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Ethan G. Zelizer

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STUDENT ARTICLES

The Sarbanes-Oxley Act: Accounting for Corporate Corruption?

Ethan G. Zelizer*

I. Introduction

American investors once had reasonable expectations about big business. Earnings disclosures were expected to be truthful, CEOs and CFOs were expected to be honest, and auditors were expected to audit accurately and responsibly. Times have changed. Scandals at Enron, WorldCom, Global Crossing, Adelphia Communications, ImClone Systems, Tyco International, and dozens of other companies have caused investors to question the fundamentals of investing and corporate responsibility. Who is looking out for the little guy? What is preventing American investors from cashing in their 401(k) accounts, bailing out of the stock market, and finding a mattress to hide their money under? Free enterprise and the public's faith in corporate America are currently at a crossroads.¹

Investors are consumers of a unique commodity. Rarely does so much faith and trust go into a purchase. Perhaps naïvely, investors rely on a company's reputation and a CEO's honor when choosing their investments. They also rely on the research, knowledge, and savvy of their brokers and trust that their 401(k) plans will be diversified enough to withstand market flux.² Ultimately, and until

* J.D. candidate, May 2003, Loyola University Chicago School of Law; B.A. Political Science and Peace Studies, Loyola University of Chicago. The author would like to dedicate this article in memory of his parents, Louis and Blossom Zelizer, who invested all they had in their son.

¹ 148 CONG. REC. H5462-02, 5462 (daily ed. July 25, 2002) (statement of Rep. Oxley).

² 148 CONG. REC. E1470-02, E1471 (daily ed. July 26, 2002) (statement of

now perhaps unknowingly, investors depend on independent auditors to practice honest accounting.³ If the recent accounting disasters have proven anything, it is that investors need more than trust to navigate the dark seas of corporate piracy. Investors need new protection.

American investors rely on the federal government to quickly implement rules and procedures when the marketplace falters. For nearly seventy years, the Securities and Exchange Commission (“SEC”) and the securities laws it enforces⁴ have kept big business relatively well behaved. Unfortunately, the existing statutory scheme did not safeguard American investors from Enron and WorldCom.⁵ Company executives made hundreds of millions of dollars, while shareholders and company employees struggled with the concept of how an “accounting problem” caused by “professionals” depleted their life savings and retirement plans.⁶

In response to the loopholes found in existing securities laws, Congress enacted the Sarbanes-Oxley Act of 2002, also referred to as the Public Company Accounting Reform and Investor Protection Act (the “Sarbanes-Oxley Act” or “the Act”).⁷ President George W. Bush described this new law as “tough” and capable of “punish[ing] wrongdoers” while “defend[ing] the rights and interests of American workers and investors.”⁸ President Bush’s acclaim aside, the effectiveness of the Sarbanes-Oxley Act will only be proven over time. The Act can be applied, however, to what we already know about the Enron and WorldCom disasters to evaluate whether it truly solves the accounting and corporate accountability problems that

Eliot Spitzer, New York State Attorney General).

³ 148 CONG. REC. E1470-02, E1471 (statement by Spitzer).

⁴ See *infra* note 37.

⁵ See *infra* note 37 (noting that although the SEC has adapted to new forms of financial fraud in the past, the corruption associated with WorldCom and Enron require new measures).

⁶ See Senator Tom Daschle and Representative Richard Gephardt, News Conference on Corporate Scandal and Pension Reform (July 26, 2002), at 2002 WL 1730009 [hereinafter *Daschle and Gephardt News Conference*] (statement of Steve Vivian, former WorldCom employee).

⁷ Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., and other chapters (2002)).

⁸ President’s Remarks on Signing the Sarbanes-Oxley Act of 2002, 08/05/02 WEEKLY COMP. PRES. DOC. 1283 (July 30, 2002), 2002 WL 14547680 [hereinafter *President’s Remarks*].

investors recently endured.

This article first examines some causes of both the Enron and WorldCom disasters. Then, this article briefly summarizes the main sections of the Sarbanes-Oxley Act that affect individual investors. Specifically, it discusses the provisions regarding audit reform, increased executive responsibility, new disclosure requirements, and changes in punishment for corporate criminal fraud. Finally, this article evaluates whether the Act will adequately protect investors from future corporate collapses and accounting scandals.

II. Enron, WorldCom, and the Ambushed Investor

When Enron suddenly collapsed in December 2001 amid allegations of accounting fraud, shadow deals, and the mismanagement of funds, it was difficult to assess the damage levied on its shareholders and employees.⁹ That damage has now been estimated at nearly \$100 billion.¹⁰ The losses associated with Enron alone equal nearly all of the investor losses resulting from “faulty, misleading, or fraudulent audits over the previous six years.”¹¹

Enron employees and their 401(k) accounts suffered perhaps the most devastating losses. In late 2000, Enron’s stock was trading at upwards of \$90 per share.¹² By late November 2001, Enron’s credit rating had been downgraded from investment-grade to junk, immediately bringing due \$3.9 billion in debt.¹³ One year later, blindsided by Enron’s misdealings, employees watched their company file for bankruptcy.¹⁴ By then, Enron had terminated thousands of its employees, while thousands more faced the harsh

⁹ *The Consumer Impact of State Pension Fund Investments in Enron Corporation: Hearing Before the Subcomm. on Consumer Affairs, Foreign Commerce and Tourism of the Senate Comm. on Commerce, Science, and Transportation*, 107th Cong. (2002) [hereinafter *Consumer Impact Hearing*] (statement of Travis Plunkett, Legislative Director, Consumer Federation of America).

¹⁰ *Id.* (citing an estimate by former SEC Chief Accountant Lynn Turner).

¹¹ *Id.*

¹² Rebecca Smith, *Questioning the Books: Enron’s Employees, in a Court Victory, Are Permitted to Form Creditors’ Panel*, WALL ST. J., Feb. 19, 2002, at A6.

¹³ Gregory Zuckerman & Jathon Sapsford, *Why Credit Agencies Didn’t Switch Off Enron*, WALL ST. J., Nov. 29, 2001, at C1.

¹⁴ Rebecca Smith, *Enron Files for Chapter 11 Bankruptcy, Sues Dynege*, WALL ST. J., Dec. 3, 2001, at A3.

reality that their 401(k) plans were worth a small fraction of what they expected.¹⁵

In contrast to Enron's sudden collapse, WorldCom's demise was arguably more predictable. The telecom giant's stock had been in steady decline since early 2000.¹⁶ By April 2002, WorldCom had announced layoffs of 7500 employees and cut its revenue projections for the year by at least \$1 billion.¹⁷ In June, it announced plans to cut another 20% of its workforce and sell its wireless unit.¹⁸ By the end of that month, WorldCom stock had dropped to under \$1 per share and the sickly telecom giant had disclosed its ailment – it failed to report \$3.8 billion in losses the previous year, effectively turning five quarters of losses into a profit.¹⁹ Only three years earlier, the market valued WorldCom at upwards of \$65 per share.²⁰ During that three-year downturn, shareholders and employees experienced profound losses. Analysts estimate that the decline in consumer confidence caused by the fall of the company resulted in shareholder losses of more than \$2 trillion, while more than half a million telecom-related industry employees lost their jobs.²¹ Like Enron, WorldCom employees were victimized. They sustained over \$280 million in pension fund losses; more than 20,000 lost their jobs.²²

Other companies wielded similarly crippling blows to their shareholders and employees. Over 9000 employees were laid off due to Global Crossing's financial misstatements, and the company's pension funds lost over \$66 million.²³ Rite Aid employees also watched their pension funds shrink as \$145 million drained out of the company amid allegations of accounting mismanagement.²⁴

¹⁵ Ellen E. Schultz, *Enron Workers Face Losses On Pensions, Not Just 401(k)s*, WALL ST. J., Dec. 19, 2001, at C1.

¹⁶ Andrew Leckey, *Taking Stock*, CHI. TRIB., May 21, 2002, at B6.

¹⁷ *Sorry, Wrong Number: Endgame*, WALL ST. J., June 27, 2002, at A12.

¹⁸ *Id.*

¹⁹ Jared Sandberg et al., *Disconnected: Inside WorldCom's Unearthing of a Vast Accounting Scandal*, WALL ST. J., June 27, 2002, at A1.

²⁰ Jared Sandberg et al., *WorldCom Admits \$3.8 Billion Error in Its Accounting*, WALL ST. J., June 26, 2002, at A1.

²¹ Sandberg, *supra* note 19.

²² *Daschle and Gephardt News Conference*, *supra* note 6.

²³ *Id.*

²⁴ *Id.*

Likewise, Tyco International stock dropped 80% from December 2001 to April 2002, while several of its top executives were indicted for various acts of accounting fraud.²⁵

These numbers translated into tragic losses for employees of these companies.²⁶ Recently, Senator Tom Daschle brought to the public's attention a "loyal [WorldCom] employee who believed in the goals of the company and believed the company's stated financial results."²⁷ The employee lost over \$400,000 after WorldCom's restatement of earnings, accounting for most of his 401(k) plan.²⁸ The losses were caused, as he understood it, by "the actions of some who appear to have committed accounting fraud."²⁹ Clearly, he deserves a better explanation.

III. Causes of Enron's and WorldCom's Collapses: The Ineffectiveness of the Securities Acts

There is no simple answer to what caused Enron and WorldCom to collapse. Some say the companies had their auditors in their pockets.³⁰ Others point to greed, dishonesty, and a lack of corporate integrity.³¹ Still others view the markets as both the cure and the cause.³² High risks may yield high returns, but this is not an

²⁵ Christopher C. Williams & Cheryl Winokur Munk, *Deals & Deal Makers: Kozlowski Accused of Trading Gifts*, WALL ST. J., Sept. 16, 2002, at C5.

²⁶ See generally *Daschle and Gephardt News Conference*, *supra* note 6 (discussing losses to WorldCom employee of nineteen years, Steve Vivian).

²⁷ *Id.* (statement of Steve Vivian, former WorldCom employee).

²⁸ *Id.*

²⁹ *Id.*

³⁰ See Barbara Roper, Consumer Federation of America, *INVESTOR PROTECTION: LESSONS FROM THE ENRON COLLAPSE AND AN AGENDA FOR REFORM 1-4* (2002), at http://www.consumerfed.org/enron_auditor_rpt.pdf (last visited Nov. 8, 2002).

³¹ See generally President's Remarks, *supra* note 8 (stating that "[t]his law says to every dishonest corporate leader [that] . . . [n]o boardroom in America is above or beyond the law, [that the honest corporate leader's] integrity will be recognized and rewarded [and that] free markets are not a jungle in which only the unscrupulous survive or a financial free-for-all guided only by greed"). See also 148 CONG. REC. H5462-02, 5475 (daily ed. July 25, 2002) (statement of Rep. Miller) (referring to the "relentless greed" of certain corporate executives).

³² See generally Judge Frank H. Easterbrook's discussion of the effect of the increased popularity of derivative securities on corporate governance models

adequate explanation for individual investors and former employees who lost their life savings. Pension funds and 401(k) plans were never intended to be high-risk ventures that could be wiped out in one fell swoop by corporate trickery.³³ Opinions will differ, but Senator Paul Sarbanes's explanations for the collapse of the two corporate giants and the wave of corporate scandals currently pounding investors' portfolios and employees' retirement accounts are persuasive. Summarily, his explanations include a lack of accounting autonomy, blurring the line between auditor and employee, and a lack of executive responsibility and accountability.³⁴

Investors are helpless without reliable information – a theory long adhered to by Congress and federal administrative agencies.³⁵ Consequently, the securities laws provide several precautionary measures including the following: (1) standardized rules governing corporate disclosures; (2) SEC reviews of corporate disclosures for accuracy, completeness, and compliance with accounting rules; (3) collections by credit rating agencies of as much information as possible to determine the creditworthiness of companies; (4) the

(favoring the promotion of market-place mechanisms, such as derivatives, to prevent another Enron and noting that, with a few caveats, “we can stop worrying about corporate governance. Things will take care of themselves nicely . . .”). *Derivative Securities and Corporate Governance*, 69 U. CHI. L. REV. 733, 743 (2002). Although Easterbrook acknowledges that it “would be nice if the small investors had access to the same portfolio insurance as large ones do,” he criticizes Congress for prohibiting the sale of single-firm futures contracts and preventing “stockholders [from] protect[ing] themselves.” *Id.* at 735-36. *See also the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002: Hearing on H.R. 3763 Before the House Comm. on Fin. Servs.*, 107th Cong. 7 (2002) [hereinafter *Hearing on H.R. 3763*] (statement of James K. Glassman, Resident Fellow, American Enterprise Institute) (noting that investors protect themselves “through a simple system of rewards and punishments.”), available at <http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=96> (last visited Nov. 8, 2002).

³³ *See* President's Remarks, *supra* note 8 (stating that “the only fair risks are based on honest information” and that “[t]ricking an investor into taking a risk is theft by another name.”).

³⁴ *See* H.R. REP. NO. 107-414, at 18 (2002); Press Release, U.S. Senate Comm. of Banking, Housing and Urban Affairs, Remarks of Sen. Sarbanes: Economic Impact of Corporate Irresponsibility (July 8, 2002), at <http://www.banking.senate.gov/prel02/0708corp.htm> (last visited Nov. 8, 2002) (stating that “[t]he legislation will strengthen corporate accountability and auditor integrity.”).

³⁵ *See Consumer Impact Hearing*, *supra* note 9 (commenting that “the market cannot function without reliable information” and that “[the system] was designed to protect investors” from corporate deception).

creation of audit committees, made up of individual board members, to supervise audits; and (5) an independent auditor to review and approve every company's financial statements.³⁶ These safeguards have been in place for nearly seventy years, however, they failed to inform investors of Enron or WorldCom's true financial state. In fact, "[p]ractically every element of our system of safeguards failed until it was too late to repair the damage."³⁷

The boards of these companies did not question illusory accounting practices and, along with their accountants, ignored ethical quandaries.³⁸ The SEC had no reason to question otherwise normal audit reports from top-notch accounting firms; thus, credit rating agencies were left issuing more favorable ratings than these companies warranted.³⁹

With no reason to question financial reports coming from these companies, the system was subject to abuse. Accounting firms have historically relied on peer review to ensure quality, and

³⁶ *See id.* For a detailed look at the current state of Securities laws, see the Securities Act of 1933, 15 U.S.C.A. § 77 (which primarily governs the registration of securities); the Securities Exchange Act of 1934, 15 U.S.C. § 78 (which primarily governs the purchase and sale of securities, securities brokerage firms and securities exchanges); the Investment Advisor's Act of 1940, 15 U.S.C. § 80-b (which governs the operation of Investment Advisors); the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa to 78fff, 78fff-1 to 78fff-4, 78ggg to 78lll (which primarily governs the activities of the Securities Investor Protection Commission); the National Securities Markets Improvement Act of 1996, 15 U.S.C. §§ 77z-3, 78mm, 80b-3a (which expanded SEC jurisdiction and preempted the authority of the States to regulate certain securities offerings); and the rules promulgated by the SEC pursuant to those Acts, <http://www.sec.gov/rules/final.shtml> (last visited Nov. 8, 2002).

³⁷ *Accounting and Investor Protection Issues Raised by Enron and Other Companies, Oversight of the Accounting Profession, Audit Quality and Independence, and Formulation of Accounting Principles: Oversight Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) [hereinafter *Accounting and Investor Protection Issues Hearing*] (statement of Shaun O'Malley, former Chair, Price Waterhouse LLP).

³⁸ *Id.*

³⁹ Notably, credit rating agencies have an incentive to ignore the signs and give favorable ratings when they should not. *See* 148 CONG. REC. E1470-02, E1471 (daily ed. July 26, 2002) (statement of Eliot Spitzer, New York State Attorney General) (commenting on a recent investigation by the New York State Attorney General's Office, which found that credit rating agencies such as Merrill Lynch based much of their buy/sell recommendations for various stocks not on the strength of the stock, but on the individual analyst's ability to bring in new clients and stock offerings in exchange for positive research coverage).

disciplining the profession has largely come from class action and shareholder litigation after accounting problems have already injured investors.⁴⁰ Nonetheless, the accounting profession has enjoyed the public's trust and a reputation for high standards of meticulousness. Enron and WorldCom proved that the trust in accountants was misplaced, and are stunning examples of the securities laws' vulnerability to accounting fraud before the Sarbanes-Oxley Act.

A. Who's Accounting for the Accountants?

The Enron scandal is "primarily a story of executives and auditors deceiving investors about the true state of a business."⁴¹ Between 1996 and 2000, Enron reported an increase in sales from \$13.3 billion to \$100.8 billion.⁴² According to Enron, it doubled its sales in just one of those years and was positioned to double its figures again in the year it declared bankruptcy.⁴³ Enron was billed as America's seventh largest company, ostensibly on its way to being the world's largest by revenue.⁴⁴

So how did Enron go from the top to rock bottom in a matter of months? The answer is easy: it cooked the books and Arthur Andersen let it.⁴⁵ For example, Enron took advantage of an accounting loophole that allowed the company to use gross value instead of net value⁴⁶ when calculating profits from energy

⁴⁰ *Hearing on 3763, supra* note 32, at 7 (statement by the Honorable Roderick M. Hills, former Chairman, SEC).

⁴¹ *Id.* (statement by James K. Glassman, Resident Fellow, American Enterprise Institute).

⁴² Dan Ackman, *Enron the Incredible*, FORBES.COM, Jan. 15, 2002, at <http://www.forbes.com/2002/15/0115enron.html> (last visited Nov. 8, 2002).

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ See Bethany McLean, *Monster Mess; The Enron Fallout Has Just Begun. Things Can't Stay the Same, Can They?*, FORTUNE, Feb. 4, 2002, at 93.

⁴⁶ This device is known as "mark-to-market accounting." Mark-to-market accounting means that financial assets, such as marketable securities, derivatives and financial contracts, are reported on a company's balance sheet at their current market value, although the realization of cash may not happen for years. *Testimony Concerning Recent Events Relating to Enron Corporation: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises and the Subcommittee on Oversight and Investigation, Committee on Financial Services* 107th Cong. (2002) (statement of Robert K. Herdman, Chief Accountant, SEC), available at <http://www.sec.gov/news/testimony/121201tsrkh.htm> (last

contracts.⁴⁷ It sold the same product over and over again, reporting its full value in revenue each time.⁴⁸ Many of the buyers were sham partnerships created by Enron executives to help generate the company's outrageous revenues.⁴⁹

Because financial statements and annual reports failed to reveal exactly how Enron made its amazing profits, few shareholders questioned the numbers until it was too late.⁵⁰ But there were warning signs. To put the enormous numbers into perspective, each of Enron's 19,000 employees supposedly generated \$5.3 million in revenues annually.⁵¹ In comparison, Goldman Sachs could only manage \$1.7 million per employee, while Microsoft, IBM, and Citigroup employees generated far less than \$1 million per employee.⁵² Despite their supposed productivity, the thousands of laid-off Enron employees each received less than \$14,000 in severance.⁵³ That is 11,000 times less than what former Chairman Kenneth Lay took home the year before Enron's collapse – reported at more than \$150 million.⁵⁴

Accounting fraud also led to WorldCom's financial disaster. Treating ongoing operating costs as capital investments, WorldCom reduced its operating expenses by spreading them into the future, inflating its books by \$3.9 billion.⁵⁵ Yet, somehow, accountants and auditors from Arthur Andersen put their stamp of approval on WorldCom's financial statements. WorldCom said as much in its official press release: "certain transfers from line cost expenses to

visited Nov. 8, 2002).

⁴⁷ Ackman, *supra* note 42.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ This is evidenced by the huge losses sustained by individual investors. See *Accounting and Investor Protection Issues Hearing*, *supra* note 37 (statement by Shaun O'Malley, former Chair, Price Waterhouse LLP, regarding the failing of all safeguards until it was "too late to repair the damage.").

⁵¹ *Id.*

⁵² *Id.*

⁵³ Associated Press, *Enron, by the Numbers* (June 18, 2002), at <http://www.cbsnews.com/stories/2002/06/15/national/main512378.shtml> (last visited Nov. 8, 2002).

⁵⁴ *Id.*

⁵⁵ *WorldCom Accounting Errors (Panel I): Hearing Before the House Comm. on Fin. Servs.*, 107th Cong. (2002) (statement of Rep. Maxine Waters).

capital accounts were [not] made according to generally accepted accounting principles.”⁵⁶ Rather than an Andersen auditor, an internal WorldCom accountant uncovered the company’s \$3.9 billion mistake.⁵⁷ Corporate accountability was noticeably absent from this financial debacle; WorldCom stated that Andersen’s audit reports for the last five quarters “could not be relied on.”⁵⁸ Andersen’s own official statement passed the blame back to WorldCom.⁵⁹ The accounting firm stated its concern “that important information about line costs was withheld from Andersen auditors by the [CFO] of WorldCom.”⁶⁰ Andersen added that their work for WorldCom followed industry standards.⁶¹

In hindsight, the answer to how Andersen could have gone astray is apparent – industry standards were lenient and subject to abuse. An “obvious conflict of interest [is] created when an external auditor is simultaneously receiving fees from a company for non-audit work.”⁶² The conflict is especially clear when non-audit fees dwarf those received from audit services.⁶³ A firm’s cross-selling of audit and non-audit services, on its face, is a desirable practice for the bottom-line of a client, considering the time it takes a firm to become acquainted with a company’s business practices and technology.⁶⁴

Importantly, however, a company’s relationship with their accountants and auditors is anything but transparent. Companies have power over their accountants through their use of “low-visibility sanctions.”⁶⁵ If an accounting firm questions a certain bookkeeping

⁵⁶ Sandberg, *supra* note 20.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Hearing on Financial Institutions and the Collapse of Enron Before the Governmental Affairs Subcomm.*, 107th Cong. (2002) (statement by Ted White), available at <http://financialservices.house.gov/media/pdf/031302tw.pdf> (last visited Nov. 8, 2002).

⁶³ *Id.*

⁶⁴ *Hearings on H.R. 3763*, *supra* note 32 (statement of James K. Glassman, Resident Fellow, American Enterprise Institute) (noting also that because accountants are fired by the public companies they audit, the public may rightfully learn of the accounting firm’s misdeeds).

⁶⁵ Jeffrey N. Gordon, *What Enron Means for the Management and Control of*

technique, or if it becomes resistant to what it may deem an unethical accounting practice, the client may withhold a contract or another service.⁶⁶ These tactics remain under the radar of investors and the public alike; they are far less visible than a conventional firing.⁶⁷ Nevertheless, pressure is leveraged on the auditors, and the company determines who will and will not cooperate.⁶⁸ In Enron's case, the account was just too big for Andersen to lose.⁶⁹ The Enron account brought Andersen over \$52 million in 2001 and was expected to reap over \$100 million in future years.⁷⁰

Although federal securities laws require comprehensive financial statements that must be prepared, in the words of the Securities Act of 1933, by "an independent public or certified accountant,"⁷¹ weaknesses in these laws were observed upon their conception. In testimony given before the 1933 Senate Committee on Banking and Currency, Colonel A.H. Carter⁷² successfully argued for the independent audit.⁷³ He explained that the independent board audits the corporate controllers: "[the corporate controller] is in the employ of the company. He is subject to the orders of his superiors. He is not independent."⁷⁴ When Senator Alben W. Barkley asked of Colonel Carter, "who audits you?" Carter replied, "our conscience."⁷⁵ As the Enron and WorldCom disasters have proven, an accountant's conscience does not make a foolproof system.

the Modern Business Corporation: Some Initial Reflections, 69 U. CHI. L. REV. 1233, 1237 (2002).

⁶⁶ *See id.*

⁶⁷ *See id.*

⁶⁸ *See id.*

⁶⁹ Roper, *supra* note 30.

⁷⁰ *Id.*

⁷¹ The Securities Act of 1933, 15 U.S.C. § 77aa(25)-(27) (2002).

⁷² Colonel A.H. Carter was President of the New York State Society of Certified Accountants and senior partner of the firm that was then named "Deloitte, Haskins & Sells." *See Accounting and Investor Protection Issues Hearing* (statement of Sen. Paul S. Sarbanes, Chairman) (citing *Hearing on S. 875 Before the Senate Comm. on Banking and Currency*, 73rd Cong. (1933) (statement of Col. A.H. Carter)).

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

B. Telling the Public What Companies Want Them to Hear

Audit and accounting reform aside, the Enron and WorldCom debacles have shown that the securities laws prior to the Sarbanes-Oxley Act did not deter certain CEOs and CFOs from misstating financial statements and defrauding investors. As President Bush stated, the time has finally come for dishonest corporate leaders to be exposed and punished: “[t]he Era of low standards and false profits is over; no boardroom in America is above or beyond the law.”⁷⁶ Before July 2002, the corporate climate lacked effective laws to delineate categorical crimes for corporate executive fraud and to establish a punishment scheme actually deterring such fraud.

In retrospect, investors were naïve to count on CEOs and CFOs to forego opportunities to loot their companies in the absence of significant legal deterrents. With stock options galore and the ability to sign away millions and billions of dollars with only their own approval, these executives became the ultimate insiders; they tipped *themselves* off about opportune times to sell by creating the environment necessary to profit from it. The harsh reality of inflated stock hit employees and investors sometime later.

In Enron’s case, executives made extraordinary money. While Enron abandoned its employees with plummeting 401(k) plans and without a way to exercise damage control, some of its executives were bringing in millions of dollars.⁷⁷ The most troubling part is that Enron executives appear to have purposely misled their employees. In the latter months of 2001, Kenneth Lay, Enron’s CEO, advised his employees to keep buying Enron stock while he sold \$70.1 million worth of it.⁷⁸ In fact, hundreds of millions of dollars worth of Enron stock in various executives’ portfolios was freed up and sold shortly before Enron fell.⁷⁹ The top 29 executives at Enron cashed in \$1.1 billion worth of stock options.⁸⁰

WorldCom executives also received their share of profits as their company fell. In early February 2002, WorldCom loaned former

⁷⁶ President’s Remarks, *supra* note 8.

⁷⁷ Joann Lublin, *As Their Companies Crumbled, Some CEOs Got Big-Money Payouts*, WALL ST. J., Feb. 26, 2002, at B1.

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *John Sidgmore Testimony Before the Senate Comm. on Commerce, Sci., and Transp.*, 107th Cong. (2002) [hereinafter *Sidgmore Testimony*] (statement of Sen. Peter Fitzgerald), available at 2002 WL 1753183.

CEO Bernard Ebbers \$408 million to cover margin calls on loans he secured with his stock in the company.⁸¹ WorldCom granted the enormous loan so that Ebbers would not have to sell his stock to cover the margin call, which may have resulted in a drop in the price of WorldCom stock.⁸² His leverage on the telecom giant also translated into an incredibly generous interest rate of less than 2.2% on the loan, the company's own rate for borrowing.⁸³ This has led some commentators to call WorldCom Ebbers's own "piggybank."⁸⁴ Ebbers is also due \$1.5 million per year for the rest of his life and use of WorldCom's corporate jets.⁸⁵

While WorldCom's stock price dropped, former CFO Scott Sullivan, who owned 3.2 million shares of stock, embarked on what the *Wall Street Journal* termed "aggressive accounting."⁸⁶ Although he never unloaded stock during the company's decline, Sullivan's capitalization of ongoing expenses may have been motivated by his own stock in the company.⁸⁷ In addition, although the current CEO, John Sidgmore, adamantly stressed that WorldCom reported itself to the SEC,⁸⁸ the SEC went on record stating that Sullivan and Ebbers "falsely portrayed [WorldCom] as a profitable business."⁸⁹

Enron and WorldCom executives tricked investors into staggering losses. These companies' bankruptcies have left record numbers of former employees adrift.⁹⁰ A select group of individuals were privy to knowledge and withheld it from millions of interested parties resulting in countless lay-offs, drained pension and 401(k) accounts, and diminished consumer confidence. The aftermath of Enron and WorldCom makes it clear that the securities laws were not

⁸¹ *Id.* (statement of Sen. Ernest Hollings); Sandberg, *supra* note 20.

⁸² *Sidgmore Testimony*, *supra* note 80 (statement of Jon Sidgmore).

⁸³ Joann S. Lublin, *As Their Companies Crumbled, Some CEOs Got Big-Money Payouts*, WALL ST. J., Feb. 26, 2002, at B1.

⁸⁴ *Id.* (quoting Brian Foley, an executive-pay consultant).

⁸⁵ *Sidgmore Testimony*, *supra* note 80 (statement of Sen. John McCain).

⁸⁶ Sandberg, *supra* note 19.

⁸⁷ See Jared Sandberg & Susan Pulliam, *WorldCom Revision Tops \$7 Billion*, WALL ST. J., Aug. 8, 2002, at A3.

⁸⁸ *Sidgmore Testimony*, *supra* note 80 (statement of Jon Sidgmore).

⁸⁹ Sandberg, *supra* note 19.

⁹⁰ Shawn Young & Jared Sandberg, *WorldCom Can Pay Full Severance*, WALL ST. J., Oct. 2, 2002, at B4.

an effective deterrent.

IV. The Sarbanes-Oxley Act

Congress designed the Sarbanes-Oxley Act to protect investors and fix the loopholes in previous securities laws.⁹¹ To rebuild investor confidence, the Act focuses on reinforcing the framework of securities law to restore the reputation of the American markets as the “fairest, most efficient, and most transparent in the world.”⁹² Taking into account the “paper-based system” present when Congress enacted the Securities Exchange Act of 1934, the Sarbanes-Oxley Act reforms existing law to reflect the use of the Internet and other current technology.⁹³

The Act can be broken up into five major sections: (1) new requirements for audit committees and auditors, including restrictions on non-audit services; (2) new corporate governance standards for directors and executive officers; (3) extended company disclosures; (4) increased enforcement and penalty schemes; and (5) mandated special studies.⁹⁴ The provisions discussed below break new ground in the fight against corporate fraud.

A. Audit Reforms and Audit Committee Requirements

Section 201 of the Sarbanes-Oxley Act distinguishes between audit and non-audit activities for the purposes of minimizing the cross-selling of services and limiting pressure on auditors.⁹⁵ Registered public accounting firms may not provide the following services to the stock issuers they audit: (1) designing and implementing financial information systems; (2) services relating to the accounting records or financial statements of the audit client; (3) brokering, dealer investment advising, or investor banking services; (4) internal audit outsourcing; (5) actuarial services; (6) appraisal or valuation services; and (7) legal and other expert services unrelated to the audit.⁹⁶ Section 202 allows for an exception to the general rule

⁹¹ H.R. REP. NO. 107-414, at 18 (2002).

⁹² 148 CONG. REC. S7350-04 (daily ed. July 25, 2002) (statement of Sen. Paul S. Sarbanes).

⁹³ H.R. REP. NO. 107-414, at 18 (2002).

⁹⁴ See generally Sarbanes-Oxley Act of 2002.

⁹⁵ See Sarbanes-Oxley Act § 201, 15 U.S.C. § 78(j)-1 (2002).

⁹⁶ 15 U.S.C. § 78(j)-1(g) (2002).

that auditors not engage in non-audit services, such as accounting for tax purposes, if pre-approval is granted from the issuer's independent audit committee.⁹⁷

Section 203 of the Act focuses on eliminating improper relationships between companies and their auditors by requiring both the lead audit partner and the reviewing partner on a publicly-traded company's audit to be changed every five years.⁹⁸ In addition, Section 206 seeks to address the "revolving door" phenomenon by prohibiting a registered public accounting firm from providing audit services to an issuer if that issuer's CEO, CFO, chief accounting officer, or controller was employed by the accounting firm within the previous twelve months.⁹⁹ In addition, Section 204 requires the external auditor to report to the audit committee all critical accounting policies and practices, alternative treatments of financial information under the General Accepted Accounting Principles ("GAAP") that have been discussed with management, the auditor's preferred treatment and its ramifications, and any material written communications between the auditor and management.¹⁰⁰

Section 301 of the Act amends Section 10A of the Securities Exchange Act of 1934 by adding several audit committee requirements aimed at increasing corporate responsibility and, in turn, accountability.¹⁰¹ Under this Section, the audit committee is directly responsible for the appointment, compensation, and oversight of its auditors' work.¹⁰² The audit committee must also be composed of independent members of the board of directors,¹⁰³ and, under the Act, a director will not be deemed "independent," if he accepts fees from the issuer or is an "affiliated person" of the issuer or its subsidiaries.¹⁰⁴ This fee requirement does not apply to a director who receives fees solely in his capacity as a committee member or

⁹⁷ *Id.* at § 78(j)-1(h).

⁹⁸ *Id.* at § 78(j)-1(j).

⁹⁹ *Id.* at § 78(j)-1(l). *See Consumer Impact Hearing, supra* note 9 (commenting on the unhealthy intimacy between the auditor and the company due to a "constant flow of personnel" between the two).

¹⁰⁰ Sarbanes-Oxley Act § 204, 15 U.S.C. § 78(j)-1(k).

¹⁰¹ *See* Sarbanes-Oxley Act § 301, 15 U.S.C. § 78(j)-1 (amending 15 U.S.C. 78(f) (2002)).

¹⁰² *Id.* at § 78(j)-1(m)(2).

¹⁰³ *Id.* at § 78(j)-1(m)(3)(A).

¹⁰⁴ *Id.* at § 78(j)-1(m)(3)(B).

director.¹⁰⁵

Under Section 301, the audit committee must establish procedures for the proper handling of complaints regarding accounting and auditing matters, and for anonymous submissions by employees with concerns about accounting and auditing matters.¹⁰⁶ Likewise, the audit committee has the authority, and must be given the funding, to consult and engage independent counsel and other advisors it deems necessary to fulfill its duties.¹⁰⁷ While it is the audit committee's function to secure the firm for audit services, it is the issuer's duty to pay for such services, ideally severing the dollar from the decision.¹⁰⁸

B. CEO/CFO Certification of Annual and Quarterly Reports

Section 302 of the Sarbanes-Oxley Act requires CEOs and CFOs to certify the following in each annual and quarterly report: (1) that they have reviewed the report, and, to the best of their knowledge, it does not contain an untrue statement or omit any material fact; (2) that the report fairly presents the issuer's financial condition and results of operation; (3) that the signing officers are responsible for internal controls and have designed them in such a way that all material information relating to the issuer and its consolidated subsidiaries is made known to them; (4) that they have disclosed to the auditors and audit committee any material weaknesses and any fraud affecting their internal controls; and (5) that there have been no significant changes in internal controls that could affect statements in the future, and that if there are such changes, of what type and importance.¹⁰⁹ The personal certification requirement is designed to create a specific deterrent to corporate executive fraud by instilling personal accountability.¹¹⁰

¹⁰⁵ 15 U.S.C. § 78(j)-1(m)(3)(B) (2002).

¹⁰⁶ *Id.* at § 78(j)-1(m)(4)(B).

¹⁰⁷ *Id.* at § 78(j)-1(m)(5).

¹⁰⁸ *Id.* at § 78(j)-1(m)(6).

¹⁰⁹ 15 U.S.C. § 7241(a) (2002).

¹¹⁰ *See Hearing on Criminal Sanctions for Corporate Wrongdoing Before the Senate Judiciary Comm.* 107th Cong. (2002) (statement by James R. Doty, Former General Counsel, SEC, Partner, Baker Botts, LLP), available at 2002 WL 1721686.

C. Other Manager and Officer Responsibility Issues

Like previous federal securities laws, Section 303 of the Sarbanes-Oxley Act makes it unlawful for any manager or officer to fraudulently influence or coerce the audit.¹¹¹ Unlike previous federal securities laws, if a violation of the financial reporting requirements demands that an issuer prepare an accounting restatement, the CEO and CFO will be required to reimburse the issuer under Section 304 for any bonus, incentive-based or equity-based compensation, or profits realized from the issuer's securities that are received within a year following the earlier of the public issuance or the filing of the restatement.¹¹² Additionally, the standard required for a court to enjoin an individual from serving as an issuer's officer or director is lowered under Section 305 from "substantial unfitness" to mere "unfitness."¹¹³

Other lessons learned from the Enron scandal can be found in Section 306 of the Act, which makes it unlawful for a company's directors or officers to buy, sell, or transfer company securities during a blackout period imposed on employee plans generally.¹¹⁴ A blackout period is an interval of three or more business days during which at least half of the participants in the company's individual account plans are unable to buy, sell, or transfer their stock.¹¹⁵ Any profits made during a blackout period through illegal transfers are recoverable by the issuer.¹¹⁶

Next, taking its cues from WorldCom, Section 402 of the Act prohibits loans to executives.¹¹⁷ Exceptions are made for home improvement, manufactured home loans, consumer credit, and extensions of credit under open-end credit plans, charge cards, or any extension of credit by a broker or dealer to an employee to buy, trade, or carry securities.¹¹⁸ These exceptions, however, only apply when

¹¹¹ 15 U.S.C. § 7242(a) (2002).

¹¹² *Id.* at § 7243(a).

¹¹³ *Id.* at § 78u(d)(2) (amending § 21(d)(2) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(d)(2), and further amending § 20(e) of the Securities Act of 1933, 15 U.S.C. § 77t(e)).

¹¹⁴ *Id.* at § 7244(a)(1).

¹¹⁵ *Id.* at § 7244(a)(4).

¹¹⁶ *Id.* at § 7244(a)(2).

¹¹⁷ *Id.* at § 78m(k)(1).

¹¹⁸ *Id.* at § 78m(k)(2).

loans are made in the ordinary course of the issuer's consumer credit business, are of a type generally made available to the public, and are made on market terms no more favorable than those offered to the public.¹¹⁹ Banking institutions and their subsidiaries are further exempt from this section, because they are subject to insider lending prohibitions and limitations under the federal banking statutes and regulations.¹²⁰

D. New Financial Disclosure Requirements

Reports of changes in beneficial ownership of issuer equity securities presently filed by directors, executive officers, and stockholders of 10% or more must now be filed with the SEC before the end of the second business day after the change occurs.¹²¹ Within a year of the Act's enactment, these disclosures must be filed electronically and made available by the issuer on its website by the end of the business day following that filing.¹²² Further, Section 401 mandates that periodic reports disclose material correcting adjustments, material off-balance sheet transactions, and relationships that may materially affect an issuer's financial condition or results of operations.¹²³

Issuers must now disclose information regarding its internal controls, code of ethics, and participation by financial experts.¹²⁴ Each annual report must include management's opinion regarding the effectiveness of the issuer's internal control procedures and a description of management's role in establishing and maintaining those procedures.¹²⁵ Senior financial officers are required to adhere to a code of ethics issued by the SEC and immediate disclosure must be made if an issuer changes or abandons ethics procedures.¹²⁶ Also, an issuer must disclose whether it has a code of ethics for its senior

¹¹⁹ 15 U.S.C. § 78m(k)(2)(A)-(C) (2002).

¹²⁰ *Id.* at § 78m(k)(3).

¹²¹ *Id.* at § 78p(a)(1).

¹²² *Id.* at § 78p(a)(4).

¹²³ 15 U.S.C. at § 7261 (2002).

¹²⁴ *See id.* at §§ 7262, 7264, 7265.

¹²⁵ *Id.* at § 7262(a).

¹²⁶ *Id.* at § 7264.

financial officers¹²⁷ and whether the audit committee includes a “financial expert.”¹²⁸ In defining a “financial expert,” the SEC must consider several factors, including an understanding of and experience with GAAP, the preparation or auditing of financial statements, experience with internal accounting controls, and an understanding of audit committee functions, although the qualifications may become more exact.¹²⁹ Under Section 408 of the Act, the SEC is now required to review each issuer’s periodic reports at least once every three years.¹³⁰

Recognizing the technological abilities of today’s companies and the expectations of the public, the SEC will also require “real time” disclosures.¹³¹ Under Section 409 of the Act, issuers must publicly disclose material changes in financial conditions or operations necessary for the protection of investors and the public interest on a “rapid and current basis” and in “plain English.”¹³²

E. Corporate and Criminal Fraud Provisions

Section 802 of the Act creates two new felonies directed at the unscrupulous executives of the world.¹³³ The first punishes any person or company who knowingly alters, destroys, mutilates, conceals, covers up, or falsifies any document or tangible object with the intent to obstruct or impede proceedings involving federal agencies or bankruptcy proceedings.¹³⁴ The penalties include fines, imprisonment up to twenty years, or both.¹³⁵ The second punishes any person or company who knowingly and willfully fails to retain or simply destroys corporate audit records or who knowingly and willfully violates any rule regarding record retention promulgated by the SEC.¹³⁶ Resulting punishments may include fines, imprisonment

¹²⁷ *Id.* at § 7264(a).

¹²⁸ 15 U.S.C. at § 7265(a) (2002).

¹²⁹ *Id.* at § 7265(b).

¹³⁰ *Id.* at § 7266(c).

¹³¹ *Id.* at § 78m(l).

¹³² *Id.*

¹³³ *See* Sarbanes-Oxley Act § 802, 18 U.S.C. §§ 1519, 1520(b) (2002).

¹³⁴ Sarbanes-Oxley Act § 802, 18 U.S.C. § 1519.

¹³⁵ *See id.*

¹³⁶ 18 U.S.C § 1520(b).

up to ten years, or both.¹³⁷ The Act also requires the United States Sentencing Commission to review and amend the Federal Sentencing Guidelines for the crimes of fraud and obstruction of justice to make them more effective deterrents.¹³⁸

The Act also changes the limitation period on the private right of action for securities fraud violations.¹³⁹ Under Section 804, the statute of limitations for securities fraud is extended to the earlier of either (1) two years after discovery of the facts constituting the violation, or (2) five years after the violation.¹⁴⁰ The longer statute of limitations abrogates a Supreme Court decision only a decade old.¹⁴¹ In 1991, the Court issued a 5-to-4 ruling in *Lampf v. Gilbertson*, holding that federal securities actions under § 10(b) should be governed by the analogous one-and-three-year limitation and repose structure provided for other causes of action under the Securities Exchange Act pertaining to willful manipulation of security prices.¹⁴² Before *Lampf*, the courts used longer limitation periods, such as the five-year statute of limitations for the Insider Trading and Securities Fraud Enforcement Act, or longer state limitation periods.¹⁴³

Enhanced penalties flourish throughout the Act. Section 807 allows for fines, imprisonment up to twenty-five years, or both for individuals who knowingly commit securities fraud.¹⁴⁴ Additionally, Section 1106 of the Act includes increased penalties for individuals committing willful violations of securities laws.¹⁴⁵ Individuals now face \$5 million in fines, up to twenty years in prison, or both, while corporations face fines up to \$25 million.¹⁴⁶ Further, Section 806 provides long-needed whistleblower protection for any employee who assists in an investigation or proceeding involving an alleged violation by the issuer.¹⁴⁷

¹³⁷ See 18 U.S.C. § 1520(b) (2002).

¹³⁸ Sarbanes-Oxley Act § 805, 28 U.S.C. § 994.

¹³⁹ Sarbanes-Oxley Act § 804, 28 U.S.C. § 1658(a)(2)(b).

¹⁴⁰ *Id.*

¹⁴¹ See generally *Lampf v. Gilbertson*, 501 U.S. 350 (1991).

¹⁴² *Lampf*, 501 U.S. at 360-63 (1991).

¹⁴³ *Id.*

¹⁴⁴ Sarbanes-Oxley Act § 807, 18 U.S.C. § 1348 (2002).

¹⁴⁵ See Sarbanes-Oxley Act § 1106, 15 U.S.C. § 78ff(a).

¹⁴⁶ *Id.*

¹⁴⁷ See Sarbanes-Oxley Act § 804, 18 U.S.C. § 1514(a). Specifically, this

V. Will Increased Accounting and Corporate Accountability Reforms Prevent Another Enron or WorldCom?

A single act of Congress is unlikely to erase the causes of Enron and WorldCom and simultaneously restore investor confidence. Congress was asked to fill a tall order, but, despite reported all-out partisan war within each body, it reached a compromise on nearly every issue. The Act, however, is not without flaws. In some areas Congress pulled punches; in others, it may have gone a bit too far.

A. The Accounting Industry – Audit Reforms and Audit Committee Requirements

Large, multi-faceted accounting contracts give companies the leverage of a powerful paycheck. If a company wants an accountant to “understand” a particular accounting practice a certain way, as evidenced by WorldCom, the company may very well get its way, at least temporarily. As Congress recognized, a strong, independent audit committee is necessary to address such worries. In that respect, Section 301 does an excellent job. Because it is directly responsible for appointment, compensation, and oversight of the work of its auditors, the audit committee is in a position to relieve cross-service pressures. With an established complaint process, independent funding, and the ability to retain independent counsel, the new and improved audit committee under Section 301 is well suited to resolve potential conflicts of interest.

Congress, however, did not believe that a strong audit committee alone could prevent an Enron-type disaster. In retrospect, the Enron and WorldCom disasters might have caused a knee-jerk reaction in Congress that triggered harsher than needed reform. The reasonable fear of “low-visibility sanctions” imposed by companies that accept multiple services from their auditors should not override fundamental business management.¹⁴⁸ As one commentator stated, “it is just as easy to bribe accountants directly: just pump up the fees for

Section prohibits “any officer, employee, contractor, subcontractor, or agent” of a company from “discharg[ing], demot[ing], suspend[ing], threaten[ing], harass[ing], or [otherwise] discriminat[ing]” against an employee in the terms and conditions of employment because of any lawful act that employee has done. *Id.*

¹⁴⁸ Gordon, *supra* note 65.

audit work.”¹⁴⁹ Although Enron’s relationship with Arthur Andersen was inappropriate, it was also atypical.¹⁵⁰ Andersen served as Enron’s auditor since 1985 and maintained permanent office space in the Enron building.¹⁵¹ Over the years, Enron and Andersen developed a “revolving door” arrangement, exchanging a constant flow of employees.¹⁵² Andersen employees attended Enron parties, wore Enron golf shirts, and attended Enron ski trips.¹⁵³ The relationship led Enron employees to question who worked for whom.¹⁵⁴

Although Enron showed the need to separate audit services from non-audit services, Section 201 of the Sarbanes-Oxley Act may have taken that notion one step too far. Rather than trusting the strengthened audit committee, the Act duplicates its efforts in a way that may lower company profits and stock value. The additional requirement in Section 203 that the lead audit and all audit reviewing partners change every five years will effectively minimize Enron/Andersen-type relationships. Further, Section 206 puts additional restrictions on executives, requiring at least 12 months between the issuer’s employment of a CEO, CFO, chief accounting officer, or controller and the executive’s employment by an auditor.¹⁵⁵ With these limitations, stark lines are drawn between the auditors and the non-auditing accountants. Therefore, Section 201’s limits on non-auditing services may be unnecessary.

There is no doubt that Sections 203 and 206 could have gone further. Section 203 could have required the entire accounting firm to be rotated every five years. Accountants in one firm have little to no incentive to report on a fellow accountant in the same firm. As one firm leaves and another sets itself up for a five year term, the new firm would have an incentive to locate and report any accounting problems left by its predecessor. Liabilities don’t leave when the firm leaves; rather, they are imbedded in the books, and become the next firm’s problem. A five-year rotation would give both the incoming

¹⁴⁹ *Hearing on H.R. 3763, supra* note 32, at 7.

¹⁵⁰ *Hearing on the Enron Bankruptcy Before the Senate Comm. on Commerce, Science and Transportation*, 107th Cong. (2001) (statement of Professor John Coffee, Jr.).

¹⁵¹ Roper, *supra* note 30.

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ 15 U.S.C. § 78(j)-1(l) (2002).

accounting firm an incentive to report problems and the outgoing firm an incentive to keep everything on the up and up. In the small world of the “Big 5,” reputations will, as shown with Arthur Andersen, make or break you. Similarly, Section 206 could have gone further by prohibiting *any* employee from jumping between issuer and auditor, or by making the 12-month period longer.

Good reasons exist, however, for why these sections do not go so far. First, with only five major accounting firms in the country – and after Andersen’s collapse, four – a large issuer has limited options. Requiring an issuer to change firms every five years would ignore stormy relationships between some companies and accounting firms. Every businessperson knows that the relationship between a company and their accountant can be fickle, to put it politely. Second, mandatory rotation of an entire firm also ignores the migration of employees among the top five accounting firms. Making Section 206 more strict, by requiring issuers and auditors to keep track of or prevent employees’ movements, would be prohibitively expensive and impractical. It will be far more effective to manage only the relationships of executives under Section 206.

Arguably, combined with the strengthened audit committee, Sections 203 and 206 do all that is necessary to regulate the “chummy relationship”¹⁵⁶ between the client and the accountant. Thus, the prohibitions against the cross-selling of audit and non-audit services in Section 201 may be unnecessary in light of the harm it could cause. As one commentator noted, the ratio of non-audit to audit work for Enron was lower than that of all but three of the 30 Dow Jones companies.¹⁵⁷ The absolute ban on particular non-audit services in Section 201 may add expenses, lower profits and stock prices, and hurt shareholders. On the other hand, having one firm do several jobs lowers overall costs and makes sense in light of its familiarity with the company’s structure, organization, and technology. In other words, having a company divide its accounting work among firms is economically inefficient.

Congress reformed what the business world perceived to be the proper relationship, while taking the law-abiding company out of its well-earned comfort zone. After all, public or not, no company likes too many eyes on its books. Perhaps, the companies who have kept their promises to the public have earned that prerogative. Simply put, given the independence of the audit committee provided by

¹⁵⁶ *Id.*

¹⁵⁷ *Hearing on H.R. 3763, supra* note 32, at 7.

Section 301 and the other controls in Sections 203 and 206, the prohibitions on non-audit services in Section 201 may simply be bad business.

B. Financial Disclosure Requirements

American investors need as much information as possible to make informed decisions regarding their investments, pension plans, and 401(k) accounts. Likewise, the more information that is rapidly available to the SEC, the more opportunity it has to prevent harm to investors. The pre-Act disclosure system forces the consumer to rely on outdated information. This is especially true in light of how fast the recent corporate scandals unfolded. With this in mind, the disclosures required under Section 403 of the Act make sense.

The disclosure requirements of Section 403 can alert the diligent investor of potential corruption in a company in which they hold stock. Under this section, sales of stock by officers, directors, or certain stockholders must be disclosed before the end of the second business day following the transaction.¹⁵⁸ Given that disclosures must be made electronically by the end of July 2003, investors will know who owns what and when. Moreover, under the “real time” disclosure requirement in Section 409, issuers must publicly disclose material changes in financial conditions or operations necessary for the protection of investors and the public interest on a “rapid and current basis” and in “plain English.”¹⁵⁹ By combining a requirement for more timely disclosures with a requirement for broad dissemination of that information in easily understandable terms, the Act improves the value of corporate disclosures to investors.

Further, Section 401 requires full disclosure of off-balance-sheet transactions and relationships with unconsolidated entities, ridding the securities laws of an accounting loophole.¹⁶⁰ Knowing that there was less to Enron than met the eye could have saved investors a lot of money. Additionally, the disclosure requirements under Sections 404, 406, and 407 of a company’s internal controls, its code of ethics, and the participation of financial experts in preparing financial disclosures¹⁶¹ will increase the SEC’s ability to foresee problems and track accountability.

¹⁵⁸ See Sarbanes-Oxley Act § 301, 15 U.S.C. § 78p(a)(1).

¹⁵⁹ *Id.* at § 78m(1).

¹⁶⁰ *Id.* at § 7261.

¹⁶¹ *Id.* at §§ 7262, 7264-65.

C. CEO/CFO Certification and Accountability

After the Enron and WorldCom debacles, Congress quickly enacted the Sarbanes-Oxley Act, and specifically Section 302, in an attempt to restore market confidence. Soon thereafter, the SEC ordered top executives of 942 of the largest public companies to swear under oath that their companies' current financial disclosures were accurate as of mid-August 2002.¹⁶² The SEC then promulgated rules requiring the top executives of all U.S. and foreign companies, including mutual-fund companies, to certify the financial reports they file with the agency.¹⁶³ These initial steps were effective in correcting investor information, as evidenced by over a dozen restatements, including significant downward restatements by Nicor Gas, Household International, and Xerox.¹⁶⁴

Unfortunately, because it cannot review each of the 68,000 quarterly and annual filings it receives every year, the SEC will continue to rely somewhat on investors and the media to report companies that fail to comply.¹⁶⁵ That is a big problem in and of itself. Investors who survived the shell shock of the last year and a half are not ready to be enforcers. Nonetheless, the SEC believes that Section 302 is "a major step in restoring public confidence in the markets," largely because executives who do not comply will be "in a heap of trouble."¹⁶⁶ The SEC was presumably referring to the criminal sections of the Act, where CEOs and CFOs face relatively severe criminal penalties.

Although they hold the proper people accountable for accounting fraud and provide a strong deterrent, the traditional securities laws do not go far enough in ensuring that defrauded investors recover their losses. While seeing crooked executives go to prison for twenty years may be appealing to average investors, they

¹⁶² Michael Schroeder, *Deals & Deal Makers: SEC Gives Broad Interpretation of Rules for Accounting Statute*, WALL ST. J., Aug. 28, 2002, at C4.

¹⁶³ *Id.*

¹⁶⁴ *Taking the Pledge: Restatements Trickle In*, WALL ST. J., Aug. 15, 2002, at A7.

¹⁶⁵ Schroeder, *supra* note 162. See also *The Money Gang: The Uncommon Wisdom of Myron Kandel* (Cable News Network Television Broadcast, Oct. 21, 2002) [hereinafter *The Money Gang*], at 2002 WL 4631279 (interview of Myron Kandel, CNN Financial Editor) (stating that the SEC only has "about two dozen accountants to [go] through all of this material.").

¹⁶⁶ Schroeder, *supra* note 162. (quoting SEC member Roel Campos).

may be disappointed at the SEC's approach to recovering their money. The bottom-line is that the SEC needs more money and better staffing. The Sarbanes-Oxley Act calls for an increase of \$776 million in SEC funding to implement the new laws.¹⁶⁷ Carefully assessing whether these new funds will close the gap between the agency's duties and its resources is imperative. The White House's proposal to cut \$208 million out of what the Senate granted the SEC is already alarming.¹⁶⁸ This 27% reduction is the type of approach that clearly undermines President Bush's "tough talk" on corporate crime and will undoubtedly lead to lower investor confidence.

Currently, the SEC compensates victims by requiring executives to disgorge ill-gotten gains.¹⁶⁹ Such gains include salaries, bonuses, and stock option proceeds received during the period when the fraud occurred.¹⁷⁰ The disgorgement system, however, is flawed. Last year, the SEC won court orders requiring executives and companies to disgorge nearly \$530 million,¹⁷¹ but the agency collected just \$27.5 million, or 5%, of the fraudulent funds ordered.¹⁷² Further, from 1995 to 2001, the SEC collected only 14% of the \$3.1 billion owed to it in disgorgement proceedings.¹⁷³ Moreover, when the SEC hits managers and executives, what is left to disgorge is often a fraction of what has been taken, due to some executives' free-spending ways and lofty attorney fees.¹⁷⁴ The SEC's official practice is simply to funnel disgorgement proceeds to the treasury department when they determine it is uneconomical to pay the victims.¹⁷⁵ Perhaps most troubling to the defrauded investor is

¹⁶⁷ Sarbanes-Oxley Act § 601, 15 U.S.C. § 78kk (2002).

¹⁶⁸ See *The Money Gang*, *supra* note 165.

¹⁶⁹ Paula Dwyer et al., *Making Them Give Back the Cash*, BUS. WEEK, Aug. 26, 2002, at 36.

¹⁷⁰ Walter Hamilton, *Bill Offers Little to Defrauded Investors*, L.A. TIMES, July 26, 2002, at 2D.

¹⁷¹ SEC Annual Report, at 15, at <http://www.sec.gov/pdf/annrep01/ar01full.pdf> (Jan. 2002).

¹⁷² Hamilton, *supra* note 170.

¹⁷³ United States General Accounting Office, Report to Congressional Requesters on SEC Enforcement: More Actions Needed to Improve Oversight of Disgorgement Collections 8-9 (July 2002), available at <http://www.gao.gov/new.items/d02771.pdf> (last visited Nov. 8, 2002).

¹⁷⁴ Dwyer, *supra* note 169, at 36.

¹⁷⁵ Hamilton, *supra* note 170 (citing Brian Gross, SEC spokesman).

that, although no money is actually recovered in many cases, the SEC still believes its court-ordered disgorgement rulings are relatively effective.¹⁷⁶

The methods the SEC has in place to compensate defrauded investors are questionable at best. Through July 2002, the SEC has won orders forcing executives to disgorge \$632 million, but it has only recovered 12%, or \$73 million.¹⁷⁷ Kenneth Lay alone left Enron with \$150 million.¹⁷⁸ The maximum fines of \$5 million for an individual and \$25 million for a corporation established in Sections 802, 807, and 1006 of the Sarbanes-Oxley Act pale in comparison to the hundreds of millions of dollars stolen by executives.

Investors should take notice of Section 804 of the Sarbanes-Oxley Act, which extends the statute of limitations on the private right of action against executives who commit securities fraud. Private actions fare poorly overall. Over the last 12 years, the average securities class-action lawsuit has settled for 12 cents on the dollar, not taking into account attorneys' fees.¹⁷⁹ Nonetheless, the ability to bring a private action for a significant period of time even after investors discover the fraud, will lead to more money being returned.

Several sections of the Act simply try to remove the opportunity for corporate fraud. Notably, Section 402 of the Act would have prohibited WorldCom from loaning its former CEO over \$400 million at a 2.2% interest rate.¹⁸⁰ Investors should take comfort in knowing that the executive is on the same ground as the public, with loans and lines of credit no more favorable than the market at that time will allow.

Perhaps the most important and most effective sections of the Act for the swindled investor involve pure retribution. Had Sections 304 and 306 been in existence during the Enron crisis, the company and its shareholders could have recovered more money. The ability to

¹⁷⁶ Kevin McCoy, *SEC Should Recover More ; Investigators Say Agency Not Getting Back Enough of Funds Lost to Fraud*, USA TODAY, July 25, 2002, at B2 (quoting SEC Enforcement Director Stephen Cutler as saying that the rulings "hang over defendants' heads," limiting their ability to raise new capital or commit new frauds). Although this argument has merit, executives' inability to raise capital fails to put money back in the pockets of injured investors, while crafty executives are likely to find at least some alternative method of financing.

¹⁷⁷ *Id.*

¹⁷⁸ Associated Press, *supra* note 53.

¹⁷⁹ Hamilton, *supra* note 170 (citing National Economic Research Associates).

¹⁸⁰ *See supra* text accompanying note 83.

recover profits made by executives during employee plan blackout periods could have significantly reduced the damage done to tens of thousands of Enron employees. Further, given the broad language of Section 304, the amount of money recoverable by the issuer after a violation of the financial reporting guidelines of the Act may have deterred executives with the risk of losing all their bonuses, compensation, and profits realized from the securities of the issuer.

VI. Conclusion

Hours after Enron's crash, while average investors, pension fund participants, and 401(k) account holders were checking for signs of whiplash, the SEC and the public began to piece together the mystery of Enron. Conspiracy theories and horror stories emerged as the average investor came face-to-face with his most notorious enemy – the corporate executive. They had never met before; rather, depending on honor and trust, the investor simply believed that the man behind the curtain acted responsibly and conducted his business in a way that would maximize everyone's investment.

The business of managing other peoples' money, information, and trust is unique to the public company. Such power comes subject to reasonable expectations, at the very least: thou shall not lie, thou shall not steal, and thou shall not sell the same energy commodities repeatedly to sham partnerships while advising employees to "invest away." In the real world, even reasonable expectations are sometimes not met, and investors should be prepared for loss, and at times, lots of it. Yet, when stocks plunge and pension funds disappear due to corporate fraud and deception, no loss is reasonable.

No matter what effect the Sarbanes-Oxley Act has on stocks, retirement plans, and pension plans, these investments will never only be subject to one investor's control. But they should not be subject to any one executive's control, either. The Sarbanes-Oxley Act introduces levels of accountability effective enough to deter corporate fraud. Although they do not put money directly back in investors' pockets, the new laws take unprecedented steps to require that companies and executives forfeit ill-gotten gains.

The Act, however, is not perfect. Arguably, the ban on accounting firms' cross-selling of non-audit services goes too far and will cost companies and investors money. Fortunately, however, with its increased disclosures, new enforcement schemes, and emphasis on corporate accountability, the Sarbanes-Oxley Act delivers significant reform and a sign to investing consumers that the curtain shielding the would-be corrupt executive has been lifted.
