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THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

A LOOK AT THE CAUSES, IMPACT AND FUTURE OF THE SARBANES-OXLEY ACT

By: Scott Green*

I. INTRODUCTION

The agents and gatekeepers of our public companies serve an important role in the capitalist system. At the most basic level, they are the appointed guardians of a stockholder's invested capital. The agents are our boards of directors and executive management of our public companies and the gatekeepers are the regulators, accountants, lawyers, and even the financial analysts whose opinions we rely on when investing capital. The near simultaneous implosion of Enron, WorldCom, Global Crossing and Adelphia Communications together with the management hijinks at Tyco, HealthSouth and Imclone, among others, led to a public crisis of confidence in our nation's financial markets in 2001 and 2002. The vast majority of agents and gatekeepers are honest, hard working people who want to do the right thing. However, this tsunami of corruption threatened to sweep up the good with the bad in its destructive path. By the summer of 2002, restoring public confidence in our markets became paramount.

Congress responded to this crisis by passing the Sarbanes-Oxley Act ("SOX" or "the Act") of 2002. The impact of this legislation was significant and immediate. A survey released in March 2003 by PricewaterhouseCoopers (PWC) found that the Act had already resulted in changes to auditing controls and compliance at 84% of United States multi-national corporations.1 The Act expanded the regulatory oversight and guidance for auditors, lawyers, and analysts as well as addressed many of the structural corporate reforms necessary through interpreting rules issued by the Securities and Exchange Commission ("SEC") and a new set of listing standards by the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD"). As is common with legislation impacting the financial markets, the Act provides an overall framework for regulating the markets, while leaving detailed oversight to the SEC. The SEC in turn allows the self-regulatory organizations (NYSE and

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NASD) to draft and implement detailed rules that address the requirements of
the Act as well as SEC requirements.

This article will review the more significant roles which certain agents
and gatekeepers played in contributing to the crisis of confidence leading up to
the Sarbanes-Oxley Act and how the Act addressed these actions. Specifically,
the article will examine the Act's response to related party transactions, financial
reporting management, excessive executive compensation, executive stock
trading, and poor culture that led to the current crisis as well as to the failings
of our auditors, lawyers and analysts as gatekeepers. The article will also briefly
evaluate the limitations of the Act going forward. Additionally, it will examine
the Act’s impact on international companies and foreign governments. Finally,
this article will analyze potential future consequences of the Act along with
providing recommendations on its implementation.

II. RELATED PARTY TRANSACTIONS AT ENRON AND
ADELPHIA COMMUNICATIONS

As defined in the Act, a “conflict of interest occurs when an
individual’s private interest interferes in any way- or even appears to interfere-
with the interests of the corporation as a whole.”2 Such arrangements might
benefit the company and may not be detrimental per se. Where conflicts arise,
they must be well communicated, managed, and subjected to detailed and
unimpeachable oversight to ensure that stockholders benefit from doing business
with the related party. This is easier said than done. Related-party transactions
are numerous and widespread. A recent survey conducted by the Wall Street
Journal that evaluated over four hundred of the nation’s largest public
companies revealed that “some 300 of those companies reported one or more
related party transactions . . . many of these transactions involved millions of
dollars.”3

At Enron, Andrew Fastow, the Chief Financial Officer (the “CFO”),
managed the creation of off-balance sheet entities with the effect of creating an
unrealistic picture of financial health for the company. In certain instances, the
CFO was also responsible for managing the off-balance sheet vehicles in which
he had a financial interest. This insider dealing resulted in the collapse of one of
the world’s largest corporations. An investigation by Enron’s Board of
Directors found:

These partnerships . . . were used by Enron
management to enter into transactions that it
could not, or would not, do with unrelated
commercial entities. Many of the most

2 Final NYSE Corporate Governance Rules, NYSE’S LISTED COMPANY MANUAL § 303A.10 (Nov.
3 John R. Emshwiller, Business Ties: Many Companies Report Transactions With Top Officers,
significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve bona fide economic objectives or to transfer risk.
—Excerpt from the Report of Investigation by the Board of Directors of Enron Corporation (Powers Report) ¹⁴

In 1997, the CFO began creating Special Purpose Entities ("SPEs") to hold assets and provide the appearance of creating legitimate financing transactions. SPEs can be very effective financing and risk management vehicles if used properly. A parent company’s debt level or other risk factors can hinder the capability of a strong business segment to obtain favorable interest rates to finance its operations. In such a situation, the parent can create an SPE and transfer the asset to it with the goal of receiving more favorable lending rates. As long as there is another independent third party investor that has contributed at least 3% of the assets and an independent party controls the entity, the SPE does not have to be consolidated into the parent for financial reporting purposes. ⁵ Furthermore, if the assets in the SPE are of high quality, banks will lend to the entity at lower lending rates than could be received by the originating company. The SPE will then use this money to pay the parent for the asset received. The bottom line is that the company obtains the money it requires, but pays less to obtain it than would otherwise be the case.

However, Enron ran out of quality assets to transfer, so inferior assets were reassigned and Enron stock pledged as a guarantee of payment to the banks. And who did Enron find to be that 3% investor in the SPEs? The CFO, through a partnership called LJM, among others. ⁶ But why would he want to invest in poor quality assets? Because the fees Enron paid LJM for managing up the transaction eliminated his risk in these vehicles. He effectively cashed out; so while he was an investor on paper, he really had no downside risk. ⁷

Enron’s Board contained a former accounting professor, the former executives of an insurance company and a bank, the former head of the Commodity Futures Trading Commission and a hedge fund manager. ⁸ Enron’s financial transactions were confusing even to this highly knowledgeable Board. What was clear is that the Board did waive their conflict of interest rules to allow these transactions to take place. The Board’s

¹⁴ William C. Powers, Jr., Raymond S. Troubh, Herbert S. Winokur, Jr., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. (Feb 1, 2002), at http://news.findlaw.com/hdocs/enron/sinreport/. See also ARTHUR L. BERKOWITZ, ENRON: A PROFESSIONAL’S GUIDE TO THE EVENTS, ETHICAL ISSUES, AND PROPOSED REFORMS 147 (Diana Roozeboom et al. eds., CCH Inc. 2002) (providing in its Appendix A an excerpt from the Report of Investigation by the Special Investigation Committee of the Board of Directors of Enron Corp. (Powers Report)).
⁵ BERKOWITZ, supra note 4, at 148.
⁶ Id. at 151-52, 156.
responsibility to understand these transactions is paramount where related parties are involved. They must ensure that the transactions are in the best interests of the company and its shareholders. Enron was not the only company that had material related party transactions that brought down the company. Conflicts of interest can be among the most damaging control weaknesses absorbed by a company, particularly if they occur between the company and its founder. The Rigas family allegedly borrowed more than $3 billion using the assets of Adelphia Communications, a company they founded. Additionally, the company created a Rigas-run investment firm, helped purchase the National Hockey League's (NHL’s) Buffalo Sabres and built a golf course on Rigas-owned land. To compound matters, the Rigas debt was not presented or disclosed in Adelphia’s financial statements, which would have produced a markedly different picture of financial health.

The new listing rules of the NYSE require companies to adopt and disclose a code of business conduct and ethics for directors, officers, and employees, and promptly disclose any waivers of the code for directors or executive officers. The code must include, among other things, policies regarding conflicts of interest and corporate opportunities. The company should also have a policy prohibiting conflicts and provide a means for communication of potential conflicts to the board.

Furthermore, “Employees, officers and directors should be prohibited from (a) taking for themselves personally opportunities that are discovered through the use of corporate property, information or position; (b) using corporate property, information, or position for personal gain; and (c) competing with the company.” Given the number of related party transactions currently in place, a tremendous amount of work must be done to replace services or otherwise implement oversight controls for our largest public companies.

Additionally, the Sarbanes-Oxley Act specifically addressed off-balance sheet transactions such as the SPEs used at Enron. The Act directed the SEC to provide rules requiring the issuer to “disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or persons.”

III. FRAUDULENT FINANCIAL REPORTING AT WORLDCOM

While Enron was arguably the primary driver leading to the creation of the Sarbanes-Oxley Act, WorldCom was by far the largest single bankruptcy in history and significantly impacted the final legislation. According to Congressman Michael G. Oxley, one of the bill’s sponsors, “WorldCom took all the oxygen out of the room because it was so huge- four or five times larger in

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10 See Final NYSE Corporate Governance Rules, supra note 2.
11 Id.
13 See Barnaby Feder, Court Approves WorldCom Plan, N.Y. TIMES, Nov. 1, 2003, at C3.
The company experienced so many lapses in accepted governance practices that the size and complexity of the company's collapse alone provides a study in how poor culture, control systems, and oversight can easily lead a company to ruin. The reported financial condition of the company was manipulated by management to such an extent that, what appeared to be a profitable company was, in reality, bankrupt. Despite over $100 billion in assets, the company filed for Chapter 11 protection in early 2002. By November of that year, the company admitted that it had overstated profits by $9 billion between 1999 and early 2002, and possibly by as much as $11 billion. The inflated profits were largely due to operating expenses that WorldCom had capitalized. Instead of recognizing expenses when they were due, the company recorded them as assets, delaying their recognition as expenses to a future date. But the company also manipulated reserves to offset expenses.

While Scott Sullivan, WorldCom's former CFO, appeared to be the individual directing the management of the financial statements, according to Dick Thornburgh, the bankruptcy court examiner, the Board did little to question management about its merger and acquisition activity, and "the company's burgeoning debt load." In addition, with the Board "placing virtually no checks or restraints" on management, the Directors did little to question nor did they seemingly understand the ramifications of giving management the "authority to borrow an unlimited amount of money without seeking the Directors' approval." The WorldCom Board also authorized the company to make or guarantee over $400 million in loans to their Chief Executive Officer (the "CEO"), Bernard Ebbers, without proper evaluation regarding whether he could repay them.

In this short case, we have examples of fraudulent financial reporting, imprudent loans to management, and a lack of adequate oversight by the Board of Directors that undoubtedly impacted the thinking of lawmakers and regulators drafting new legislation and implementing rules. The Sarbanes-Oxley Act, SEC rules, and NYSE and NASD listing requirements address these issues by:

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15 See Feder, supra note 13.
18 Id.

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• Requiring the principal executive officer and principal financial officer to personally certify their financial statements with fines and incarceration as enforcement tools.21
• Precluding the board from awarding loans to executives22
• Requiring the creation of a written charter, not only for the board, but also for their governance, compensation and audit committees and annual performance evaluations against these charters.23
• Requiring independent directors to meet regularly in executive session without the company’s management present.24

Principal executive and financial officers must produce a section 302 certification to file with their annual financial statements. These officers certify that they are responsible for internal controls over financial reporting and, to the best of their knowledge, that the financial statements are accurate. Penalties for knowingly filing false financial statements include fines of up to $5 million and twenty years in jail.25

The implementing rules of the SEC also preclude boards from awarding preferential loans to their officers. Section 402 of SOX makes it unlawful for a company to “directly or indirectly, including through any subsidiary, extend or maintain credit, arrange for the extension of credit, or renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer.”26

Additionally, the listing rules of the NYSE and the NASD now require the existence of a fully independent audit committee that has a defined charter and annual self-evaluation process so an evaluation of diligence is present.27

IV. COMPENSATION AT TYCO

Executive compensation is one of the most contentious issues a board can face. The interests of the shareholders must be weighed against the compensation requirements of its executive team. Even where a compensation plan is derived at by a deliberate and prudent process, the amounts can be perceived as unfair by rank and file employees and shareholders. Where there is no deliberate process, wholesale looting of the company can occur. According to an indictment filed by New York State, Tyco’s Chairman and Chief Executive Officer (CEO), Dennis Kozlowski is accused of running a sophisticated criminal enterprise—so sophisticated, in

22 Id at § 402(a)(k)(1).
23 See Final NYSE Corporate Governance Rules, supra note 2, at § 303A.4(a)-(b)(ii), § 303A.5(a)-(b)(ii), § 303A.6, § 303A.7(c)(ii).
24 See id. at § 303A.3
25 House Committee on Financial Services, supra note 14, at 5.
27 Id. at § 301.
fact, that prosecutors named it “Top Executives Criminal Enterprise,”28 which they used to describe Kozlowski’s management team throughout the indictment. Kozlowski stands accused of thirty-eight felony counts of stealing $170 million directly, and $430 million indirectly through illicit stock sales. Some of the other excesses the State accused Kozlowski of include:

- Deciding what bonuses would be paid to whom, and when, without regard to restrictions that the board placed on executive compensation.
- Hiding unauthorized bonuses in transactions booked as “nonrecurring charges.”
- Using the company treasury to pay his personal bills.
- Publicly supporting Tyco stock while privately selling it.
- Using corporate money to purchase directors’ residences at greatly inflated prices.
- Selling corporate residences to himself at far less than fair value.29

The SEC piled on the offenses by including in its complaint that Kozlowski:

- Used $7 million of Tyco’s funds to purchase a Park Avenue apartment for his first wife, from whom he was separated.
- Forgave tens of millions of dollars in loans to executives and directors, including himself.
- Accelerated the vesting of Tyco stock for himself and others.
- Used corporate money to buy his New Hampshire house for three times its apparent fair market value.

Kozlowski excesses began in 1997 with the purchase of the security firm ADT. The purchase enabled him to further his hold on the board. The officers and directors of ADT were no strangers to generous compensation packages. The Chairman kept his headquarters in Bermuda and used his yacht as a floating executive suite. Kozlowski appointed two of ADT’s directors to the four-man compensation committee, which quickly adopted ADT’s more generous compensation schemes. Under the plan, Kozlowski’s total compensation rocketed from $8.8 million in 1997 to $170 million in 1999.

Still it was not enough. During this period, Kozlowski allegedly utilized his relocation accounts and an employee corporate loan program- a program designed to help employees pay taxes due on stock granted under a Tyco stock ownership plan- to buy homes, artwork, jewelry and a 1930’s vintage yacht. He is also accused of using the accounts to reward favored executives, provide huge charitable gifts in his name and throw extravagant parties.

29 Id.
The excesses did not stop there, either. Kozlowski owned houses in the posh districts of Greenwich, Connecticut; Boca Raton, Florida; Nantucket, Massachusetts; New York City; and Beaver Creek, Colorado. 30 Why a person legitimately making $170 million in a single year would put it all on the line by embezzling from his company is one for the psychoanalysts. Regardless, these events did lead the NYSE to include in its listing rules the following requirements:

- The company must have a compensation committee comprised entirely of independent directors.
- The compensation committee must have a written charter detailing its purpose and responsibilities which include, at a minimum, the review and approval of corporate goals and objectives relevant to CEO compensation and evaluation of performance and determine as a committee, or together with the board, the CEO's compensation based on that evaluation. The committee will also make recommendations with respect to non-CEO compensation.
- The compensation committee must prepare a committee report on executive compensation to be filed with the SEC on form 10-K.
- The committee must perform an annual self evaluation of performance against their charter.31

The lack of independence on the compensation committee was not the only conflict of interest on Tyco's Board. Another director, Frank Walsh, was paid $10 million and another $10 million was paid to his charity for consulting work he performed for the company arranging an acquisition. So despite originally being independent, his independence was compromised when he began consulting for the company. To address this, the NYSE listing requirements also defines what constitutes director independence and requires the entire board to evaluate the independence of each of its members: "No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company). Companies must disclose these determinations."32

New York Stock Exchange rules extend this definition for a period of three years after the end of the relationship that disqualifies independence to both the individual in question as well as to their immediate family members. A director or family member that receives more than $100,000 a year in direct compensation or is an executive officer of another company doing more than

31 See Final NYSE Corporate Governance Rules, supra note 2, at § 303A.4(b)(ii), § 303A.5(b)(ii), § 303A.7(c)(i).
32 See id. at § 303A.2(a).
$1 million or 2% of that company’s consolidated gross revenues with the company also precludes independence.\textsuperscript{33}

V. EXECUTIVE STOCK TRADING AT IMCLONE AND ENRON

There is no more treasonous act to an agency relationship than that of a company executive using inside information to trade ahead of his or her stockholders. Imclone’s former CEO, Sam Waksal, was convicted for acting on insider information. He not only sold his stock just prior to public notification of the FDA’s rejection of Imclone’s cancer drug Erbitux, but also tipped off family members. The revelations forced the resignations of senior executives and continue to weigh heavily on the company at a time when it should be concentrating its efforts on correcting its application and getting its drug approved. Waksal was eventually sentenced to seven-plus years in prison for his actions.\textsuperscript{34}

While Waksal broke existing securities laws, director, officer and principal stockholder disclosures were nevertheless tightened under the Act. Disclosures not only include transactions in equities, but swap agreements as well with requirements for electronic filings to a publicly available website. If the company maintains a website, they must also post this disclosure the day after filing. Furthermore, if an issuer is required to prepare an accounting restatement due to material non-compliance of the issuer, as a result of misconduct, with any financial reporting requirement, any profits realized from the sale of securities of the issuer during that twelve month period must be forfeited.

The growth in defined contribution or 401k pension plans has been well documented. It has not been unusual for a large percentage of a defined contribution plan’s assets to be comprised of company stock. The company encourages, or even requires a portion of plan assets consist of company stock to keep it in stable hands. At Enron, company stock accounted for 62% of assets in the employee’s 401k plan at the end of 2000.\textsuperscript{35} What was unusual, however, was that employees at Enron were prevented from selling their company stock while it imploded due to a company directed “black-out period.” “Black-out periods” can be legitimately instituted to change administrators, add or remove funds, close the books or other plan events. During Enron’s black-out, however, executives freely sold their company awarded stock while rank and file employees had their investments in company stock frozen via their 401k plan.

To prevent similar conflicts, Section 306 of the Act prohibits insiders from trading during pension blackout periods. Specifically, “it shall be unlawful for any director or executive officer of an issuer of any equity security . . . , directly or indirectly, to purchase, sell or otherwise acquire or transfer any

\textsuperscript{33} See id. at § 303A.2(b)(i).

\textsuperscript{34} Constance L. Hayes, Former Chief of Imclone is Given 7-year Term, N.Y. TIMES, June 11, 2003 at CI.

equity security of the issuer . . . during any blackout period with respect to such equity security if such director or officer acquires such equity security in connection with his or her service or employment as a director or executive officer."

VI. THE CULTURE AT HEALTHSOUTH

It is hard to put a price tag on a strong, open and honest corporate culture, but easier to associate a cost to a company of a closed, fraudulent culture with an imperial CEO. The Justice Department has charged Richard Scrushy, the former CEO of HealthSouth, with an eighty-five count indictment which includes conspiracy, mail, wire and securities fraud; false statements; false certifications; and money laundering. Investors have punished the stock of the nation’s largest chain of rehabilitation hospitals, pushing it down over 75% since these issues were raised. Fifteen insiders have pled guilty to a number of charges of financial wrongdoing at the company intended to mislead the financial community. Eleven of these insiders who have been cooperating with investigators describe a culture in which board minutes were altered, board members investigated by the company’s security chief, and employee fear of reporting fraudulent activities, or even bad news to management. Corporate counsel tells how he delayed giving bad news to the CEO because he knew it would make him unhappy. An accountant who did report suspected fraud was later passed over for promotion. One supervisor went so far as to convince a physical therapist to drop his plans to report his suspicions to the company’s fraud hotline.

Those who would flout the laws of our country will reward those that sustain them, and punish those that they perceive as a threat. In order for corporate governance systems to work effectively, there must be a strong culture which rewards doing the right thing and provides an effective means for reporting bad behavior. Employees must trust that whistle blowing will not lead to punitive measures against them, rather that their courage will be embraced. To help put these conditions in place, the SEC is implementing rules which require each company to construct a code of ethics for senior financial officers. The audit committee of the board of directors must also establish procedures for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters. Furthermore, Section 806 of SOX puts in place important protections for employees of publicly traded companies that provide evidence of fraud. The act prohibits actions to “discharge, demote, suspend, threaten, harass or in any other manner discriminate against an employee . . . because of a lawful

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act done by the employee and provides remedies in the form of compensatory damages.

VII. OBSTRUCTION OF JUSTICE AT ARTHUR ANDERSEN

While the poor judgment and professionalism of Andersen’s assessment of Enron and WorldCom’s financial statements is what stands out in the minds of managers, regulators, and the press, Andersen was actually undone by being found guilty of obstructing justice. In an indictment filed in the United States District Court, Southern District of Texas, the government accused Andersen of the wholesale destruction of documents germane to the Enron case with the intent to “alter, destroy, mutilate and conceal objects with intent to impair the objects, integrity and availability for use in such official proceedings.” Found guilty, Andersen was forced to disband and over one thousand of their clients had to find new auditors.

Interestingly, the indictment did spell out some of Andersen’s shortcomings regarding their work on Enron’s financial statements. These include:

- Andersen did not object or otherwise cure public statements by Enron incorrectly characterizing numerous charges as non-recurring, even though Andersen believed the company did not have a basis for this conclusion.
- The Andersen team handling the Enron audit contravened the accounting methodology approved by Andersen’s own specialist working in its Professional Standards Group.
- Internal reviews of the Andersen team assigned to Enron received a rating of “2” on a five point scale with “5” being the highest.
- Andersen had direct knowledge of allegations of financial reporting fraud made by Sherron Watkins, the famous Enron whistleblower.

So it is clear that, despite the indictment made concerning obstruction of justice, the government believed that there were deficiencies in Andersen’s capabilities as independent auditor of Enron.

Enron was one of Andersen’s largest clients, reportedly the source for $25 million in annual audit fees and $27 million in consulting and other fees. Andersen also performed the role of internal auditor for a period of time which

41 See Andersen, supra note 39.
42 BERRKOWITZ, supra note 4, at 9.
creates the appearance of a conflict of interest. How can the independent auditors opine on their own work? The answer is they can not.

To address the professional standards of the independent auditors apparently absent at Enron and others, Congress established the new Public Company Accounting Oversight Board ("PCAOB") under SOX to regulate the accounting profession and "to oversee the audit of public companies that are subject to the securities laws and related matters." It has been charged with the awesome responsibility of setting ethical and conflict-of-interest standards, disciplining accountants and conducting annual reviews of the largest accounting firms. In short, the Board now has regulatory oversight of the accounting profession and has taken over many functions that were previously self-regulated with oversight from the Securities and Exchange Commission. Andersen's legacy is the end of the profession's self regulation.

The Act further requires that partners only serve a client for five years at which time they must rotate off. Additionally, the Act prohibits a registered public accounting firm who is providing audit services to contemporaneously provide non-audit services such as bookkeeping, systems design and implementation, appraisal or valuation services, fairness opinions and contribution in kind reports, actuarial services, internal audit outsourcing services, management or human resource functions, broker/dealer, investment advisory or investment banking services, or legal and expert services unrelated to the audit. Other services, including tax services, are allowed with the approval of the audit committee of the board of directors.

VIII. CONFLICT OF INTEREST AT VINSON & ELKINS

As one of the oldest and most prestigious law firms in Houston, the firm of Vinson & Elkins was a trusted advisor to Enron and was paid handsomely. Enron paid the law firm $36 million in 2001, representing roughly 7% of their global revenue. In response to the Sherron Watkins memo detailing concerns about the special purpose entities, Enron retained Vinson & Elkins to investigate the allegations even though Watkins had specifically written that they should not be selected for examining these transactions due to the obvious conflicts of interest.

Good investigators leave no stone unturned. They need to be independent, objective and have a heavy dose of professional skepticism while performing their inquiry. Having worked on a number of transactions for the company, and having a long, profitable relationship with its management, it would have been difficult for the best intentioned lawyers to remain objective and diligent. Predictably, the firm's investigation was ineffective. In the report, Vinson & Elkins said that the issues raised "do not, in our judgment, warrant a

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43 Id.
45 Id. at § 201(g)(1)-(9).
46 Id. at § 201(h).
47 BERKOWITZ, supra note 4, at 12.
further widespread investigation by independent counsel and auditors." The eventual bankruptcy of Enron puts this opinion in a particularly harsh light.

The Sarbanes-Oxley Act allows the SEC to establish professional standards of conduct for the nation’s attorneys. These standards include “up the ladder” reporting obligations that would be triggered when an attorney “becomes aware of evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer.” The lawyer would then have to report the matter to the chief legal counsel of the company. If the attorney does not receive an adequate response from the company’s chief legal counsel and the CEO, the lawyer must report the violation to the company’s board of directors, the audit committee of the board, or a committee consisting of outside directors. That is where the lawyer’s duties currently end. These actions protect the lawyer from disciplinary action and civil liability.

IX. ANALYST INDEPENDENCE AT INVESTMENT BANKS

Investors often rely on research conducted by analysts affiliated with broker/dealers. These analysts are represented to be independent of a bank’s investment banking and trading operations. However, the pressure to issue positive research for those companies with which the bank has a relationship can be intense as there are millions of dollars in commissions and fees at stake. At times, the ties between a company and a bank can be so strong, that research analysts are awarded unprecedented access and favored treatment which presumably would be cut off if an unfavorable research report were issued.

The House Committee on Financial Oversight reviewed the ties between Jack Grubman, an analyst for Salomon Smith Barney, and WorldCom’s CEO Bernie Ebbers and CFO Scott Sullivan. They found “a lack of independence” with Grubman attending “company board meetings, exclusive of other analysts.” By providing Grubman with access to information not available to other analysts, the company hoped to color his analysis in their favor. Investors who relied on Grubman’s “independent and objective research” would be disappointed as WorldCom collapsed.

Henry Blodget, the senior research analyst and group head for the Internet sector at Merrill Lynch, Pierce, Fenner & Smith was permanently barred from the securities industry and fined for issuing fraudulent research in which he expressed views that were inconsistent with his privately expressed negative views. In short, the Securities and Exchange Commission found that he issued positive research on GoTo.com while privately disparaging the company. Blodget also issued research reports on “six other internet companies

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48 Id. (quoting Vinson & Elkins).
50 House Committee on Financial Services, supra note 14, at 21.
that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts regarding those companies.\textsuperscript{51}

The Act directed the SEC to implement rules to address "conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information."\textsuperscript{52} The Act also prohibits retaliation by a broker/dealer for a negative research report on a present or prospective investment banking client and requires safeguards to separate research from investment banking activities.

X. THE ROLE OF SELF REGULATORY ORGANIZATIONS (SROs)

The nation's two largest stock markets, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD), are self regulatory organizations (SROs), meaning that they not only provide a marketplace for stocks, but they also self-police their members and set listing requirements for companies that wish to list their securities with them. This is all done under the supervision of the SEC. After the passage of Sarbanes-Oxley, the NYSE and NASD embarked on an evaluation of their governance structure with particular emphasis on the relationship of their regulatory enforcement efforts to the rest of the organization. There is an inherent conflict between providing a competitive market and self-regulation which both organizations are continually analyzing and attempting to address. The NYSE and NASD also issued new listing requirements that went above and beyond what was required under the SOX.

Some additional NYSE requirements include:

- a board that consists of an independent majority
- a nominating /corporate governance committee that is composed entirely of independent directors
- a compensation committee that is composed entirely of independent directors
- additional audit committee requirements including the preparation of a charter and an annual self-evaluation
- a requirement that non-management directors regularly meet in executive session without management
- that each company must have an audit department
- that each company adopt and disclose corporate governance guidelines which include director qualification standards, responsibilities,


\textsuperscript{52} Sarbanes-Oxley Act of 2002, supra note 12, at § 501.
compensation, continuing education, succession, and annual performance evaluation of the board

- the adoption of a code of ethics for directors, officer, and employees and disclosure of waivers for officers and directors
- CEO certification that they are not aware of any violations of the NYSE corporate governance listing standards

The listing requirements further define “independence” to create bright line criteria regarding whether a director is and remains independent for the purpose of meeting corporate governance requirements. NASD listing standards are similar except that the independence thresholds are lower reflecting the smaller market capitalization of many of their listings. The NASD rules also do not require independent compensation or nominating committees, but do require that a majority of the full board’s independent members approve compensation and nomination proposals. While it is too early to determine how these rules will impact sitting directors, there is little doubt that board independence will be improved going forward.

XI. THE ACT’S IMPACT ON INTERNATIONAL COMPANIES AND FOREIGN GOVERNMENTS

When SOX was drafted, “many international firms and foreign governments sought exemptions from the legislation.” Despite much concern and lobbying, no exemptions or accommodations were made for foreign entities in the Sarbanes-Oxley legislation. Those foreign entities that file 20-Fs with the SEC instead of the 10-Ks required by domestic public companies must also certify their financial statements. Additionally, a registered public accounting firm must audit and attest to management’s assertions. The Act specifically requires that foreign accounting firms register with the Public Company Accounting Oversight Board (PCAOB), but the board is negotiating joint supervision rules with the European Union (the “EU”) that would rely on the oversight of European regulators to conduct reviews of registered accounting firms in their jurisdiction.

The recent massive fraud at the Italian company Parmalat shows that Europe is not immune from problems similar to those experienced in the United States. Using a complicated and layered ownership structure, the company effectively hid its financial problems from the world for years. Grant Thornton, the company’s auditors, have been implicated in helping set up and continue to audit certain companies in question. In the United States, the SEC has sued Parmalat accusing them of selling “bonds and other securities while

53 SCOTT GREEN, MANAGER’S GUIDE TO THE SARBANES-OXLEY ACT: IMPROVING INTERNAL CONTROLS TO PREVENT FRAUD (John Wiley & Sons, Inc., 2004).
54 House Committee on Financial Services, supra note 14, at 18.
engaging in one of the most brazen corporate financial frauds in history."57 This fraud promises to be as complex and global as any before it. Some estimate the assets of Parmalat to be worth 1 to 2 billion euros, while debt has been estimated to be as high as 14 billion euros.58

Italy is not the only EU country experiencing corporate abuses. KPMG Forensic recently reported that the number of big fraud cases in Britain almost doubled in 2003 to 153 from 83 the previous year.59 Union Bank of Switzerland (UBS), one of Europe’s largest banks, has been implicated in bribery and share price rigging in Hong Kong.60 Accounting scandals and irregularities have also been reported at the Dutch supermarket group Ahold and Zurich-based Adecco, the largest temporary employment agency in the world.61

Playing catch-up, the EU has made proposals to improve corporate governance and audit services throughout the Union. Oversight is currently conducted on a national level with no uniformity between member states. These new proposals include improved uniform disclosure requirements, better director independence, and coordination of the corporate governance efforts of member states.62 There are also initiatives to join EU and US auditing standards, establish pan-European auditor ethics, and coordinating national auditor oversight systems into a pan-European board.63

The effects of the legislation in Asia have been less potent, however, as Japan has used Enron and other large frauds as an excuse to put off real corporate governance reform.64 Not long ago, in a fraud similar to Enron, Yamaichi Securities used off-balance sheet vehicles to manipulate their financials resulting in their collapse.65 Furthermore, some believe Japan’s banking sector crises has been a partial result of poor corporate governance and shareholder accountability.66 Despite this evidence that the Japanese governance system needs improvement, problems in the US seem to have retarded reforms aimed at correcting these shortcomings as critics point to the inability of US style corporate governance to prevent similar fraud.

Clearly, the impact of Sarbanes-Oxley overseas has been significant, both positive and negative, and promises to continue to drive change throughout the world.

59 Bob Sherwood, Number of Big Fraud Cases Almost Doubles, FINANCIAL TIMES, Jan. 26, 2004, at 4.
62 House Committee on Financial Services, supra note 14, at 18-19.
63 Id. at 19.
65 Id.
66 Id.
There is no question that the Sarbanes-Oxley legislation has had a significant impact on both the operations and regulatory costs of public companies. If history is any guide, simply passing the Act will not deter fraud and other criminal activity. Much of the bad behavior detailed above broke existing laws dating back to 1933 and 1934. Since passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, we have experienced the S&L crisis and a series of corporate frauds and other financial shenanigans which include the collapse of Drexel, Burnham and Lambert and Barings Brothers, the turmoil and sale of Kidder Peabody and Banker’s Trust, and the bankruptcy of Orange County, California. The penalties may be more stringent, and the chances of getting caught greater, but it is safe to say that neither Congress nor the SEC can legislate or regulate individuals into doing the right thing. Like a single-minded killer, a criminal intent on illegal behavior will not be dissuaded by laws and regulations. They will search for new ways to circumvent existing behavioral boundaries and controls. It is not possible to know with certainty the next iteration of fraud that will be created by these rogues, only that it will happen.

The questions then become, what will be the response to the next corporate crises? How many more scandals will the public endure before they call the capitalist system into question? How much more regulation can our public companies carry before they fall to foreign competition? The answers to these questions depend on the type of, severity of, and response to the crises that surface. Public debate will once again shape new legislation, regulations, or both to calm public fears and restore a sense of confidence in our markets. The costs of this confidence can not be ignored. Large multi-national corporations expect to spend over 35,000 hours complying with the internal control requirements of SOX and expect audit fees to increase 38%. This multi-million dollar burden will negatively impact the bottom lines of these companies. But the cost to our economy from a loss of confidence in our markets can not be underestimated. The cost to our public companies from a loss of our capital markets could easily dwarf such preventive expenditures.

There is an important relationship between open markets and regulation that our business and legislative leaders must carefully monitor and make adjustments to address pending threats. Aggressive legislation and prosecution by each of the states could tilt that relationship into over-regulation. There is a temptation for states to jump on the Sarbanes-Oxley bandwagon without regard to what other states are doing. Both California and New York have passed additional documentation requirements above what is required by SOX. With every state passing rules, the complexity of corporate compliance multiplies with the potential that a company has met the letter and spirit of the SOX

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67 See Fonda, supra note 55.

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legislation, and that of all states except the one where they mistakenly have not complied with an arcane state rule. Some attorney generals have further suggested applying elements of SOX legislation to non-profit organizations. Even private companies are not immune from the spill-over effect of this and related legislation as they will have to be in a position to comply fully with SOX and state laws before they go public. Even those that have no intention of going public may need to comply with certain SOX practices to meet lender and insurance requirements. At some point, the burden of compliance will be too much for our companies to bear.

XIII. CONCLUSION

New legislation and regulation are normally a governmental response to issues or crises. We have shown that the Sarbanes-Oxley Act was a response to a wave of corporate fraud and the passivity of our nation's boards of directors as well as audit, legal and analyst conflicts of interest and/or incompetence. Under the supervision of the SEC, the NYSE and NASD have created new listing standards and the PCAOB has initiated regulation of the accounting profession. Some states even added another layer of public company regulation and are considering rules for not-for-profit corporations. Even public companies domiciled outside the United States must comply with SOX if their securities are to trade in our public financial markets.

The need for this dramatic change, as costly as it is, was reinforced by the long line of corporate frauds exposed over several months. But even the best legislation can not predict the shape or scope of the next financial crises. Where the Sarbanes-Oxley legislation responded to the bad behaviors of yesterday, it will not prevent bad people from finding new ways to do bad things. The recent mutual fund scandals adequately make this point. Unlike other scandals before it, agents found new ways to reward themselves and favored clients at the expense of those they were paid to represent. Mutual fund agents allowed privileged clients to trade into their investment vehicles when it appeared, based on late breaking news that such an investment would immediately increase in value. Sometimes, the agents would trade for themselves. This activity diluted the returns of those of us without privileged access who played by the rules.

What is clear is that the agents and gatekeepers must do all they can to ferret out and address bad behavior before it has a chance to destroy a company. Simply implementing new governance processes means nothing if there is not a culture of transparency and openness and a willingness to take action against those whose actions breach the moral and ethical boundaries expected of them, regardless of their position or power. We, as shareholders, employees, and

71 Paula Lacey Herman, Practical impact of Sarbanes-Oxley on privately held companies, HARTFORD BUS. J., Mar. 17, 2003.
pensioners, must expect nothing less and speak in one voice to ensure that our agents and gatekeepers do just that.