally, the system should include adequate inspection, monitoring and auditing of all of these systems." (p. 87)

THE RELATIONSHIP BETWEEN THE COMMON LAW DEFENCE OF REASONABLE CARE AND STATUTORY DUE DILIGENCE DEFENCES

"Some of these (regulatory) provisions made a lack of reasonable care a component of the actus reus; ie, the offence itself consisted of a failure to take reasonable precautions to ensure a result or prevent an occurrence" (p. 100)

ALTERNATIVES AVAILABLE TO THE ACCUSED

"Reasonableness of care is often best measured by comparing what was done against what could have been done. The reasonable alternatives the accused know or ought to have known were available, provide a primary measure of due diligence. To successfully plead the defence of reasonable care the accused must establish on a balance of probabilities that no feasible alternatives could be employed to avoid or minimize harm. (Stuart J. p. 106)

"Although the cost of the alternatives may be taken into account in determining whether they were reasonable, economic necessity is not a defence. The greater and more foreseeable the potential risk, the less likely that the expense of the available alternatives will be held to render taking them unreasonable." (p. 107)

LIKELIHOOD AND GRAVITY OF POTENTIAL HARM

"What steps are reasonable to prevent harm will depend on a combination of its likelihood and its consequences. Together they constitute the "risk". Harm may be highly likely, but minor; extremely unlikely, but, if it occurs, have serious consequences; or it may be both likely and serious. In the latter case, the utmost care must be taken. In the former case, the amount of precautions to be taken will depend on the overall assessment of the risk, and weighing the risk against the feasibility including cost, of prevention." (p.109)

ADEQUACY OF TRAINING AND SUPERVISION OF EMPLOYEES

"The adequacy of training programs, instructions and supervision is a factor in industrial safety cases, in cases involving serving liquor to minors, and in environmental cases. Training, supervision, and instruction must be on-going programs. Handing out a safety booklet to employees when they are hired has not been considered a model training program." (p. 113)

COMPLIANCE POLICIES, PROGRAMS, AND AUDITS

"If the duty of a company is to set up a system to avoid violations, a logical extension of this duty is that the company should look not only at individual operations as they are established or changed, but should systematically establish systems, policies, and programs designed to prevent violations, and should consider periodic reviews of its overall operations for compliance with all applicable laws." (p. 133)

RE: USE OF SELF-EVALUATION AGAINST A COMPANY

"Of course, compliance audits are a two edged-sword. Demonstration that a systematic compliance audit has been carried out by competent personnel should be strong evidence of reasonable care. Production of such an audit in evidence by the defendant would necessitate the prosecutor adducing substantial expert evidence to displace the inference of due diligence that it would suggest, unless it was apparent, on its face or in light of other evidence, that the audit was perfunctory or that the accused should have recognized its inadequacy. On the other hand, such an audit not only describes and diagnoses, but also prescribes. For this reason, an audit showing that an actual or potential non-compliance had been discovered and recommending remedial steps that were not carried out, would be cogent evidence of lack of reasonable care. This has resulted in reluctance to carry out such program, attempts to design them so they are privileged, and lobbying for legislation or policies that would prevent their use as evidence against the accused in prosecutions." (p. 137)

DEFICIENCIES OF THE HISTORICAL / TRADITIONAL APPROACH

The article "*Control and Risk Self-Assessment - The Dawn of a New Era in Corporate Governance*" outlines weaknesses of the historical/traditional approach to control oversight (Section 15).

Evidence of the use of traditional audits can be an accepted element of due diligence examinations, however, it has often been found to be very deficient when examined in court, if it is used as a defence at all. If the traditional audit approach is used as a primary management strategy in due diligence areas, significant resources must be dedicated to the audit/inspection function. Often times this is not done, or if it is done, the auditors/inspectors are not adequately trained and/or supervised.

PRIMARY ADVANTAGES OF SELF-ASSESSMENT AS A DUE DILIGENCE DEFENCE

Enterprise-wide self-assessment has the following main advantages as a due diligence defence:

1. Coverage is broad and comprehensive. The process when fully implemented, is a standard component of the annual management processes such as planning, budgeting, performance evaluation and results review.

2. Staff at all levels and in all functions are involved in the risk assessment and control design process. Awareness of the existence and importance of due diligence objectives is heightened.

3. The process fulfills key due diligence expectations related to integrating requirements into the corporate culture, communication, training, supervision, compliance monitoring, and audit.

4. Self-assessment can be used to directly assess the objective of complying with a particular law or set of regulations. This type of assessment is necessary to ensure that the compliance control framework is capable of identifying and responding to changes in the law, regulatory interpretation, technology, business circumstances, and other factors. It also focuses on the objective of compliance as an objective on its own, independent of the area of this specific area being regulated.

5. The risk assessment component is consistent with the way courts view the practicality of implementing/using control procedures.

6. It ensures that staff understand which control elements are in use because of a law, versus those control elements that serve direct business/quality objectives. When laws change, controls that are only in use to satisfy regulatory requirements and serve no genuine business purpose can be identified and eliminated. Staff are also aware of situations where legislation prescribes minimum or mandatory control portfolio items for certain objectives. These situations do not allow the normal risk acceptance/portfolio optimization decision process to occur unless staff are willing to risk non-compliance with the legislation.
7. The self-assessment quality assurance process rewards candidness. This encourages staff at all levels to identify and report high risk and/or non-compliance situations.

8. Self-assessment, when used in conjunction with the six level quality assurance program described in this workbook, can be shown to have

significantly higher reliability levels with respect to the completeness and accuracy of the information on control and risk presented to the Officers and the Board of Directors.

9. The value of self-evaluation has often been recognized by the courts as a valuable component of an overall due diligence system. This has led the courts to tend not to allow self-evaluation information produced in good faith to be used against an individual or company.

PRIMARY DISADVANTAGES OF CRSA AS A DUE DILIGENCE COMPLIANCE TOOL

1. It exposes areas of due diligence vulnerability quickly and graphically including conscious documented awareness of risks. Some organizations are happier not knowing.

2. It provides a focal point for interviews and data gathering by investigators, plaintiffs and prosecutors.

3. The courts, although generally supporting the concept of privilege over self-evaluative material, have not been unanimous in their treatment of evidence derived/obtained from self-evaluation.

4. It highlights to staff at all levels and in all functions areas of unethical conduct on the part of the organization and/or senior management and risk tolerance levels which may exceed civil standards of care.

SUMMARY CONCLUSIONS

1. In organizations that have less than a full commitment to ethical business conduct, full implementation of a risk self-assessment system will probably not occur and would not be wise. If implementation does occur in organizations with serious ethics problems, it should be done selectively due to the litigation risks that it presents. Information related to objectives that are potentially dangerous must be handled with great care or avoided in the self-assessment process altogether.

2. For organizations that want to be, and be seen as, ethical and diligent, self-assessment presents a powerful tool to assist in meeting these objectives.

3. A very strong case could be presented in court that organizations with fully implemented risk self-assessment programs have significantly better due diligence and control management system than those organizations using the historical/traditional approach.

4. Self-assessment analysis done in areas where there is potential for civil or criminal litigation should be handled with care.

POLITICAL RISKS

Refer to "Integrated Risk Management: The New Imperative in Public Administration" in Section 15 – Background Articles.

SAMPLE GUIDANCE RELATED TO SELF-ASSESSMENT AND REPORTING FROM FRIED, FRANK, HARRIS, SHRIVER & JACOBSON, A LEGAL FIRM THAT SPECIALIZES IN SECURITIES LAW

September 6, 2002

Disclosure Controls: An Action Plan

"Disclosure controls" are one of the hottest topics in corporate America. Companies both within and outside the United States are reviewing what they currently do and wondering what to do next. New SEC rules require all public companies to create, maintain and enforce procedures for collecting, processing and disclosing information in their SEC filings within prescribed time periods. Moreover, CEO's and CFO's are responsible for designing the controls, assessing them within the 90 days prior to the filing of every periodic report and publicly disclosing the results of their evaluation.

The need for strong disclosure controls is highlighted further by the new accelerated deadlines for filing Form 10-K's and Form 10-Q's, the new two-business day deadline for filing Section 16 reports, and the SEC proposals regarding disclosure on Form 8-K of a host of significant business transactions within two business days of the transaction. Significantly, the SEC Form 8-K proposals provide a limited safe harbor for companies that develop and comply with adequate disclosure controls. The SEC has even warned in a recent release that companies with inadequate disclosure procedures may violate the disclosure control requirements even if their disclosures are not faulty.

Overall, it is important that all issuers, both domestic and foreign, and their senior officers focus diligently on the strength and adequacy of their disclosure controls and encourage robust and open discussion. The SEC has not mandated or identified any specific set of controls. There is no definitive checklist prescribed by statute, rule or lore. We have provided below a list of procedures that companies should consider in developing and refining their internal disclosure review procedures. Many companies will need fewer procedures; some institutions may develop more. All companies should periodically review their internal review procedures and modify them over time as their business and personnel change and as additional SEC proposals and rules are issued.

1. Consider setting up a "Disclosure Committee." The SEC has recommended-but not mandated-that companies establish a "disclosure committee" to consider the materiality of information and determine disclosure obligations on a timely basis. The disclosure committee could be made responsible for establishing and supervising the company's entire disclosure process-becoming, in effect, the company's "watchman" for public disclosures. Possible committee members include, among others, the principal accounting

officer or controller, the general counsel, the principal risk management officer, the investor relations officer, and possibly business unit heads. Significant international business units may also need representation. The chair of the committee may be a member of senior management-perhaps the CFO or general counsel. For efficiency and effectiveness, we do not recommend a large group-what one gains from a broader representation one loses in the ability of a small group to focus expeditiously on the real issues. In any event, the smaller group would be responsible for soliciting input from other officers throughout the organization. Companies should consider having each committee member read every periodic report (or at least specific portions related to their area of expertise), and should consider preparing a charter outlining the committee's responsibilities and membership criteria. The disclosure committee should report directly to the CEO or CFO.

2. Consider designating a "Disclosure Controls Monitor." Each public company should consider designating one individual to be responsible for the operational aspects of disclosure procedures. The disclosure controls monitor would report to the disclosure committee. Depending on the company's internal structure, the monitor may be a member of the finance department-perhaps the controller-or a member of the legal department such as an assistant general counsel. The disclosure controls monitor might be responsible for ensuring that the procedures are properly documented, communicated, implemented and enforced. The monitor could also be responsible for monitoring the SEC's disclosure rules in detail and serving as an internal resource regarding these rules.

3. Consider preparing written "Disclosure Guidelines." Many companies have created insider trading policies, corporate governance guidelines, ethics codes, derivatives policies, sexual harassment policies, employee manuals, and confidentiality policies. It may be advisable to prepare yet another policy paper describing the company's "disclosure guidelines." The guidelines could include a series of checklists rather than only narrative text in order to make it more likely that the guidelines would actually be used by employees involved in the disclosure process rather than just stored on the shelf.

   The guidelines may include, among other things, the responsibilities and requisite qualifications of the disclosure control monitor, a model disclosure timeline, the list of officers responsible for different sections of the various reports, the company's forms of legal rules checklists, and the company's values in preparing corporate disclosure. The guidelines could be reviewed and approved by the disclosure committee, the audit committee, an outside law firm, and the company's auditors. The guidelines should be distributed broadly throughout the company so that each person's role is clearly and unambiguously defined.

   The company's disclosure guidelines also need to focus on how the employees responsible for drafting the disclosure obtain access to real time information about developments in the business. Given the international and decentralized nature of many companies, it is often difficult for information to flow to those responsible for the disclosure. This is particularly true for information which has not had an impact on earnings for the current reporting period but which may in fact reflect trends or risks in the business during future periods.

4. Prepare a detailed disclosure preparation timetable. Public companies should consider developing a detailed annual timetable which reviews, on a week-by-week or month-by-month basis for at least the next year, critical dates and deadlines during the disclosure process. The timetable would include items relating to the annual report, quarterly reports, proxy statement, annual report to shareholders, annual meeting, shareholder proposals, release of quarterly earnings and board and committee meetings. Specific topics to be covered include deadlines related to:

   - the preparation of first drafts of reports, o the receipt of comments,
   - board and audit committee review of filings;
   - law firm and outside auditor review of filings; and
   - SEC reports, proxy statements, stock exchange requirements and state law.

   The timetable should also identify the distributees of various drafts. The timetable should allow reports to be circulated to senior management and, as appropriate, the audit committee and the board sufficiently in advance of filing in order to enable the officers and directors to carefully review the filing and discuss their questions.

5. Establish definitive personal responsibility for portions of filings. Different officers from throughout the organization should be delegated personal responsibility for portions of filings in their areas of expertise. Responsibility breeds better disclosure. Officers in charge of specific areas such as litigation, environmental matters, regulatory matters, intellectual property, insurance and risk management, and finance should be sent their portions of the filing for review and should also be encouraged to prepare disclosures as issues arise in their areas of expertise. The heads of business units could be assigned to review the descriptions of their specific business units. This personal responsibility should include gathering data from others as necessary. The disclosure controls monitor or disclosure committee should ensure that responsibility for every section of every periodic report is assigned to a specific employee and that these responsibilities are documented and circulated. In addition, one employee in the company should be responsible for performing an overall "rules check" for each filing.

6. Assign specific responsibility for reviewing "risk factor" disclosure. Any risk factor section and forward-looking statements warning should be reviewed and updated, where appropriate, each quarter. This task is so critical that it should be assigned to a specific senior officer in the company who will likely have the best feel for the true risks in the business taken as a whole. It will be more difficult for plaintiffs' attorneys to discredit the company's forward-

looking statements warning and related risk disclosure if these sections are modified regularly to reflect the company's actual circumstances.

7. Schedule internal "drafting sessions" for the company's periodic reports. Depending on the company, it may be advisable for the disclosure committee to meet one or more times in order to conduct an internal "drafting session" for the company's filings. Robust discussion of disclosure topics is a critical element of good reporting. Companies should consider whether the external auditors and outside law firm should be invited to participate in at least some of these sessions. Particular focus should be placed on the MD&A, risk factors and any trends in the business which committee members believe need to be discussed and/or disclosed.

8. Clarify the involvement of the company's outside law firm. Companies should clarify the role of the company's outside law firm as part of their overall set of disclosure controls and procedures. Some companies may prefer to minimize costs and not involve outside counsel. Other companies may request only a detailed rules check of reports without substantive review, or only a review of specific sections, such as "litigation," or the review of descriptions of legal contracts such as credit agreements. Some companies may want outside counsel to participate with management in a "due diligence" type examination of each report or specific portions, such as MD&A. Other companies may prefer to simply send the document to the outside counsel and request "any comments." Companies should recognize that the benefit of outside counsel's last minute review will be extremely limited. To a large extent the involvement of external counsel will depend on the level of involvement of the company's internal counsel.

9. Clarify the role of the company's outside auditor. Obviously the auditor is required to audit the annual financial statements and perform a review of the quarterly financials. The disclosure committee and senior management should clarify the level of review desired by the outside auditor beyond the traditional role. Companies at a minimum should involve the outside auditor in reviewing the MD&A, including the critical accounting policies, description of new accounting standards, and quantitative and qualitative disclosures regarding market risk. It may even be desirable, depending upon the context of the review, to have the outside auditors perform an agreed-upon-procedures review.

   Companies may also consider engaging the company's auditor to provide an examination report or a review report regarding the MD&A in accordance with Statement on Standards for Attestation Engagements (SSAE) No. 10. The examination report would state that, in the auditor's opinion, the MD&A includes, in all material respects, the required elements of the rules and regulations adopted by the SEC. The review report would state that, based on the auditor's review, nothing came to the auditor's attention that caused them to believe that the company's presentation of MD&A did not include, in all material respects, the required elements of the rules and regulations adopted by the SEC. At the present time, SSAE No. 10 examination and review reports are not standard practice and many accounting firms have historically been reluctant to furnish them. The procedure would also add an extra cost to the company. Additionally, the process of preparing the MD&A may need to be revised in order to put the auditors in a position to develop procedures to provide an MD&A report. However, the new requirements of CEO/CFO certification and disclosure controls may lead more companies to consider seeking this additional comfort. We would recommend that our clients discuss with their auditors the feasibility and cost of obtaining such a report.

10. Assign responsibility for reviewing competitors' filings and research reports. The company should consider assigning an officer specific responsibility to review SEC filings by competitors (and potential competitors) and perhaps by key customers and suppliers. This person could also be responsible for reading public analyst reports on the company and its competitors. Analyst reports are important because they focus on the data that is of most interest to investors and frequently identify industry trends and the true risks in the business. This officer should consult with the disclosure controls monitor and/or the disclosure committee if these competitor filings or analyst reports suggest that additional disclosures are required in the company's own filings.

11. Prepare for significantly enhanced "real time" SEC disclosure. The SEC has proposed significantly increasing the number of events reportable on Form 8-K and requiring such events to be reported within two business days of the event. As proposed, reportable events would include entering into or terminating a material contract, incurring a material direct or contingent financial obligation, losing a 10% customer, material asset impairments or restructuring charges, changes in senior management, and changes in ratings.

    Specific procedures will need to be implemented in order to comply with these types of "real time" disclosure obligations. Information about a broad array of topics will need to reach the disclosure committee and/or disclosure controls monitor on a much swifter basis. Companies should strongly consider distributing a list of potential disclosure items throughout the company so that all levels of management who become aware of a reportable event can notify the disclosure controls monitor immediately of the need to file a Form 8-K so that the filing can be made within the two business day period. The new Form 8-K requirements will require a much broader segment of managers in different business units to be involved in the disclosure process, particularly in companies with diverse international operations, because material information which occurs anywhere in the organization will require much more immediate disclosure. Also, multiple transactions may collectively result in Form 8-K disclosure requirements depending on the final rules. It may also be advisable due to the two business day deadline to have a designated "backup" disclosure controls monitor in the event the primary monitor is out of the office, on vacation, ill or otherwise engaged in other matters.

12. Develop procedures for distributing draft reports to senior management. The disclosure committee and/or disclosure controls monitor should consider what information needs to be distributed to senior management in order to assist in their review of the company's draft SEC filings. Thought is often stimulated by underlying data and disclosures made by others. The following material-which may also be reviewed by the disclosure committee or disclosure controls monitor-might be circulated to senior management together with the draft reports:

    - a copy of the company's previous periodic report as well as its periodic report for the same period in the prior year;
    - detailed financial statements for the period by region, product line and division;
    - recent audit and compensation committee minutes;
    - summaries of material litigation;
    - updates on material transactions, major executive compensation issues or transactions with affiliates;
    - recent industry data and analyst reports; and
    - public disclosures by competitors for the same or recent periods.

    In particular, the draft distributed to senior management should delineate changes from prior disclosures (perhaps by including a blackline against the last periodic report if appropriate) so that senior management can consider whether any prior disclosure from past periods needs to be updated.

13. Consider obtaining certifications from company personnel with respect to their areas of expertise or knowledge. There has been much discussion of whether CEO's and CFO's should receive limited 10b-5 certificates from other officers in the company. This procedure can also assist the company's own defense in showing that it utilized adequate disclosure controls and procedures. At the least, the request that they sign a certificate will focus the officers on their responsibility. Obviously, supplemental certifications will generally need to be limited to the areas where the personnel have knowledge and will likely not be as broad as the certification which the CEO and CFO themselves must provide. Memoranda confirming oral certifications can substitute for actual signatures.

14. Review insider trading policies in light of changes to the disclosure process. If the company's new disclosure controls and procedures result in more, or different, employees having access to material nonpublic information, those employees should be included in appropriate warnings and pre-clearance policies in order to protect against possible insider trading.

15. Document the procedures used for each particular report. The disclosure controls monitor should keep a detailed record of the procedures followed with respect to every SEC filing. The record should establish that the company has followed its standard disclosure guidelines.

The new requirement to establish and maintain disclosure controls applies to all U.S. and non-U.S. issuers that have registered securities under Section 12 of the Securities Exchange Act of 1934 or that are required to file periodic reports with the SEC pursuant to Section 15(d) of the Exchange Act. This specifically includes all non-U.S. companies filing their annual reports on Form 20-F or, in the case of Canadian MJDS issuers, Form 40-F. Moreover, in each annual and quarterly report, the principal executive and financial officers must certify that they have designed disclosure controls to ensure that they are aware of material information, evaluated the effectiveness of such disclosure controls and provided their conclusions about the effectiveness of the procedures in the report being certified. Current reports on Form 8-K and Form 6-K do not need to be certified. However, disclosure controls are required to be designed, maintained and evaluated to ensure full and timely disclosure in all periodic reports, current reports, proxy statements and information statements.

New York
Valerie Ford Jacob
Kenneth R. Blackman
Stuart Gelfond
Jean E. Hanson
Michael Levitt

Washington, DC
Dixie L. Johnson
Karl Groskaufmanis
Richard Steinwurtzel

London
Timothy E. Peterson
Daniel Bursky