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IS THERE A NEW SHERIFF IN CORPORATEVILLE? THE OBLIGATIONS OF DIRECTORS, OFFICERS, ACCOUNTANTS, AND LAWYERS AFTER SARBANES-OXLEY OF 2002

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1. *See, e.g.*, David S. Hilzenrath, *Financial Watchdog Became an Enabler*, WASH. POST, Jun. 16, 2002, at A20 (chronicling the demise of Arthur Andersen).

"Where also were the outside accountants and attorneys when these transactions were effectuated?"[2]

INTRODUCTION

Who is minding the store in Corporateville? Where is the sheriff who is supposed to guard the public's investment—the independent directors, corporate executives, their auditors, attorneys and regulators? Investors and the public at large asked themselves these questions while they watched in disbelief as their investments in corporate stalwarts such as Enron,[3] WorldCom,[4] Adelphia,[5] Tyco,[6] and Global Crossing[7] evaporated. That disbelief must have turned to chagrin as headline after headline chronicled a startling common theme: corporations, their directors and

2. Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990). The Honorable Stanley Sporkin is a former director of the SEC's Enforcement Division.

3. Enron engineered its debt-heavy balance sheets so that some liabilities were reported as assets and some accounts receivable were reported as solid assets. Independent audits have now shown that cash reserves were vastly exaggerated and debt, much of it from unprofitable overseas ventures, was vastly underestimated. Further, at least $20 million of Enron's debt existed off the balance sheet. Much of this debt was related to affiliate partnerships that were allegedly set up in order to hide losses, inflate earnings, and personally benefit the Enron corporate executives. *See* Wendy Zellner, *The Fall of Enron*, BUS. WK., Dec. 17, 2001, at 30; *see also* Rebecca Smith & John R. Emshwiller, *Trading Places: Fancy Finances Were Keys to Enron's Success, and Now to Its Distress*, WALL ST. J., Nov. 8, 2001, at A1 (describing complex financial maneuvers that facilitated Enron's purported profitability).

4. WorldCom improperly accounted for billions of dollars of operating expenses as capital investments, thereby exaggerating the size of its assets and downplaying losses. In addition, the company over-reported the worth of its assets by more than $50 billion. WorldCom also parked large amounts of reserves in slush funds that it raided to boost purported earnings in quarters when profits were unlikely to meet Wall Street expectations. *See WorldCom Accounting Fraud Rises to $7 Billion*, *available at* http://www.sunspot.net/business/bal-te.bz.worldcom09aug09,0,3011354.story?coll=bal-business-indepth; *see also* Jared Sandberg, Rebecca Blumenstein & Shawn Young, *WorldCom Admits $3.8 Billion Error in its Accounting*, WALL ST. J., at A1 (June 26, 2002) (explaining that by failing to report $3.8 billion in expenses, WorldCom may have committed "one of the largest accounting frauds in history").

5. *See, e.g.*, Richard Waters, *Adelphia Misses Bond Payments to Probe $2.3 Billion Loan*, FIN. TIMES, May 17, 2002, at 33 (stating that huge loan to CEO's family would have to be repaid by company and investors).

6. *See, e.g.*, Vanessa Valkin, *Tyco Unwilling to Certify Accounts*, FIN. TIMES, July 24, 2002, at 25 (describing executive misdeeds at Tyco).

7. *See, e.g.*, Elizabeth Douglass & Tim Rutten, *Accounting Worried Global Crossing Exec*, L.A. TIMES, Jan. 30, 2002, at 1 (describing how Global Crossing and its subsidiaries engaged in deceptive accounting practices by inflating revenue and cash flow figures, in order to spur investor interest).

executives, and the accountants and attorneys who advise them, cannot be trusted with the public's money.[8]

Congress attempted to answer the public's questions with what might be the most significant amendments to the securities laws since the 1930s. Congress heard testimony[9] from corporate executives who either claimed that they thought their bankrupt companies were in sound financial health[10] or who "took the fifth" for fear of self-incrimination,[11] and from auditors who insisted that they had properly certified the financial statements of these collapsed corporate giants.[12] Congress reacted swiftly, apparently adopting the theory that "nothing concentrates the mind like the prospect of a hanging . . . ."[13] The result: The Sarbanes-Oxley Act of 2002,[14] a new

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8. *See, e.g.*, Melissa Harrison, *The Assault on the Liability of Outside Professionals: Are Lawyers and Accountants Off The Hook?*, 65 U. CIN. L. REV. 473 (1997); Russell G. Pearce, *The Professionalism Paradigm Shift: Why Discarding Professional Ideology Will Improve the Conduct and Reputation of The Bar*, 70 N.Y.U. L. REV. 1229 (1995); Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry Into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75 (1993); David B. Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 801 (1992).

Previously, the American Bar Association's Corporate Responsibility Task Force had recommended strengthening ethical rules for lawyers and reforming the way corporate boards operate. The ABA provisions are not as extensive or far reaching as Sarbanes-Oxley. *See* REPORT OF THE ABA TASK FORCE ON CORPORATE RESPONSIBILITY (Mar. 31, 2003), *available at* http://www.abanet.org/buslaw/orporateresponsibility/finalreport.pdf (detailing how the ABA responded to the ethical questions facing lawyers and corporations).

9. Both the House and Senate held hearings on the Enron scandals. *See Hearings on the Financial Collapse of Enron Corp. (Second Day) Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy & Commerce*, 107th Cong. (2002), transcript *available at* 2002 WL 254207; *see also Hearing on the Enron Collapse Before the Senate Comm. on Commerce, Science, & Transp.*, 107th Cong. (2002), transcript *available at* 2002 WL 274631. The House also held hearings on the unraveling of WorldCom. *See Hearing on WorldCom Accounting Errors (First Panel) Before the House Comm. on Fin. Servs.*, 107th Cong. (2002), transcript *available at* 2002 WL 1481376.

10. "On the day I left, I absolutely and unequivocally thought the company was in good shape," said Enron Chief Executive Jeffrey Skilling. Skilling left Enron in August 2001. *See* Tom Hamburger & Greg Hitt, *House Panel Challenges Skilling Over Role at Enron*, WALL ST. J., Feb. 8, 2002, at A3.

11. *See id.* (explaining that neither Ken Lay nor any other then-current Enron executives testified at the Feb. 2002 hearings, citing their Fifth Amendment rights); Jonathan Krim & Christopher Stern, *Two Key WorldCom Witnesses Silent: Founder Ebbers, Ex-CFO Sullivan Take Fifth Before Angry House Panel*, WASH. POST, July 9, 2002, at A1 (discussing that in the House hearings on WorldCom, former CEOs Bernard Ebbers and Scott Sullivan refused to testify, invoking their Fifth Amendment rights).

12. Melvin Dick, an audit partner at Arthur Andersen, told the committee that auditors must depend on the numbers the companies provide them and that financial statements are not the responsibility of the auditors because they are management's responsibility. *See* Krim & Stern, *supra* note 11, at A1. While Mr. Dick's literal words clearly reflect generally accepted auditing standards, committee members expressed outrage at what was perceived to be an effort to disclaim responsibility for the financial collapse of Arthur Andersen's audit clients. "Panel members save their greatest derision for Dick and for Arthur Andersen, the accounting firm that was convicted of shredding documents in the Enron scandal and has all but shut its doors. 'You were General Custer and WorldCom were the Indians, and you got slaughtered,'" lectured Rep. Sue W. Kelly (R-N.Y.). *Id.*

13. Paul Maco, *New U.S. Law May Not Stop Fraud: Although Sarbanes-Oxley Should Reduce Abuses, Legislation Isn't Enough*, WALL ST. J. EUROPE, Aug. 6, 2002, at 11. *See*

code of corporate of ethics[15] backed by severe civil and criminal sanctions.[16]

The Act seeks, in essence, to revitalize the spirit of the Securities Act of 1933[17] and the Securities and Exchange Act of 1934, which were also reactions to the financial scandals of their time.[18] Many of the provisions of Sarbanes-Oxley reflect long-held positions of the Securities and Exchange Commission (SEC or Commission) about corporate governance and accountability.[19] The Act focuses on personal accountability for corporate directors, managers, accountants, and lawyers to safeguard the public's investments.[20] For example, the Act empowers the old and perhaps tired watchdog audit committee to serve as a new sheriff.[21]

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also Paula Cruickshank' *Bush Signs Sarbanes-Oxley Corporate Accountability Legislation into Law*, CCH BUS. & FIN. GROUP, *at* http://business.cch.com/banking-Finance/news/8-9-pc.asp (last visited Feb. 6, 2004) ("This new law says to every dishonest corporate leader: You will be exposed and punished; the era of low standards and false profits is over; no boardroom in America is above or beyond the law." (quoting President George W. Bush)).

14. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) [hereinafter Act].

15. *See id.* § 406 (requiring corporations to "disclose whether or not, and if not, the reason therefore, such issuer has adopted a code of ethics"). The Act also specifically requires that companies disclose whether or not they have a code of ethics, and if not, why not. *See* discussion *infra* Part IV; *see also* S. REP. NO. 107-205, at 32 (2002) (stating that not coincidentally the Senate Report stated that the Enron scandal raised concerns about the ethical standards of corporate managers).

16. The Act creates four new crimes. *See* Act § 807 (securities fraud crime); Act § 906 (false certification crime); Act §§ 802, 1102 (two new obstruction of justice crimes). In addition, the Act increases the penalties for five other crimes, including conspiracy (§ 902), mail and wire fraud (§ 903), violations of ERISA (§ 904), and criminal violations of the Securities Exchange Act of 1934 [hereinafter Exchange Act or 1934 Act] (§ 1106). *See also supra* text accompanying notes 102, 113.

17. 15 U.S.C. §§ 77a-77z, 77aa (2000) [hereinafter 1933 Act or Securities Act].

18. Congress enacted the 1933 and 1934 Acts, as well as the Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78 dd-ka (1977) (FCPA), in part as a response to financial scandals of the time. *See, e.g.*, JOEL SELIGMEN, THE TRANSFORMATION OF WALL STREET 2 (rev. ed.) (1995) (noting that Senator Ferdinand Pecora's Senate Banking Committee hearings had the goal of determining what legislation could prevent another stock market crash); *see also* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 153 (3d ed. 1995) (observing that the SEC encouraged Congress to enact the FCPA in order to discourage poor auditing practices and misleading SEC filings).

19. *See, e.g.*, Act §§ 301, 407 (setting out the obligations of a corporation's audit committee and state how it should be constituted and funded). Section 301 amends the 1934 Act to clarify standards of audit committees. Section 407 requires audit committees to have one financial expert as member. *See* discussion *infra* Part III. The idea of an audit committee is not new. In the late 1970s, the SEC persuaded the New York Stock Exchange to require all listed companies to have an audit committee comprising members independent from management. *See also In re* NYSE, Exchange Act Release No. 13,346, 11 SEC Doc. 1945 (Mar. 9, 1979) (concluding that an audit committee would prevent management from concealing illegal activities of auditors).

20. *See* Jeremy Kahn, *The Chief Freaked-Out Officer: How Enron, Tyco, and the Rest Have Made the Chief Financial Officer's Job Less, Uh, Fun*, FORTUNE, Dec. 9, 2002, at 202 (describing how corporate scandals and Sarbanes-Oxley have focused accountability on corporate executives).

21. *See, e.g.*, Act § 103(a)(2)(A) (requiring that auditing firms provide "a description, at a minimum, of material weakness in such internal controls, and of any material

Executives are required to execute detailed representations about their companies' financials, and internal procedures and controls.[22] Auditors are subject to regulation by a new body empowered to rewrite generally accepted auditing standards and auditor ethical rules, all designed to transform auditors into sheriffs, policing their clients.[23] Lawyers are also deputized under new reporting obligations that require them to bring improper conduct to the attention of appropriate officials.[24] Stiff liability provisions that could result in banishment from Corporateville back all of these obligations.[25]

The Act, however, is more than just a reaction to scandalous headlines or an enactment of new or increased criminal penalties.[26] Perhaps more

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noncompliance found on the basis of such testing"); *see id.* § 404(b) ("With respect to the internal control assessment . . . each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer."); *see also* Theo Francis, *It Still Costs Big to Insure Against a Boardroom Scandal*, WALL ST. J., July 31, 2003, at C1 (describing new regulatory powers of audit committees at public companies).

22. *See* Act § 302(a) (requiring officers to sign reports, which serves as a certification of any given report's accuracy).

23. *See id.* § 101 (establishing Public Company Accounting Oversight Board (PCAOB) "to oversee the audit of public companies that are subject to the securities laws . . ."); *see also* discussion *infra* Part V.

24. *See* Act § 307 (authorizing rules requiring attorneys to report evidence of material violations of securities law and breaches of fiduciary duties to corporation's chief legal counsel or chief executive officer and, if those officials do not properly respond, requiring attorneys to report evidence to audit committee or to board of directors); *see* discussion *infra* Part VI.

25. Banishment is, of course, one of the most severe penalties society can impose on one of its members for breaking the social contract. *See, e.g.*, MAD MAX BEYOND THUNDERDOME (Warner Bros. 1985) (explaining that when Max refuses to execute his vanquished opponent in the ring as per Thunderdome laws, he is banished from Bartertown into the desert, only to be saved from certain death when a trained monkey brings him water). Although perhaps not quite as extreme, banishment from serving as an officer/director or practicing before the Commission as a professional, might qualify as a fate equal to professional death for some.

26. In addition to adding new criminal penalties and increasing the severity of others, Congress also attempted to expand civil liability for securities fraud by increasing the statute of limitations, something the SEC has long sought. *See, e.g.*, Arthur Levitt, Remarks at the Meeting of the Association of the Bar of the City of New York (June 5, 1995), *available at* http://www.sec.gov/news/speech/speecharchive/1995/spch045.txt. Section 804 increases the statute of limitations for securities fraud to not later than the earlier of two years after discovery or five years after the violation. However, section 804 amends 28 U.S.C. § 1658 (time limitations on commencement of civil actions arising under Acts of Congress) not the securities laws.

Rather than amend the statute of limitations provisions provided for under specific statutes, section 804 of the Act amends the catch-all statute of limitations provision provided for under 28 U.S.C. § 1658(a), which states that "[e]xcept as otherwise provided by law, a civil action arising under an act of Congress enacted after the date of the enactment of this section may not be commenced later than 4 years after the cause of action accrues." Section 804 of the Act added a second provision to § 1658, which provides:

> Notwithstanding subsection (a), a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(A)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78C(A)(47)), may be brought not later

significant than those penalties are the corporate governance theories reflected in the Act that may impact the conduct of corporate managers and their relationship with their professional advisors: corporate managers now must comply with a series of federal law obligations that are more typical of those found in state corporation law. In addition, corporate advisors now have federal law obligations imposed on them, which may in some ways transform them into law enforcement scouts[27]—a role many have

than the earlier of (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation. 28 U.S.C. § 1658(B).

The term "securities laws" includes the following: the Securities Act of 1933, the Securities Exchange Act of 1934, and the Sarbanes-Oxley Act of 2002, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Securities Investor Protection Act of 1970.

The impact of this provision is questionable at best. Express causes of action have a one and three year limitation period under the Securities Act, 15 U.S.C. § 77a, *et seq.* and the Exchange Act, 15 U.S.C. § 78a, *et seq.* Implied causes of action under Exchange Act § 10(b) have the same limitation period as the express causes of action. *See* Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991) (borrowing the limitation period for the cause of action implied under section 10(b) and Rule 10(b)-5 from the express causes of action in the Securities Act and the Exchange Act). Because § 804 applies to "fraud" actions, it may have been intended to apply to actions brought under § 10(b) of the Securities Act. *Lampf*, however, makes that possibility problematic at best since the Court applied the statute of limitations applicable to the express causes of action in the securities laws to the cause of action the courts applied under § 10(b)—not the statute of limitations in § 1658. Until the courts address the issue, it is unclear which violations of the securities laws, if any, will be subject to the new four-year statute of limitations. *See* Michael Perino, *Statutes of Limitations Under the Newly Passed Sarbanes-Oxley Act*, N.Y.L. J., at 4, Aug. 2, 2002; *see also* Act § 803 (providing that judgments in securities law actions are non-dischargeable in bankruptcy).

Section 804 has also raised questions as to whether it applies retroactively. The section provides that it "shall apply to all proceedings addressed by the section [28 U.S.C. § 1658(B)] that are commenced on or after the date of enactment of this Act." Act § 804(b)(2)(B). One district court has held that a claim, which had expired under the old statute of limitations period, could proceed because the claim was filed after the passage of the Act, and within the new statute of limitations provision. *See* Roberts v. Dean Witter Reynolds, No. 8:02-CV-2115-T-26EAJ, 2003 WL 1936116, at *4 (M.D. FL. Mar. 31, 2003). The district court certified the issue for interlocutory review and the case is pending before the U.S. Court of Appeals for the 11th Circuit. *See id.* Other district courts, however, have held that Section 804 of the Act does not revive previously extinguished claims. *See In Re* Heritage Bond Litig., Nos. CV 01-5752 DT(RCX), CV 02-383 DT (RCX), CV 02-993 DT (RCX), CV 02-2745 DT (AJWX), CV 02-6484 DT (RCX), CV 02-6841 DT (RCX); CV 02-6512 DT (AJWX), 2003 WL 22502577, at *16 (C.D. Cal. Jan. 6, 2003); *In Re* Merrill Lynch & Co. Research Reports Sec. Litig., 272 F. Supp. 2d 243, 265 (S.D.N.Y. July 2, 2003); Glaser et al v. Enzo Biochem, No. CIV.A. 02-1242-A, 2003 WL 21960613, at *5 (E.D. Va. July 16, 2003) (pending before the U.S. Court of Appeals for the 4th Circuit Dkt. No. 03-2188 (DBRO) since Oct. 8, 2003 filing).

27. The extent of the limitations on corporate managers and the precise obligations of their professional advisors will not be known until all of the regulations required by the Act are written. Eleven sections of the Act direct the SEC to write rules, frequently under very short deadlines: Act § 3(a) (general rulemaking authority); Act § 208 (auditor independence and related matters); Act § 302(a) (CEO and CFO certifications); Act § 303 (improper influences on auditors); Act § 306(a) (in consultation with the Dep't of Labor, concerning trading by directors and officers during blackout periods for pension fund participants); Act § 307 (conduct of attorneys); Act § 401(a) (off balance sheet transactions); Act § 401(b) (pro forma financial statements); § 404 (management assessment of internal controls); Act §

argued that the SEC has long sought to impose on professionals who advise public companies.[28]

Yet, after Sarbanes-Oxley, the real question still lingers: Will deputizing new corporate sheriffs result in someone minding the store? And ultimately, will the Act, in the words of Representative Oxley, "help to restore faith in the system?"[29]

I. LEGISLATIVE BACKGROUND

There is little formal legislative history to the Act in terms of committee and conference reports. Rather, news headlines about the corporate scandals such as Enron and WorldCom *are* the legislative history of the

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407 (disclosure of financial expert as member of audit committee); and Act § 802 (retention of audit work papers). Section 306(b) directs the Secretary of Labor to issues rules in conjunction with the SEC (under § 306(a)) regarding trading by officers and directors during trading blackout periods for pension participants.

Ten other sections direct that various reports and studies be prepared: § 108(d) (principle-based accounting); § 207 (mandatory rotation of accounting firms); § 307 (conduct of attorneys); § 308 (effectiveness of enforcement action remedies); § 401(c) (special purpose entities); § 701 (competition in the auditing profession); § 702 (credit reporting agencies); § 703 (securities professionals involved in violations of laws); § 704 (review of SEC enforcement actions involving reporting violations); and § 705 (investment banks and financial institutions involved in manipulating financial statements). In addition, two other sections direct the United States. Sentencing Commission to review the Federal Securities Guidelines for obstruction of Justice (§ 805) and securities and accounting fraud and related offenses (§ 1104).

28. As the court noted in *SEC v. Arthur Young & Co.*, 590 F.2d 785, 788 (9th Cir. 1979), "[t]o accept the SEC's position would go far toward making the accountant both an insurer of his client's honesty and an enforcement arm of the SEC. We can understand why the SEC wishes to so conscript accountants. Its frequently late arrival on the scene of fraud and violations of securities laws almost always suggests that had it been there earlier with the accountant, it would have caught the scent of wrong-doing and, after an unrelenting hunt, bagged the game. What it cannot do, the thought goes, the accountant can and should. The difficulty with this is that Congress has not enacted the conscription bill that the SEC seeks to have us fashion and fix as an interpretative gloss on existing securities laws."

29. *See* H.R. CONF. REP. NO. 107-610, at 2 (2002) (statement of Rep. Oxley). Some members of Congress did not believe that the Act went far enough in restraining corporate abuse. *See, e.g.*, H.R. REP. NO. 107-414, at 55 (2002) (statement of Rep. LaFalce) ("The bill should have included a provision to mandate rotation. Auditor rotation would provide a number of important benefits . . . a new audit firm would bring to bear a skepticism and fresh perspective that a long-term auditor may lack.").

Both the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) have issued proposals to strengthen corporate accountability. *See* NASD, SUMMARY OF NASDAQ CORPORATE GOVERNANCE PROPOSALS (2002), *available at* http://www.nasdaq.com/about/CorpGovSummary101002.pdf.; NYSE, CORPORATE GOVERNANCE RULE PROPOSALS REFLECTING RECOMMENDATIONS FROM THE NYSE CORPORATE ACCOUNTABILITY AND LISTINGS STANDARDS COMMITTEE AS APPROVED BY THE NYSE BOARD OF DIRECTORS (2002), *available at* http://www.nyse.com/pdfs/corpgov prob.pdf (Codified in [new] Sec. 303A, NYSE listed company manual). On November 24, 2003, the SEC adopted new rules, which become effective on January 1, 2004, to "enhance the transparency of the operations of Boards of Directors" and "will operate in conjunction with the revised listing standards [adopted by the NYSE and NASDAQ]." *See, e.g.*, Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, 68 Fed. Reg. 66,992-67,011 (Nov. 28, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249, 270, 274).

Act.

The first version of the legislation that ultimately became "Sarbanes-Oxley," was H.R. 3763, introduced by Rep. Michael Oxley (R-Ohio) on February 14, 2002, just months after the Enron story first emerged.[30] That bill was passed, as amended by the House, on April. 24, 2002, as the "Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002."[31]

The House bill contained sections on auditor oversight,[32] audit committees[33] and the disclosure of information.[34] Some sections, however, simply codified existing law, [35] while others were little more than a directive to the SEC to promulgate new regulations to address perceived problems based on the headlines of the day. As stated by the bill's sponsor, Representative Oxley:

> I am confident that we are striking the right balance, particularly when it comes to the role of the Securities and Exchange Commission. CARTA gives the SEC the flexibility to deal with problems without legislating every time. Congress created the SEC precisely to deal with situations

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30. *See* Rebecca Smith & John R. Emshwiller, *Trading Places: Fancy Finances Were Keys to Enron's Success, and Now to Its Demise*, WALL ST. J., Nov. 8, 2001, at A1 (describing the significant decline of Enron's stock price).

31. H.R. 3763, 107th Cong., 2d Sess. (2002) [hereinafter Transparency Act]. The official title, as introduced, was "[a]n Act [t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and for other purposes."

32. *See id.* § 2 (requiring a public regulatory organization to review the work of auditors and accounting firms. The Transparency Act also calls for the SEC to modify its rules on auditor independence and the consulting services that accounting firms may provide their audit clients).

33. *See id.* § 9 (directing a working group to study the practices of audit committees and decide whether the SEC should establish new duties and responsibilities for audit committees).

34. *See id.* § 6 (requiring the SEC to establish rules requiring disclosure of off-balance sheet transactions).

35. *See, e.g., id.* §§ 2(a)(1) (directing SEC to write rules for a public regulatory organization which would have review authority over auditors of public companies), 2(c) (directing SEC to modify its rules regarding auditor independence and consulting services provided by auditing firms), 3 (unlawful to violate rules SEC writes regarding improper influence on the conduct of audits); 4 (directing compliance with real time disclosure rules the SEC would write), 6 (directing the SEC to write rules about off-balance sheet transactions and relationships), 7 (directing SEC to improve transparency regarding certain insider relationships and transactions), 8 (requiring stock exchanges to adopt rules requiring listed issuers to adopt a senior financial officer code of ethics or be de-listed). Other sections were drawn in part from existing law. *See, e.g.*, Transparency Act § 11 (changing the existing standard for the SEC to obtain an officer/director bar in an enforcement action from "substantial unfitness" to "unfitness" but listed a series of factors based largely on existing case law which the SEC had to establish to obtain the bar. The factors included: "1) the severity of the persons [sic] conduct giving rise to the violation, and the persons [sic] role or position when he engaged in the violation; 2) the person's degree of scienter; 3) the person's economic gain as a result of the violation; and 4) the likelihood that the conduct giving rise to the violation, or similar conduct may recur if the person is not so prohibited."); *see also* SEC v. Patel, 61 F.3d 137 (2d Cir. 1995) (discussing factors in Transparency Act § 11).

> like this. We need to empower the SEC to act without tying its hands and within flexible statutory changes . . . . Let us remember that a strong regulator is not one that is completely dictated to by Congress. A strong regulator has some say over his jurisdiction, some power and discretion to shape the capital markets; and I trust the SEC with this authority and so does our bill.[36]

The Senate bill, introduced by Senator Paul Sarbanes (D-MD) on June 25, 2002, as the "Public Company Accounting Reform and Investor Protection Act," was passed by the Senate on July 15, 2002, the text offered as a substitute for the text of H.R. 3763, which had earlier passed the House.[37] Both the House and the Senate bills sought to address the problems highlighted by the wave of corporate scandals. The legislation included sections on auditor independence, the use and misuse of accounting principles, and self-dealing by corporate officials. Unlike the House bill, the Senate bill sought to address expressly the headline-based problems by imposing new obligations and reporting strictures on directors, executives, and their advisors, rather than just directing the SEC to write new rules. [38]

The two bills went to conference on July 19, and by July 24, an agreement had been reached.[39] In conference, the Senate "insisted on its amendment," which was to substitute the Senate language in lieu of the

36. 148 CONG. REC. H1544-45 (daily ed. Apr. 24, 2002) (statement of Rep. Oxley). The Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002 was accompanied by H.R. REP. NO. 107-414 (2002) from the Committee on Financial Services.

37. Although the House approved its bill in April, the Senate stalled. The original Senate calendar called for a vote in September, but after WorldCom, Majority Leader Daschle called for a July vote. *See* David S. Hilzenrath et al., *How Congress Rode a "Storm" to Corporate Reform*, WASH. POST, July 28, 2002, at A1 (explaining that while an accounting reform bill had stalled in the months after Enron, World Com made accounting reform too important a political issue for Congress and President Bush to miss the opportunity to enact reform).

38. *See, e.g.*, 148 CONG. REC. S6436 (daily ed. July 9, 2002) (Amend. No. 4174 offered by Sen. Leahy) ("To provide for criminal prosecution of persons who alter or destroy evidence in Federal investigations or defraud investors of publicly traded securities."); 148 CONG. REC. S6438 (daily ed. July 9, 2002) (Amend. No. 4175 to Leahy Amend. No. 4174 offered by Sen. McConnell) ("To provide for certification of financial reports by labor organizations and to improve quality and transparency in financial reporting and independent audits and accounting services for labor organizations."); 148 CONG. REC. S6538 (daily ed. July 10, 2002) (Gramm Amend. No. 4184) ("[F]ell when Division I of Leahy Amend. No. 4174 was withdrawn."); 148 CONG. REC. S6541 (daily ed. July 10, 2002) (Amend. No. 4186 offered by Sen. Biden) ("To increase criminal penalties relating to conspiracy, mail fraud, wire fraud, and certain ERISA violations."); 148 CONG. REC. S6551 (daily ed. July 10, 2002) (Amend. No. 4187 offered by Sen. Edwards) ("To address rules of professional responsibility for attorneys."); 148 CONG. REC. S6777 (daily ed. July 15, 2002) (Amend. No. 4261 offered by Sen. Shelby) ("To require the SEC to conduct a study and submit a report to the Congress on aider and abettor violations of the Federal securities laws.").

39. *See* H.R. CONF. REP. NO. 107-610, at 69 (2002) (reconciling the differences between the House and the Senate regarding the Senate amendment to the bill).

House bill.[40] The result, entitled the "Sarbanes-Oxley Act," was passed by the House on July 24, 2002, and by the Senate on July 25, 2002. The legislation was forwarded to the President on July 26, 2002, and signed into law on July 30, 2002.[41] The legislation, as enacted, clearly addressed what Congress saw as the scandals *du jour*. For example:

In congressional hearings, directors testified that they had no clue that the companies they supposedly governed were about to tumble into bankruptcy and had engaged in massive fraud.[42] As a result, section 301 reconstitutes and empowers the audit committee of the board of directors in an effort to transform it from a toothless watchdog to a potentially effective sheriff—a guardian of the public's investment.[43]

Legislators were outraged when Enron executives testified that they believed their company was financially sound as it collapsed into bankruptcy.[44] Sections 302 and 906 now require certain corporate officers to execute detailed representations about the financial condition of their companies.[45]

Likewise, the record of the hearings before both the House and Senate reflect the disbelief of both chambers' members as they listened to auditors, who had certified the financial health of collapsed entities, essentially disclaim responsibility for knowing the true financial condition of their clients, and directors who disclaimed knowledge of the true financial condition of their company.[46] Sections I and II of the Act create a new entity to oversee the auditing profession and give this entity extensive authority over generally accepted auditing standards.[47]

The House report noted that Enron's officers were permitted to sell their

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40. The Conference reports states, "[t]he Senate amendment struck all of the House bill after the enacting clause and inserted a substitute text." *Id.*

41. *See generally* Act, Pub. L. No. 107-204, 116 Stat. 745 (2002).

42. *See, e.g., infra* notes 44 and 112 (describing how WorldCom CEO Bernard Ebbers claimed total ignorance about company's financial woes).

43. *See* discussion *infra* Part III (examining the augmented authority provided audit committees under the Act).

44. *See* Krim & Stern, *supra* note 11, at A1; *see also* Tom Hamburger & Gret Hitt, *House Panel Challenges Skilling Over Role at Enron*, WALL ST. J., Feb. 8, 2002, at A3. Regarding the fraudulent transactions Enron had committed, Mr. Skilling told the Senate, "[q]uite frankly, as long as the accountants had told me that they thought this was an appropriate structure, I felt comfortable with it." *See* April Witt, *Skilling's Testimony Met with Skepticism; Former CEO's Knowledge of Enron Deals Questioned*, WASH. POST, Feb. 27, 2002, at A1; *see also infra* note 112 (describing further Mr. Skilling's professed lack of knowledge). Former WorldCom CEO Bernard Ebbers and CFO Scott Sullivan refused to testify, invoking their Fifth Amendment rights. *See* Krim & Stern, *supra* note 11, at A1.

45. *See* discussion *infra* Part IV (delineating the ethical mandate imposed on individual corporate officers under Act).

46. *See* discussion *infra* Parts IV and V (reflecting the need for increased oversight authority and responsibility in light of recent corporate scandals).

47. *See* discussion *infra* Part V (illustrating Congress's decision to form an independent auditing board to establish and enforce enhanced corporate auditing standards).

stock while employees could not.[48] Section 306 of the Act now prohibits this practice.[49]

The Senate Report commented that Richard Breeden, former Chairman of the SEC, testified that "Enron and its special purpose entities" highlighted the need for disclosure of off-balance sheet transactions.[50] Section 401 of the Act now requires all annual and quarterly reports to disclose all material off-balance sheet transactions.

While the Act clearly lacks formal legislative history—traditional committee reports and similar materials—collectively, the floor debates, congressional hearings on Enron and similar scandals, the headlines of the day, and the manner of the Act's passage all underscore the point of the legislation, which is to bring a new breed of ethics to the marketplace by imposing personal accountability on directors, executives, and their advisers who are essentially required to assume the role of the town sheriff as guardians of the public trust—all backed by sanctions which could include being barred from Corporateville. [51]

II. THE AUDIT COMMITTEE: AN OLD WATCHDOG, PERHAPS A NEW SHERIFF

> "If there is any concern about auditor independence, it is in the hands of the audit committees."[52]

The Act attempts to create a new—or at least reenergize an old—

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48. *See* H.R. REP. NO. 107-414, at 18 (2002) (indicating the intention of the proposed Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 to prevent "company insiders" from trading their own shares when their employees are unable to do so because of a "blackout" in an employee retirement account).

49. *See* Act § 306 (forbidding company directors and executives from purchasing, selling, or transferring company securities during a "blackout" period).

50. *See* S. REP. NO. 107-205, at 28 (2002) (addressing the need for enhanced disclosure of off-balance sheet transactions by requiring companies to file annual and quarterly reports with the SEC documenting all off-balance transactions). The Senate Report commented on the fact that Enron loaned millions of dollars to its directors and executive officers. *See id.* at 29-30. Section 402 of the Act now prohibits this practice. *See* Act § 402(a)(1). The Senate Committee noted that pro forma earnings statements had been misleading to investors because the accounting used did not comply with Generally Accepted Accounting Practices (GAAP), and added that this problem was "exemplified" by the Enron experience. *See* S. REP. NO. 107-205, at 29; *see also* Act § 401 (requiring companies to reconcile pro forma data with that reported under GAAP).

51. *See* Act § 105(c)(4) (granting authority to the Oversight Board to revoke registration of an accounting firm as well as barring people from working for registered accounting firms if auditors violate any provisions of securities laws, rules of Oversight Board, rules of SEC, or professional standards); *see also* Act § 602(a) (allowing the SEC to bar permanently any person from practicing before the Commission if that person engaged in unethical or unprofessional conduct, or willfully violated or willfully aided and abetted violation of securities laws).

52. *See* Cassell Bryan-Low, *More Ernst Nonaudit Services Under Fire*, WALL ST. J., Mar. 10, 2003, at C1 (quoting strategist Beth Brooke of Ernst & Young regarding the increased use of stronger audit committees).

corporate sheriff from the old audit committee watchdog that is reconstituted with financial expertise and outsiders, and empowered to become virtually a separate governing entity from the board of directors and management. Like many of the provisions in the Act, the audit committee concept is not new. Audit committees have long been mandated by exchange rules.[53] Likewise, the SEC has long used audit committees as a vehicle for corporate reform.[54] In recent years, however, the committee may have lapsed from corporate watchdog to a toothless, sleeping hound.[55]

Sarbanes-Oxley gives the audit committee the opportunity to again become a true corporate sheriff and guardian of the public's investment, dictating its structure, membership and powers. Under the Act, the audit committee's mandate is simple and clear—watch *everything*.

The structure and membership of the audit committee is essentially dictated by the Act in view of its defined policing role. Under section 301, only independent directors can be on the committee.[56] While the term "independent director" is specifically not defined, the Act states that an audit committee member cannot accept any consulting, advisory, or other compensatory fee from the issuer or be an affiliated person of the issuer or its subsidiary,[57] other than as a member of the board of directors or a board committee.

Personal knowledge of the company's financial condition, and thus

53. The various public exchanges have long required audit committees for their member companies. *See, e.g.*, NYSE Manual § 303 (1999); Am. Stock Ex. Guide (CCH) ¶ 10,021, § 121 (1984); NASD Manual (CCH), Art. IX § 5 (1997).

54. *See, e.g.*, *In re* NYSE, Inc., Exchange Act Release No. 13,346, 11 SEC Docket 1945 (Mar. 9, 1977) (describing how the SEC successfully persuaded the New York Stock Exchange to require all members of the exchange to have audit committees); *see also* SEC v. Int'l Sys. & Controls, 18 SEC Docket 1410 (D.D.C. 1979), 1979 WL 170005 (requiring companies that violate the Foreign Corrupt Practices Act to create audit committees with specific oversight and audit authority); *see also* SEC v. KPMG, 79 SEC Docket 1555 (S.D.N.Y. 2003) (alleging that the defendant audit firm violated generally accepted auditing and accounting practices by permitting the Xerox Corporation to manipulate its accounting procedures so that Xerox could meet financial expectations); SEC v. KPMG, Accounting and Auditing Enforcement Act Release No. 17,954, 2003 WL 187268, at *1 (Jan. 29, 2003); *SEC Institutes Administrative Proceedings Pursuant to Rule 102(e)(3) Against Two Former Xerox Corporate Officers*, SEC NEWS DIGEST 2003-129 (July 8, 2003) (announcing the suspension of two Xerox executives for misrepresenting the corporation's financial performance through a series of fraudulent accounting schemes).

55. *See* Perry Wallace, *The Evolving Legal & Ethical Role of the Corporate Attorney After the Sarbanes-Oxley Act of 2002*, 52 AM. U. L. REV. 579, 589 (2003) (stating that because management fed board information that was then fed to the audit committee, audit committees were "pretty much re-enforcing what the management want[ed]").

56. The SEC is given authority to exempt particular relationships. *See* Act § 301(3)(C); *see also* NYSE Corporate Governance Proposals Rule 303A (instructing that a public company with over 50 percent of the voting power held by an individual, group or other company need not have a majority of independent directors comprise its board of directors); NASD Manual (CCH), Rule 4200(a)(14) (1997) (defining the term "independent director").

57. *See* Act § 301(3)(B) (enumerating the criteria necessary to be considered an independent member of an audit committee).

personal accountability, is emphasized effectively in the new structure by requiring that at least one member of the committee have financial expertise. Section 407 requires issuers who do not appoint such an expert to disclose the reason that at least one member of the audit committee is not a "financial expert."[58] A financial expert is defined as a person who "through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer . . . [has an] understanding of generally accepted accounting principles and financial statements . . . ." Experience in the profession qualifies someone as a "financial expert."[59] This ensures that most issuers will have such an expert on the audit committee, since it would be difficult, at best, to explain to the investment community the reasons for not having financial expertise on the committee.[60] Read together, sections 301 and 407 effectively separate the committee from management, thus emphasizing its independent role and ensuring its expertise.

The Act gives the newly empowered sheriff a broad mandate. First, the committee is charged with the responsibility for appointing, compensating, and overseeing the work of any registered public accounting firm employed by the issuer "for the purpose of preparing or issuing an audit report or related work"—clearly a mandate which exceeds simply overseeing the preparation of the financial statements.[61] Indeed, the Act specifically states that the committee's authority extends to resolving any disagreements between management and the auditor that relate to financial reporting.[62]

Second, the committee is required to establish procedures for receiving complaints relating to accounting, internal controls, and auditing matters.[63] The procedures adopted must include provisions for the receipt, retention, and treatment of such complaints. In addition, there must be a procedure under which employees can make anonymous submissions.[64]

58. Act § 407.

59. Act § 407(b) (relying on certain considerations to determine whether a person fits the definition of an independent director); *see also* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 34-47235 (Jan. 31, 2003) (citing 17 C.F.R. §§ 228-29, 249 (2003)) (proposing that an audit committee "financial expert" possess first-hand knowledge of generally accepted accounting and auditing principles).

60. *See infra* note 68 and accompanying text (highlighting the Act's directive requiring public companies to adopt a code of ethics applicable to top financial officers to remedy recent transgressions and promote fiscal responsibility throughout corporate America).

61. Act § 301(2).

62. *See* Act § 301(2) (directing the audit committee of a public company to assume responsibility for the work of any public accounting firm employed by the company).

63. *See* Act § 301(4)(A) (dictating the procedures for employee complaints concerning auditing matters).

64. *See* Act § 304(4)(B) (obligating audit committees to ensure anonymity in the employee complaint process); *see* also Act § 806(a) (immunizing employees of public companies who blow the whistle on accounting fraud).

Third, the committee is given broad authority to retain any advisors it deems appropriate to carry out its duties. This includes the right to retain "independent counsel and other advisers, as it determines necessary to carry out its duties."[65] This authority gives the committee the power to carry out virtually any type of inquiry related to the financial condition of the issuer it deems appropriate. When coupled with the obligation of the issuer to fund the committee's activities at levels determined appropriate by the committee and the independent structure of the committee, it is clear that the Act intends to create a committee that has the ability and tools to oversee management's financial activities—an effective in-house sheriff. [66]

III. CORPORATE EXECUTIVES: KNOW THE FINANCIAL HEALTH OF YOUR COMPANY OR BE BANISHED FROM CORPORATEVILLE

"A strong dose of character, honesty and ethics would not hurt, either."[67]

Inside the company, the Act attempts to deputize senior corporate officers as sheriff/protectors of the public's investment by legislating ethics and by barring executives from self-dealing while requiring them to know the financial health of their companies—or face being barred from serving as an officer or director. First, the Act reverts to the frequently invoked formula of essentially requiring a written code of ethics.[68] This code is augmented with new prohibitions on self-dealing by executives, underscoring the message that corporate integrity standards apply even, and indeed especially, to those at the top of the heap. Second, in an attempt to ensure that the public can rely on a corporation's financial statements—and that there will never again be a $3.8 billion accounting "error" like at WorldCom—the Act also makes it clear that the buck stops with the executives who sign the beefed-up certifications that corporations must now file with the SEC.[69] This new morality mandate, however, is not an

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65. Act § 301(5).

66. Indeed, if a corporation does not fund what the audit committee wants to do, the corporation faces the prospect of being de-listed. *See* Standards Relating to Listed Company Audit Committees, 17 C.F.R. §§ 228-29, 240, 249, 270 (2003).

67. *See* 148 CONG. REC. H5462 (daily ed. July 25, 2002) (statement of Rep. Oxley).

68. *See* Act § 406 (mandating the SEC to issue rules requiring companies to disclose whether or not a code of ethics for senior financial officers has been implemented); *see also* Philip B. Livingston & Ridge A. Braunschweig, *Codes of Ethics: How To Comply with the Letter and Spirit of the Sarbanes-Oxley Act*, DIRECTORSHIP, Oct. 2002, at 1 (describing codes of ethics for doctors, lawyers, journalists, and engineers); *see also* Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559, 1562, 1582-98 (1990) (discussing the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) that "made the failure to implement an effective code of conduct a potential source of liability" for securities firms); *see also* Lori Chordas, *Code of Ethics*, BEST'S REVIEW, Mar. 1, 2001, at 47 (describing the creation of the Defense Industry Initiative on Business Ethics and Conduct to answer the government's worries about the lack of standards in defense industry).

69. *See* Act § 302(a) (requiring a corporate official to certify the accuracy of financial

aspiration. Severe sanctions that include a revitalized officer/director bar as well as new crimes and penalties underscore the message—get with the program or get out.[70]

A. Ethics Begin With Standards: Requirement of a Code of Ethics

The concept of adopting a code of ethics is hardly new, [71] but the Act revitalizes the concept in terms of the way corporate America does business by practically guaranteeing that issuers will actually adopt such codes. Under the Act, every issuer is now, in effect, required to adopt a code of ethics for its senior financial officers that apply to its principal financial officer, controller and similar persons. In a manner similar to the "disclosure/compelled adoption" model used to require audit committees to retain a financial expert, section 406 directs the SEC to issue rules "to require each issuer . . . to disclose whether or not, and if not, the reason therefore, such issuer has adopted a code of ethics for senior financial officers . . . ."[72]

Clearly, the section does *not require* the adoption of such a code. Under its plain terms, the section only requires issuers to disclose *if* they have such a code, and, *if not*, to explain why not. By adopting Justice Brandeis's axiom,[73] however, there can be little doubt that issuers will, in fact, adopt codes of ethics. This is particularly true since the term "code of ethics" is defined to mean standards that will promote honest and ethical conduct, full and fair disclosure in periodic filings, and compliance with government regulations.[74] Indeed, corporate managers entrusted with the public's money would be extremely hard-pressed to explain to shareholders,

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reports and charging officials with the responsibility to ensure internal controls are in place).

70. *See* Act § 906(c)(2) (imposing fines of up to five million dollars and twenty years imprisonment for falsely certifying financial reports); *see id.* § 305(a)(1) (reducing the standard to obtain an officer/director bar).

71. *See The Good, the Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 HARV. L. REV. 2123, 2124 (2003) ("Legislators have invoked the importance of corporate codes after each modern wave of corporate wrongdoing: the electrical equipment industry price-fixing crisis of the 1960s, the foreign payments crisis of the 1970s, the insider trading crisis and related RICO prosecutions of the 1980s, and the defense procurement fraud crisis of the same decade."); Carolyn Wiley, *The ABC's of Business Ethics: Definitions, Philosophies and Implementation*, INDUS. MGMT., Jan.-Feb. 1995, at 22-24 (stating that ninety-percent of Fortune 500 companies and about half of all companies have codes of ethics); AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.36 (1994) (advocating rules of governance similar to codes of ethics).

72. Act § 406(a).

73. LOUIS BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 62 (Nat'l Home Library Found. ed. 1933) (1914) ("Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.").

74. *See* Act § 406(c)(1)-(3) (detailing the values fundamental to a code of ethics for senior officials).

investors, and the public the reasons they chose not to adopt such a code of ethics.[75]

The ethical requirements incorporated into each company's code of ethics are augmented by the prohibitions on self-dealing incorporated in sections 402 and 306 of the Act. Essentially, the Act bars personal loans to officers and directors or their equivalent.[76] Thus, an officer can no longer secretly obtain multi-million dollar loans, as well as forgiveness of those loans, à la Adelphia[77] and Tyco.[78] The Act also precludes officers of the issuer from trading securities of the issuer at times when employees may not be permitted to trade company stock that is held in their pension plans.[79] Officers also cannot sell off their holdings while employees watch helplessly as the value of their 401(k) plans plummet during pension blackout periods, as was the case in the Enron scandal.[80] These prohibitions are in addition to the traditional fiduciary duties insiders may have to shareholders and the long-existing Exchange Act prohibitions on insider trading.[81]

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75. *See generally* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Code of Ethics, 17 C.F.R. § 228.406 (2003) (requiring companies that do not adopt a code of ethics to explain their reasons for not doing so); Code of Ethics, 17 C.F.R. § 229.406 (2003) (providing compliance guidance for registrant).

76. *See* Act § 402(a) (amending § 13(k) of Exchange Act to read, "[i]t shall be unlawful for any issuer . . . directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to 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.").

77. *See* Waters, *supra* note 5, at 33 (describing the controversial $2.3 billion loan huge personal loans made by Adelphia to its CEO and his family).

78. *See* Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, 80 HARV. BUS. REV. 106, 111 (Sept. 2002) (noting the company's board did not question the millions of dollars in undisclosed private loans received by the Tyco executives and CEO).

79. *See* Act § 306(a)(1) ("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 equity security of the issuer . . . during any [pension fund] 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.").

80. *See* Marcy Gordon, *Executives to be Banned From Trading Stock During Pension "Blackout" Periods for Employees*, ASSOCIATED PRESS, Jan. 15, 2003 (criticizing top Enron executives, such as then-chairman Kenneth Lay, and company directors, who reaped hundreds of millions of dollars by selling their stock during the blackout period, while Enron employees lost nearly all their retirement savings).

81. Corporate officials traditionally have a fiduciary duty to the issuer's shareholders. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 228-29 (1980) (discussing fiduciary duties in the context of insider trading). The Exchange Act imposes a similar duty on officials. *See* Exchange Act § 16(a), 15 U.S.C. § 78p(a) (2000) (requiring officers and directors to disclosure their holdings in the issuer's stock). Similarly, the Exchange Act § 16(b) (prohibiting purchases and sales within a six month period by insiders, i.e. "short swing" profits). These two sections of the Exchange Act were intended to prevent insiders from abusing their positions within the company. *See* H.R. REP. NO. 73-1383, at 13 (1934) (providing legislative history showing Congress's intent that § 78p of the Exchange Act provide protection from insider abuse); *see also* M. Breen Haire, *The Uneasy Doctrinal Compromise of the Misappropriation Theory of Inside Trading Liability*, 73 N.Y.U. L. REV. 1251, 1258 n.31 (1998) (explaining the ways that Congress addressed insider trading in

Section 402 prohibits any issuer from extending loans to certain officers and directors:

> It shall be unlawful for any issuer . . . directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer . . . .[82]

Existing loans are generally grandfathered as long as they are not altered after the effective date of the Act.[83]

While the intent of the section seems clear, in many ways the section 402 prohibitions may be over-broad and have unintended effects. These prohibitions may have the impact of barring virtually any transaction between an issuer and an officer, which could be construed as an extension of credit. Thus, for example, section 402 may preclude such traditional corporate benefits as split-dollar life insurance or the exercise of stock options without payment by the corporate official.[84] It seems doubtful that Congress intended to prohibit such transactions. Similarly, section 306 adds to the existing prohibitions on insider trading by prohibiting officers and directors from purchasing or selling securities of the issuer during certain periods.[85] Specifically, the section precludes officers and directors

section 16 of the Exchange Act). The Act also shortened the time period for filing reports under section 16 to two days and directed the SEC to establish a website within one year where the reports would be published. Issuers with a website are also required to publish the reports on it. *See* Act § 403(a)(4)(B) ("Beginning not later than 1 year after the date of enactment of the [Act] . . . the Commission shall provide each such statement on a publicly accessible Internet site not later than the end of the business day following that filing."); Act § 403(a)(4)(C) (stating that the issuer must post the statement on their corporate website no later than the end of business the day following that filing); *see also* Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5, 68 Fed. Reg. 25,788, 25,788-90 (May 13, 2003) (to be codified at 17 C.F.R. pt. 240) (requiring electronic filing and website posting of beneficial ownership reports filed by officers, directors, and principal securities holders under § 16(a) of Exchange Act).

82. *See* Act § 402(a) (modifying Exchange Act § 13(k)).

83. There are a number of exceptions to this provision that generally focus on matters regulated by other statutes or regulations. Generally the exceptions deal with matters such as home improvement and manufactured home loans as defined in 12 U.S.C. § 1464(j), consumer credit transactions under 15 U.S.C. § 1602(h), extension of credit under an open end credit plan as defined in 15 U.S.C. § 1602(i), charge cards under 15 U.S.C. 1637(c)(4)(E), and any extension of credit permitted by a broker or dealer registered under the Exchange Act or which is permitted by the rules or regulations of the Board of Governors of the Federal Reserve System.

84. *See, e.g.*, Joseph E. Bachelder III, *Executive Compensation, Part I: Sarbanes-Oxley Impact on Executive Compensation, Loans*, 228 N.Y.L. J. 3 (Aug. 30, 2002) (discussing the effect of the Act on executive compensation and loans).

85. *See* Act § 306(a)(1) (prohibiting directors, executive officers, or their equivalents from purchasing, selling or otherwise acquiring equity securities of the issuer during a blackout period if the securities are acquired by virtue of their company statuses); *see also supra* note 81 (discussing § 16 (a) and (b) of the Exchange Act). Undisclosed insider trading also violates § 10(b), and Rule 10b-5 of the Exchange Act, 15 U.S.C. § 78j(b) (2000). *See generally* United States v. O'Hagan, 521 U.S. 642, 651-53 (1997) (comparing the traditional (classical) and misappropriation theories of insider trading liability under § 10(b)).

from trading in the issuer's stock during a pension fund "blackout" period—essentially when participants in the pension fund cannot trade the shares they own in those funds. Accordingly, if company employees are precluded from trading the issuer's shares held by the pension fund because of a "blackout," officers and directors will also be precluded from buying or selling the shares of the company.[86] Everyone then is on a level playing field. If an insider violates the section, the company, or other shareholders on behalf of the company, can, within two years, bring what is essentially a derivative action to recover the profits for the corporation.[87] The action is similar to the action that can be maintained under Exchange Act Section 16(b) for short swing profits.[88]

B. *The End of "I don't know corporate finance": New Requirements for Certifying Financial Information*

Adopting another long held position of the SEC, but adding more teeth, the Act attempts to compel personal accountability for a company's financial statements by requiring corporate executives to sign detailed certifications concerning the financial health of their corporations.[89] The SEC has long required the officers and directors of issuers to sign annual and quarterly filings,[90] and it has maintained the position that signing officers are responsible for the content of those filings.[91] Although the

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86. The prohibition has important limitations. For example, it only applies to equity securities obtained by an insider in connection with his or her employment as a director or officer of the company. *See* Act § 306(a)(1) (forbidding directors, executives and their equivalents from engaging in insider trading during a blackout period). Likewise, it only covers "certain blackout periods." Generally, these periods consist of more than three consecutive business days, and they do not include regularly scheduled periods in which plan participants and beneficiaries cannot trade. *See* Act. § 306(a)(4) (defining "blackout" period). In addition, at least 50 percent of the plan participants or beneficiaries under all individual account plans maintained by the issuer must be precluded from trading for a period to qualify as a "blackout" period. *See* Act § 306(a)(4)(A) (explaining that, to qualify as a "blackout period," a period must prohibit at least 50 percent of the issuer's plan participants from selling, acquiring or transferring an equity interest of the issuer).

87. *See* Act § 306(a)(2)(B) (allowing a company to bring an action to recover profits and imposing a two year statute of limitations on such an action); *cf. supra* text accompanying note 81 (discussing steps taken to prevent insider trading).

88. *See* Act § 306(a) (discussing ways in which the Exchange Act § 16(b) prevents "short swing" profits by insiders).

89. *See* Act § 302(a)(1)-(3) (requiring that the principal officers certify that each financial report filed under § 15(d) of the Exchange Act is accurate).

90. *See, e.g.*, Exchange Act §§ 13(a) & 13(b)(2), 15 U.S.C. § 78m; 17 C.F.R. § 240.15d-14(a) Certification of Disclosure in Annual and Quarterly Reports ("Each principal executive officer or officers and principal financial officer or officers of the issuer, or persons performing similar functions, at the time of filing of the report must sign the certification.").

91. In private damage actions, courts have considered the fact that an officer signed the document in determining whether scienter has been pled. *Compare In re* Criimi Mae, Inc. Sec. Litig., 94 F. Supp. 2d 652, 661 (D. Md. 2000) (finding that the defendant's signature, experience, position, and access to inside information, alone, were insufficient to prove

Exchange Act provided for civil and criminal liability for false filings,[92] executives have felt free to disclaim knowledge about the financial condition of their companies when convenient—a fact made clear during the hearings into the scandals, which form the backdrop of the Act. [93] Sections 302, 906, and 404 seek an end to the era of "I don't know" corporate finance and seek to make corporate executives guardians of the corporate treasure chest, rather than defilers of it.

The obligations of the chief executive and financial officers [94] under the Act go far beyond the Exchange Act requirement of signing periodic filings. Under the Sarbanes-Oxley Act, corporate officers for the first time must make detailed representations about the issuer's financial information and disclosures.[95] In addition, under section 404, annual reports must

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scienter), *with In re* Cylink Sec. Litig., 178 F. Supp. 2d 1077, 1081-83 (N.D. Cal. 2001) (noting that a corporate officer signed financial statements and concluding that this fact, combined with other evidence, was sufficient to show that the officer acted recklessly or with requisite intent, i.e. scienter).

92. *See, e.g.*, Exchange Act §§ 13(b)(4) and (5) (stating that civil penalties are normally invoked, but that criminal penalties may be invoked for people who "knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account"); *see also* Newby v. Lay, 258 F. Supp. 2d 576, 588 (S.D. Tex. 2003) ("'When the public sees a corporate official's signature on a document, it understands that the official is thereby stating that he believes that the statements in the document are true.'" (quoting the Brief for the SEC, Amicus Curiae, Howard v. Everex Sys. Inc., 228 F.3d 1057 (9th Cir. 1999))). However, scienter is not a prerequisite for civil liability. *See* SEC v. McNulty, 137 F.3d 732, 740-41 (2d Cir. 1998), *cert. denied*, 525 U.S. 931 (1998) (agreeing with a lower court finding that scienter is not a prerequisite to civil liability).

93. *See* Hamburger & Hitt, *supra* note 44, at A3; Krim & Stern, *supra* note 11, at A1; Tim Carvell, *Let Us Now Braise Famous Men: It's Been Quite a Fiscal Year for CEOs*, FORTUNE, Nov. 18, 2002, at 136-38 (highlighting Enron CEO Jeffrey Skilling's professed ignorance during Enron's collapse); *see also* Ameet Sachdev, *Scandal and Upheaval: Corporate America's Image Suffers From Probes, Charges and Andersen's Conviction*, CHI. TRIB., Dec. 31, 2002, at C1 (describing Enron Chairman Kenneth Lay's failure to answer questions before Congress regarding financial disclosures by pleading his Fifth Amendment privilege against self-incrimination).

Additionally, in the House hearings on WorldCom, former CEO Bernard Ebbers and former CFO Scott Sullivan refused to testify, invoking their Fifth Amendment rights. *See* Krim & Stern, *supra* note 11, at A3 (describing how Ebbers' and Sullivan's refusal to testify infuriated several panel members); *see also* Hugo Lindgren, *The Year in Ideas: Know-Nothing C.E.O.*, THE N.Y. TIMES MAG., Dec. 15, 2002, at 100 ("When Bernard Ebbers, the C.E.O. of WorldCom, was confronted with evidence that his company had used shady accounting to hide billions of dollars in expenses, he claimed total ignorance. He apparently was in the same sinking boat as the company's shareholders; like everyone else, he simply trusted the quarterly reports.").

94. Act § 302 speaks in terms of the "principal" executive and financial officers, while Act § 906 refers to the "chief" executive and financial officers. *Compare* Act § 302 (referring to "principal" executive and financial officers), *with* Act § 906 (referring to "chief" executive officers). The terms appear to be used interchangeably. The failure to conform the terms probably results from the manner in which Act was written and passed.

95. The SEC mandates these certificates, in addition to those required for certain issuers under § 21(a) of the Exchange Act. Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, June 27, 2002, *available at* http://www.sec.gov/rules/other/4-460.htm (requiring principal executive officer and financial officer of 947 listed issuers to certify to the best of their knowledge that no

contain "an internal control report" which states that management is not only responsible for the establishment and maintenance of financial reporting controls and procedure, but is further charged with assessing the effectiveness of those controls and procedures over the prior year.[96]

Accountability for officers begins with section 302. That section specifically directs the SEC to promulgate rules requiring the principal executive officer and principal financial officer to certify in each annual or quarterly report that, to their knowledge:

> (1) the signing officer has reviewed the report;
>
> (2) the report does not contain any untrue statement of a material fact;
>
> (3) the financial information fairly presents in all material respects the financial condition of the issuer;
>
> (4) the signing officer is responsible for:
>
> (a)establishing and maintaining the internal controls of the company;
>
> (b)ensuring that those controls have been designed to ensure that material information relating to the company is known to the officers and others;
>
> (c)ensuring that they have evaluated the effectiveness of those controls; and
>
> (5) the signing officers have disclosed to the auditors and audit committee:
>
> (a) all significant deficiencies in the design or operation of the internal controls;
>
> (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
>
> (c) the signing officers have noted any significant changes in the company's internal controls.[97]

The first part of the section requires the signing officers to certify that the filing is not fraudulent, that the internal controls relied on by the

covered reports contained untrue statements or omissions of material facts). The authority of the SEC to order those certifications has been challenged. *See Newby*, 258 F. Supp. 2d, at 576 (challenging the SEC's authority to order certification).

96. *See* Act § 404(a) (requiring that internal control report "state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting"). Act establishes further checks and balances on the management by requiring an issuer's auditor to report on the issuer's assessment of the effectiveness of its controls and procedures for financial reporting. *See* Act § 404(b) (requiring that "each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer").

97. *See* Act § 302(a) (listing the requirements for certifying officers).

auditors to audit the information in the filed financial statements are adequate, and that any problems have been disclosed to the auditors and the audit committee. Requiring officers to report problems to the audit committee in the second part of the provision, coupled with the audit committee's new independence, is intended to put an end to the era of management investigating its own misdeeds. This section has been supplemented through rules that affirmatively require officers to certify the company's financial reports.[98] The obligations imposed by section 302 will be enforced by the SEC through civil law enforcement actions.[99]

Section 906 reinforces part of the section 302 certifications and adds criminal penalties by adding § 1350 to title 18 of the U.S. Code. Section 1350 requires that the chief executive officer and chief financial officer of each public company provide written statements that:

> certify that the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 . . . and that the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.[100]

This certification is filed with each periodic report that is filed under the Exchange Act.[101] In contrast to the civil penalties that may be imposed for violating section 302, a violation of section 906 is punishable by up to ten years in jail and a $1 million fine.[102] A willful violation is punishable by up to twenty years in jail and a $5 million fine.[103] The Department of

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98. The rules promulgated by the SEC to implement this section essentially track the language of the statute. *See* Certification of Disclosure in Companies' Annual Quarterly and Quarterly Annual Reports, 17 C.F.R. § 240.13a-14 (2002) (requiring "each issuer's principal executive and financial officers to certify the financial and other information contained in the issuer's quarterly and annual reports").

99. *See* Act § 302(b) (providing that the officers of issuers who reincorporate in foreign jurisdictions will still be required to execute the certifications); Certification of Disclosure in Companies' Quarterly and Annual Reports, 17 C.F.R. § 240.13a-14(a); *see also* Certification of Disclosure in Companies Quarterly and Annual Reports, 67 Fed. Reg. 57,276, 57,278 (Sept. 9, 2002) ("New Exchange Act Rules 13a-14 and 15d-14 apply to the principal executive officers and principal financial officers . . . of any issuer that files quarterly and annual reports with the commission under either § 13(a) or § 15(d) of the Exchange Act, including foreign private issuers . . . .").

100. 18 U.S.C. § 1350(b), as promulgated by Act § 906(a).

101. *See* Act § 906(a) (stating that each periodic report filed by an issuer must be accompanied by a written statement by both the chief executive officer and the chief financial officer of the issuer).

102. *See* Act § 906(c)(1) (listing the criminal penalties for an incorrect certification). The Justice Department has started enforcing this section. *See, e.g.*, Counts 48, 49, and 50 of the indictment of Richard M. Scrushy, Chairman and CEO of Healthsouth, No. CR-03-BE-0530-S (Oct. 29, 2003 N.D. Ala.) [alleging false certifications in Healthsouth annual reports].

103. *See* Act § 906(c)(2) (listing the criminal penalties for a certification that is willfully incorrect). Act §§ 401 and 403 complement § 906 by requiring certain additional disclosures. *Compare* Act § 401 (directing the SEC to issue rules, which will require issuers to disclose (1) Any "material correcting adjustments" identified by the auditors; and (2) Off-

Justice may enforce this provision through criminal prosecution.[104]

Although the Section 906 certification is similar to the Section 302 certification, they are not identical. Both sections require that the signing officers attest that the reports fairly present the financial condition of the company. Under Section 906, however, the signing officers must specifically certify that the issuer's financial statements comply with the Sections 13(a) and 15(d) of the Exchange Act, a requirement that is not incorporated into Section 302.[105] Failure to execute a Section 302 certification may result in a civil enforcement action by the SEC. In contrast, failure to execute a Section 906 certification does not result in any penalty. The Department of Justice appears to lack the authority to compel compliance with Section 906. Rather, the section only provides for sanctions if the certification is false, but not for failing to file it.[106]

Finally, under section 404, annual reports filed under section 13(a) or

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balance sheet transactions that "may have" a material effect on the issuer's financial conditions), *with* Act § 403 (mandating directors and officers to disclose transactions in which they are involved), and Act § 906 (requiring written statements from directors with file financial reports). Section 401 also requires that pro forma statements be issued in a manner that is not misleading and directs the SEC to conduct a study concerning special purpose entities and the related disclosure rules. *See also* Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, 68 Fed. Reg. 5,982, 5,989 (Feb. 5, 2003) (Apr. 7, 2003) (to be codified at 17 C.F.R. pt. 249) (requiring disclosures of material facts that provide investors with clear understanding of off-balance sheet arrangements and their material effects, in separately captioned subsections). *See* Act § 404 (directing the SEC to issue rules that will require issuers, as part of their annual reports, to provide an assessment of their "internal control structure" and procedures for financial reporting, and requiring the issuer's auditors to attest to, and report on, management's assessment.). The final rule also implements § 404.

104. The distinction between "knowing" and "willful" is not defined in the statute. *See generally* Dennis J. Block & Jonathan M. Hoff, *Disclosure After Sarbanes-Oxley*, 228 N.Y.L. J. 5, 7 (Aug. 22, 2002) (discussing these certifications).

105. The text of Act § 302 does not require that the signing officers represent that the filing complies with all of the provisions of the Exchange Act, or the rules thereunder. Likewise, the text of the section does not require a certification that the financial statements have been prepared in accordance with GAAP. Rather, § 302 only requires certification that the financial statements "fairly present" the financial condition of the issuer. Authorities have found that financial statements may fairly present the financial condition of the issuer even when those statements have not been prepared in accordance with GAAP. *See In re* Cabletron Sys., 311 F.3d 11, 34 (1st Cir. 2002) (stating that deviation from GAAP does not automatically signal accounting irregularity); *In re* WorldCom, Sec. Litig., 2003 U.S. Dist. LEXIS 10863, at *20 (S.D.N.Y. 2003) (stating that departure from GAAP, standing alone, is not sufficient to show that defendant company had access to facts that contradict the company's public statements). *But see* Romine v. Acxiom Corp., 296 F.3d 701, 705 (8th Cir. 2002) ("The SEC regulations provide that financial statements are presumed misleading unless prepared in compliance with GAAP principles.").

106. *Compare* the text of Act § 906, *with* the discussion of § 302, *supra* notes 97 and 99 and accompanying text. *See also* Act § 3(b)(1) (providing, in part, that "[a] violation by any person of this Act, any rule or regulation of the Commission issued under this Act, or any rule of the Board shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934").

15(d) of the Exchange Act[107] must contain "an internal control report" that states that management is responsible for establishing and maintaining controls and procedures for financial reporting.[108] The annual report must also contain an assessment of the effectiveness of those controls and procedures for the financial reporting of the previous year.[109] The issuer's auditor must also report in his internal control report the effectiveness of the issuer's procedures for financial reporting. The specific requirements of the auditor's report are outlined in the SEC rule (adopted as Final on May 27, 2003) that accompanies section 404.[110]

Regardless of these drafting anomalies, the intent of sections 302, 404, and 906 is clear—to bring a new ethical standard to the marketplace by forcing corporate executives to take responsibility for the financial information published by their companies. By compelling corporate officers to make specific representations about the financial condition of their companies, the sections should enhance disclosure. This is because corporate officers and issuers will in effect be required to institute new internal due diligence procedures to review carefully all of the financial and other information covered by the certifications, so that the executing officers are in a position to make the representations required by each section. These additional procedures should help to ensure the integrity of the filings. Increased scrutiny through more detailed procedures should also have the salutary effect of improving disclosure.[111] In this regard, the sections thus effectively implement the SEC's long-held position that the officers who execute periodic filings are responsible for the content of

107. *See* 15 U.S.C. § 78m(a) (requiring issuers to file annual reports); *see also* 15 U.S.C. § 78o(d) (requiring issuers to file supplementary materials as necessary, pursuant to 78m).

108. *See* Act § 404(a)(1) (directing the Commission to prescribe rules requiring each annual report to state management's responsibility for establishing and maintaining an adequate internal control structure and financial reporting procedure); *see also* Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. 36,636, 36,646 (June 18, 2003) (to be codified at 17 C.F.R. pt. 249) (requiring management to include internal controls reports in Form 10-K).

109. *See* Act § 404(a)(2) (requiring that each annual report assess the effectiveness of the internal control structure and the issuer's financial reporting procedures); *see also* Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. at 36,646 (Aug. 14, 2003) (to be codified at 17 C.F.R. pt. 249) (explaining that companies must disclose, in quarterly reports, any changes in internal control over financial reporting in the quarter covered the report, and requiring a discussion in annual reports of how changes in internal controls are likely to materially affect, or have materially affected, the company's internal control over financial reporting).

110. *See* Act § 404(b); *see also supra* notes 108 and 109 and accompanying text (describing SEC rule).

111. *See, e.g.*, Peter A. McKay, *Though Their Stock is Publicly Held, Companies Adopt a Private Mentality*, WALL ST. J., July 28, 2003, at C1 (discussing increased costs of complying with Sarbanes-Oxley).

those filings.[112] The sections may also increase the executive officers' exposure to liability in civil damages actions[113] and create a kind of in-house sheriff augmenting the role of the audit committee.

C. Shape Up or Else: New Penalties and Risk of Banishment

To provide incentives to the new corporate sheriffs—the audit committee and certifying officers—to perform their duties, the Act contains provisions, which may increase civil liability,[114] enhance criminal liability, and make banishment from corporate life a more likely remedy for misconduct.[115] The Act creates new securities fraud crimes and other

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112. *See* Commission Proposes Amendments Regarding CEO, CFO Certification Under Sarbanes-Oxley, SEC Press Release No. 2003-39 (Mar. 21, 2003), *available at* http://www.sec.gov/news/press/2003-39.htm (announcing new rules to hold officers responsible for financial reports). The impetus for this provision may well have been the specter of high-ranking corporate officials testifying before Congress as their company tumbled into bankruptcy; that they thought their company was financially sound; or that they were unaware of huge problems with its accounts. In his testimony before Congress, Jeffrey Skilling routinely claimed ignorance of the validity of Enron's filings, stating at different points, "Quite frankly, I will state right now that I'm not an accountant . . . . And to be quite frank, I am not an accountant . . . . Quite frankly . . . again, I'm not an accountant . . . Quite frankly . . . I am not an accountant . . . . Quite frankly, I – I . . . I don't know, I'm not an accountant." Ed Bradley, *Differences Between Viewers of "Nightline" and "Late Night with David Letterman": Faulty Memory of Jeffrey Skilling*, Commentary, *60 Minutes* (CBS television broadcast, Mar. 10, 2002); *see also* Carvell, *supra* note 93, at 135 (describing Jeffrey Skilling's testimony before Congress regarding his role as former Enron CEO, in which Mr. Skilling answered "I do not recall" twenty-six times); Michelle Mittelstadt, *Lay 'Finally Listening to His Lawyers,' Expert Says*, DALLAS MORNING NEWS, Feb. 5, 2002, at 1D (describing negative inferences drawn from Enron Chairman Kenneth Lay's failure to show up for long-promised congressional hearing). However, the effect in many ways is to make corporate officials actually double-check the outside and inside auditors. Otherwise the signing officers would not be in a position to execute the certifications.

113. In private damages actions under the securities laws, plaintiffs must meet stringent pleading standards. The standards were enacted by Congress in the 1995 amendments to the Securities Act and to the Exchange Act. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 15 U.S.C. § 78a (2003). The detail required by the §§ 302 and 906 certifications may assist plaintiffs in private securities actions in meeting those stringent pleading requirements. *See also supra* notes 105 and 106 (discussing differences between § 302 and § 906).

114. *See* Private Securities Litigation Reform Act § 78(a) (Civil Penalties: Act § 806 (protection for whistleblowers) and Act § 806(c)(2) (compensatory damage remedy). Criminal Penalties: Act § 802 (alteration of documents); Act § 805 (enhancement under sentencing guidelines for obstruction of justice and fraud); Act § 807 (defrauding shareholders of publicly-traded companies); Act § 902 (attempts and conspiracies to commit criminal fraud offenses); Act § 903 (mail and wire fraud); Act § 904 (ERISA violations); Act § 905 (amendments to federal sentencing guidelines for certain white collar offenses); Act § 906 (failure to certify financial reports); Act § 1101 (tampering with a record or impeding an official proceeding); Act § 1104 (amendments to federal sentencing guidelines); Act§ 1106 (increased penalties under Exchange Act); and Act 1107 (retaliation against informants)); *see also* Field Guidance on New Criminal Authorities Enacted in the Sarbanes-Oxley Act of 2002 (H.R. 3763) Concerning Corporate Fraud and Accountability, *available at* http://www.usdoj.gov/ag/readingroom/sarox1.htm (last visited Feb. 16, 2004).

115. *See, e.g.*, Act § 906(c) (imposing criminal penalties of fines up to $5 million and twenty years imprisonment for willfully certifying false statements on periodic financial

crimes, increases the penalties for many existing securities-related crimes, and gives the SEC broad new enforcement powers.[116] Violations can trigger SEC injunction proceedings, fines, and possibly even jail time.[117] The Act enhances these remedies by increasing the penalties for mail and wire fraud[118] and the penalties for violating section 32(a) of the Exchange Act.[119] It also creates new express statutory prohibitions in matters involving securities fraud,[120] obstruction,[121] interfering with auditors,[122] and retaliating against whistleblowers.[123]

Perhaps the most significant remedy under the Act, however, is the revitalized officer/director bar. An officer/director bar has long been a favorite SEC remedy, but it was difficult, if not impossible, to obtain and was not an effective remedy until now.[124] Section 305 enhances the SEC's

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reports); Act § 1102(c) (imposing fines and imprisonment of up to twenty years for altering, destroying, mutilating, or concealing documents).

116. *See* Act §§ 906(c), 1102(c); *see also infra* notes 118-123 and accompanying text.

117. *See* Act §§ 906(c), 1102(c).

118. *See* Act § 903 (increasing maximum penalty for mail and wire fraud from five years imprisonment to twenty years).

119. *See* Act § 1106 (increasing penalty from $1 million to $5 million, and ten years imprisonment to twenty years).

120. *See* Act § 807 (adding a penalty of a fine and/or imprisonment up to twenty-five years for securities fraud).

121. *See* Act § 802 (creating a penalty of a fine and/or imprisonment up to twenty years for obstructing investigation or proper administration).

122. *See* Act § 303 (penalizing improper influence on conduct of auditors); *see also* Improper Influence on Conduct of Audits, No. 34-47890, FR-71, File No. S7-39-02 (May 20, 2003) (to be codified at 17 C.F.R. pt. 240), *available at* http://www.sec.gov/rules/final/34-47890.htm (prohibiting officers from coercing, manipulating, misleading, or fraudulently influencing auditors if they know or should know that such conduct would make financial statements materially misleading).

123. *See* Act § 1107 (penalizing retaliation against informants).

124. The SEC began using officer/director bars in consent decrees in the 1970s and eventually claimed it could obtain this remedy as "ancillary relief" under the courts' equitable powers. *See* SEC v. Posner, 16 F.3d 520 (2d Cir. 1994). In 1990, the SEC had the remedy added to the Exchange Act. *See* Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, Title II, § 201, 104 Stat. 935 (1990), 15 U.S.C. § 78u(d)(2). However, the required showing that the officer or director was "substantially unfit" proved difficult to meet. *See* discussion *infra* notes 125 and 127 (describing requirements for officer/director bar).

In testimony earlier this year, SEC Chairman Donaldson reported that for the fiscal year through Aug. 20, 2003, the Commission had sought officer/director bars against 144 offending corporate executives and directors. Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002 before the Senate Comm. on Banking, Housing & Urban Affairs, 108th Cong. (2003) (William H. Donaldson, Chairman, U.S. Securities and Exchange Commission), *available at* www.sec.gov/news/testimony/090903tswhd.htm (last visited Feb. 16, 2004). The SEC has sought to debar many of the Enron executives for their role in the company's demise. *See* SEC Oct. 2, 2002 Release 2002-143 (SEC seeks permanent bar against former Enron CFO, Andrew Fastow, from acting as director or officer in a publicly traded company, in addition to other penalties); SEC May 1, 2003 Release 2003-58 (SEC files amended complaint against five former Enron executives for violating federal securities laws, seeking permanent officer/director bar against all five, among other remedies). Tyco and IGI executives have also been targets of the bar. *See* SEC Mar. 13, 2002 Release 2002-35 (seeking officer/director bar, among other remedies, against John Gallo, former president and CEO of IGI, Inc. in connection with alleged enforcement powers and ability to punish corporate officials by making it easier for the Commission to obtain an order barring an individual from serving as an officer or director of a public company.[125]

Previously, the SEC had the authority to seek such an order. Under the Securities and Exchange Act of 1934, § (d)(2),[126] the SEC could obtain such an order if it could establish that the officer was "substantially unfit."[127] Courts interpreting this section typically held the SEC to a very high standard of proof, drastically limiting the circumstances under which such an order could be obtained.[128] Accordingly, the SEC has long sought to reduce the standard of proof.[129]

The Act grants the SEC's request—it lowers the standard of proof the SEC must meet to obtain such a bar to mere "unfitness."[130] The Act also

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earning inflation scheme);. SEC Sept. 12, 2002 Release 2002-135 (officer/director bar sought against former TYCO Chief Executive, Financial and Legal Officers in connection with self-dealing allegations, in addition to seek disgorgement and other penalties).

The SEC has also succeeded in obtaining an officer/director bar in court, as well as through settlements of actions. *See, e.g.*, SEC June 28, 2002 Release 2002-97 (announcing ruling in E.D. Tex. Imposing an officer-director bar against corporate executive at Carreker Corp., in addition to civil penalties and ordering disgorgement); *see also* SEC Release 2002-177 (Dec. 17, 2002) (Former Tyco Director and Chairman of Compensation consented to entry of order permanently barring him from acting as an officer or director in a publicly-held company, in addition to other relief); SEC Release 2003-30 (Mar. 11, 2003) (Former ImClone CEO Sam Waksal agrees to partial resolution of SEC charges in insider trading case, including being barred from acting as an officer or director in a publicly-traded company).

125. *See* Act § 305 (changing threshold for bar from officer or director from being "substantially unfit" to being "unfit"). *See also* discussion *infra* note 127.

126. 15 U.S.C. § 78u(d)(2) (2003).

127. The 1990 amendments to the Exchange Act added a section that authorized the SEC to seek a court order to preclude a person from serving as an officer or director of a public company. Pub. L. No. 101-429, title II, § 201, 104 Stat. 935 (1990). The section provided that the SEC was required to demonstrate that the person was "substantially unfit" to serve as an officer or director of a public company. *Id.* The SEC has had limited success in obtaining such relief in view of the difficult standards engrafted onto the section by the courts. *See, e.g.*, SEC v. Patel, 61 F.3d 137, 141-42 (2d Cir. 1995) (finding that before imposing permanent bar on individual from serving as officer or director of any public company, court should consider whether a conditional bar, such as a bar limited to a particular industry, or a bar limited in time, might be sufficient, especially where there has been no prior history of unfitness; thus, a district court may take into account any prior punishment imposed in a criminal proceeding, and if the district court decides that a conditional ban or ban limited in time is not warranted, it should give reasons why lifetime injunction is imposed). Previously, the SEC took the position that courts could issue an officer/director bar as part of equitable ancillary relief. *See, e.g.*, SEC v. Drexel Burnham Lambert, Inc., 837 F. Supp. 587, 614 (S.D.N.Y. 1993), *aff'd sub nom.* SEC v. Posner, 16 F.3d 520 (2d Cir. 1994), *cert. denied*, 513 U.S. 1077 (1995); *see also* Securities Enforcement Remedies and Penny Stock Reform Act of 1990, *supra* note 124.

128. *See, e.g., Patel*, 61 F.3d at142 (instituting partial, limited bar rather than lifetime bar because of tough standard).

129. *See* Stephen M. Cutler, Director, Div. of Enforcement, SEC, Remarks at the Glaser LegalWorks 20th Annual Federal Securities Institute Speech (Feb. 15, 2002), *available at* http://www.sec.gov/news/speech (last visited Feb. 16, 2004).

130. *See* Act § 305(a)(1) (amending Exchange Act of 1934 by striking "substantial unfitness" and inserting "unfitness").

broadens the remedy by providing for the first time that the SEC can seek an officer/director bar in a cease and desist administrative proceeding where there is a violation of section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, or any rules under either section.[131] Previously, the SEC could only seek an officer/director bar in a civil injunctive action brought in U.S. district court.[132]

In addition to the officer/director bar provision, the Act contains two provisions specifically aimed at taking the profit out of corporate executives' wrongdoing. Section 304 penalizes the chief executive officer and chief financial officer if their company is required to restate its financial statements. This section requires benefiting individuals to reimburse the issuer for any bonus or other incentive-based compensation paid during the twelve-month period following a restatement of the company's financial statements.[133] Section 303 requires those officers to pay the company any profits realized from the sale of its securities during that twelve-month period.[134] Collectively, the increased enforcement power of the SEC and the increased personal liability of executives are intended to help ensure that the new ethics sought by the Act are implemented in the corporate marketplace from the top down.

IV. AUDITORS: A MAKE-OVER FROM ENABLERS[135] INTO SHERIFF

> Auditing is "a franchise that demands you defend and protect, above all else, the public trust; a franchise that asks you to stand firm—even under

131. The significance of this provision is questionable. Frequently, the SEC seeks a fine as one of the remedies for misconduct. Since the SEC cannot seek a fine in an administrative proceeding, this provision may not represent a significant addition to the SEC's remedies. On the other hand, it may give the SEC increased flexibility in settling cases. In some instances, where the SEC has settled an administrative proceeding, it has obtained a fine as part of the settlement by instituting and settling a civil action just to obtain the fine. *See, e.g., In re the Matter of* Huttoe, Admin. Proceeding No. 3-9509 (Dec. 11, 1997); *In re The Matter of* Krause, Admin. Proceeding No. 3-9477 (Oct. 9, 1997). If the SEC is given the authority to impose fines in administrative proceedings, however, it may chose to bring more enforcement actions in that forum rather than in federal district court. *See* SEC Civil Enforcement Act, S. 183, 108th Cong. (2003) (amending securities laws, if passed, to give SEC power to impose fines in administrative proceedings).

132. *See* Exchange Act § 21(d)(1) (giving courts authority to prohibit persons from serving as officers or directors); *see also supra* note 131 and accompanying text.

133. Act § 304.

134. Act § 303. Section 303 prohibits any officer, director or person acting at their direction "to fraudulently influence, coerce, manipulate, or mislead" an accountant conducting an audit. Section 403 contracts the time period for filing § 16 insider trading reports from within ten days of the close of the calendar month to within two days from the day of the transaction. *See also* Act § 409 (concerning "real time" disclosure, which directs that issuers disclose material changes in their financial condition or operations on a "rapid and current" basis and in "plain English").

135. *See, e.g.*, David S. Hilzenrath, *Financial Watchdog Became an Enabler*, WASH. POST, Jun. 16, 2002, at A20 (chronicling the demise of Arthur Andersen).

the weight of management's pressure to 'see things their way.'"[136]

Under the Act, the internal policing efforts of the audit committee and executives are checked by public auditing firms.[137] The auditing firms' procedures may receive a make-over by a new auditor regulatory body authorized under the Act.[138]

Auditors have long issued opinions concerning the financial statements of companies that are relied on by the public.[139] Those opinions have been based on the application of "generally accepted auditing standards" (under the acronym GAAS, which some have thought appropriately descriptive), which are issued by self-regulatory groups.[140] This contrasts with accounting principles generally promulgated by the Financial Accounting Standards Board (FASB) over which the SEC[141] has long exercised persuasive authority.[142]

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136. *See* SEC Chairman Arthur Levitt, Address at the Fall Council of the American Institute of Certified Public Accountants (Oct. 24, 2000), *available at* http://www.sec.gov/news/speech/spch410.htm (last visited Feb. 16, 2004).

137. *See* Act § 103 (defining auditing, quality control, and independence standards and rules).

138. *See* Act § 101 (outlining establishment and administrative provisions).

139. *See, e.g.*, United States v. Arthur Young & Co., 465 U.S. 805, 819 (1984) (discussing different opinions auditors issue about companies the public relies upon when evaluating companies' stock).

140. *See infra* note 142 (discussing American Institute of Certified Public Accountants (AICPA)).

141. The 1934 Act gives the SEC authority to prescribe the "details to be shown in the balance sheet and earning, income statement, and the methods to be followed in the preparation of such reports." 1934 Act § 13(a)-(b). The 1934 Act also requires financial statements to be certified by independent public accountants. 1934 Act § 13(a)(2). Included in this grant of authority is the ability to promulgate rules defining "independence" of auditors. 1934 Act § 13(a). The 1934 Act specifically states that the financial statements are to be filed "in accordance with such rules and regulations as the Commission may prescribe." *Id.* The SEC first exercised this authority in 1937 when it declared that an audit firm was not sufficiently independent from the corporation it was auditing because one of the firm's partners had an interest in the corporation that was greater than one percent of his personal fortune. *Independence of Accountants*, Accounting Series Exchange Act Release No. 2 (1181, Fed. Sec. L. Rep. (CCH) ¶ 3003 (May 6, 1937)).

142. Although the SEC turned to the industry for accounting standards when the Financial Accounting Standards Board (FASB) was created in 1973, the SEC then recognized the FASB as the only private organization with the authority to promulgate accounting principles used in preparing financial reports. *See Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards*, Accounting Series Exchange Act Release No. 150 (Fed. Sec. L. Rep. (CCH) ¶ 3152 (Dec. 20, 1973)). Although the FASB does not require SEC approval to promulgate a new accounting principle, the SEC participates in the FASB's public comment process and often identifies issues it wants the FASB to address. *See, e.g.*, K. FRED SKOUSEN, EARL K. STICE & JAMES D. STICE, INTERMEDIATE ACCOUNTING STUDY GUIDE 5, 10-12 (13th ed. 1999). Further, the FASB has reversed its position on issues in the past after the SEC expressed disapproval of an accounting principle. *Id.* at 14. Also, it is important to remember that the SEC always could exercise its statutory authority to promulgate a standard and overrule a FASB rule. *Id.* at 9.

The development of auditing standards was left to the industry itself through the AICPA. In 1947, the AICPA issued ten Generally Accepted Auditing Standards (GAAS) that provided a general framework for proficiency, testing, and reporting of an auditor.

As with other corporate governance issues addressed by the Act, the perceived problems posed by self-regulation and the often cozy relationship between auditors and their clients are not new. For example, following the corporate bribery scandals of the 1970s, which led to the passage of the Foreign Corrupt Practices Act of 1977,[143] the SEC asked Congress to create a board that would promulgate auditing standards and oversee the auditing profession.[144] The Senate rejected that proposal.[145] Over the years, the SEC again without success sought an independent body to set auditing standards.[146] In 1997, the SEC and the AICPA did, however, form the short-lived Independence Standards Board (ISB) to formulate rules governing auditor independence.[147] Political events led to its dissolution in July 2001[148] in the wake of well-publicized battles between then-SEC Chairman Arthur Levitt, the industry, and Congress over auditor

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More specific guidance on performing an audit is provided through Statements on Auditing Standards (SAS) that are published by the Auditing Standards Board, a committee of AICPA.

143. Pub. L. No. 95-213, § 102, 91 Stat. 1494 (1977). The FCPA was in fact a small response to a few corporate bribery scandals that left many important questions regarding auditor independence relatively untouched. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 528 (rev. ed. 1995). In a report to Congress, the SEC stated that the "most obvious factor" eroding auditor independence was the growing amount of consulting services performed by accounting firms for their auditing clients. *See Report of the Securities and Exchange Commission on the Accounting Profession and the Commission's Oversight Role*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,634, at 80, 545-47 (July 1, 1978) (noting that there was no requirement that auditors disclose whether they also performed consulting services for their clients). After the SEC's proposal to create a "small, full-time, appropriately-staffed board to streamline the standard-setting process and lend enhanced credibility through the involvement of persons outside the profession" was rejected by both the Senate and the industry, the SEC concluded that no new legislation was necessary because it wanted to give the profession a chance to respond. *Id.* at 80, 554-55 (noting that whenever the SEC threatens to promulgate detailed rules, the profession responds with satisfactory rules to address SEC concerns).

144. *Id.* at 80, 544-57.

145. *Id.*

146. *See* Steve Liesman et al., *Dirty Books? Accounting Debacles Spark Calls for Change*, WALL ST. J., Feb. 6, 2002, at A1 (describing efforts over time to implement independent auditor monitoring organization).

147. On May 21, 1997, the SEC and the AICPA announced the formation of a new private sector auditing body to establish independent standards for the auditors of public companies. *See* SEC and AICPA Announce the Creation of a New Independence Standards Board, SEC Release No. 97-41, (May 21, 1997), *available at* http://www.sec.gov/news/press/pressarchive/1997/97-41.txt (last visited Feb. 16, 2004).

148. *See* William T. Allen & Arthur Siegel, *Threats and Safeguards in the Determination of Auditor Independence*, 80 WASH. U. L.Q. 519, 525 (2002) (explaining the ISB was composed of an equal number of members from the profession and from outside the profession and was similar to the FASB in that it issues rules through a public comment process). The ISB, at the urging of the SEC, dissolved itself in May 2001. A general reason for this was a hostile "political climate." *See also* Michael Schroeder, *SEC May Back Down on Key Consulting Issue*, WALL ST. J., Oct. 25, 2000, at C1 (indicating both chambers of Congress had drafted bills that would undo any SEC rule and threatened to attach them as riders to an appropriations bill if the SEC went too far in drafting new auditor independence rules).

independence.[149] Throughout that process, SEC enforcement efforts against auditors were spotty and inconsistent at best.[150] In 2001, the SEC brought its first civil injunctive action in over twenty years against an accounting firm.[151]

The scandals of Enron, WorldCom, and others of their ilk not only shook the public's confidence in corporate America, but also shook Congress.[152] Senator Sarbanes questioned the effectiveness of the largely self-regulated auditing industry.[153] These events finally led Congress to create an independent board for establishing auditing standards and enforcing those standards under its control, a step that may transform Congress's auditors into the sheriff sought by the SEC over twenty-five years ago in *SEC v. Arthur Young*.[154]

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149. *See, e.g.*, Michael Schroeder, *Tougher Curbs on Auditors Likely at SEC*, WALL ST. J., Nov. 14, 2000, at C1 (explaining Levitt's efforts to get an independent auditor board); *see also* Michael Schroeder, *Levitt Will End 8 Activist Years as SEC Chief Early in 2001*, WALL ST. J., Dec. 21, 2000, at C1 (describing Levitt's clashes with Congress).

150. *See SEC and Corporate Audits: Hearing Before the Subcomm. on Oversight & Investigations of the House Comm. on Energy & Commerce*, 99th Cong. 3 (1985) (Rep. Dingell) (commenting "[t]he SEC has ample statutory authority at this moment to address problems in . . . audit enforcement. Yet, the Commission seems to take great pride in its reluctance to use the powers granted to it by Congress"); *In re* Wade, 47 SEC 1081 (1984) (describing the lack of consistent SEC enforcement is illustrated by comparing the sanctions sought in "opinion shopping" cases.). In *Wade*, the company's original auditor felt that GAAP required the company to recognize losses on a transaction. *Id.* at 1084. The company discussed the issue with other auditing firms until it found one who would agree that the company did not have to recognize a loss. *Id.* at 1085. The three auditors knew of this history when they certified the financial statements. *Id.* at 1089. Three accountants were suspended (two for a three year period and one for life). *Id.* at 1093. *Cf. In re* Broadview Fin. Corp., 48 SEC 146, 158 (1985) (describing the company's overstating of revenues and repercussions for the inappropriate recognition). While the SEC did not suspend the auditors in this case, which involved a company's overstating revenues, it did warn that opinion shopping should be a "red flag" to auditors and that the Commission would investigate auditors in the future. *Id.* Both *Wade* and *Broadview Financial Corp.* involve similar conduct by auditors—in one case the auditors were suspended; in the other, they were only issued a warning.

151. *See In the Matter of* Maier, Release No. 2001-62 (June 19, 2001), *available at* 2001 SEC LEXIS 1170 (describing the injunction against Maier, a partner at Arthur Andersen LLP for issuing "materially false and misleading audit reports").

152. *See, e.g.*, Jonathan Weil, *Audits of Arthur Andersen Become Further Focus of Investigation by SEC*, WALL ST. J., Nov. 30, 2001, at A3 ("Andersen [the auditor of Enron and WorldCom] likely will face questions on a host of fronts.").

153. *See* 148 CONG. REC. S6330 (daily ed. July 8, 2002) (describing the statement of Sen. Sarbanes noting that although the accounting profession has historically regulated itself, the recent accounting scandals "have raised serious questions" about that system).

154. *See* SEC v. Arthur Young & Co., 590 F.2d 785, 788 (9th Cir. 1979) ("To accept the SEC's position would go far toward making the accountant both an insurer of his client's honesty and an enforcement arm of the SEC. We can understand why the SEC wishes to so conscript accountants. Its frequently late arrival on the scene of fraud and violations of securities laws almost always suggests that had it been there earlier *with the accountant* it would have caught the scent of wrong-doing and, after an unrelenting hunt, bagged the game.").

A. Auditors Potentially Get a Make-Over and Become the Outside Sheriff Under the Public Company Accounting Oversight Board and the SEC

The Act creates a new SEC-supervised entity to recreate GAAS for the auditors of public companies and gives that entity enforcement authority to police the conduct of auditors.[155] Under the Act, the newly-created Public Company Accounting Oversight Board (PCAOB) is required to promulgate standards for conducting audits and "perform other duties or functions . . . [as] necessary or appropriate to promote *high professional standards among, and improve the quality of audit services* offered by, registered public accounting firms and associated persons thereof. . . ." [156] The auditor, like the audit committee, may thus become the sheriff as envisioned by Chief Justice Burger when writing for a unanimous Supreme Court nearly twenty years ago:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[157]

To ensure that auditors fulfill this function, the Act gives the PCAOB[158] broad authority to write auditing and ethical standards, subject to SEC approval.[159] Indeed, the term "audit" in § 2(a)(2) of the Act is defined to be a process that is in accord with the rules of the Board, not those of the industry as had previously been the case.[160] The PCAOB is directed to

155. *See* Act § 101 (describing the establishment and administrative provisions of the Public Company Accounting Oversight Board).

156. *See* Act § 101(c)(5) (indicating the duties of the PCAOB) (emphasis added).

157. See United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984) (requiring the accounting firm Arthur Young to turn over to the IRS the tax statements of its client, rejecting claim that such documents were privileged).

158. *See* Act § 101(e)(1)-(2) (2002) (describing only two of the Board's five members are permitted to be Certified Public Accountants, although all five must understand the nature of financial disclosures under the securities laws and be "prominent individuals of integrity and reputation").

159. *See* Act § 101(c)(2) (describing the Board will determine quality and ethical standards for preparing audit reports).

160. *See* Act § 2(a)(2) (defining the audit process under the rules of the Board); *see also* Statement Regarding the Establishment of Auditing and Other Professional Standards, PCAOB Release No. 2003-005 (Apr. 18, 2003) (indicating that although the PCAOB is empowered to adopt existing industry standards if it so chooses under Act § 103(a)(1), it has already announced that it will not designate a professional group of auditors to propose standards, but instead will appoint an advisory group to assist it in proposing auditing standards.); *id.* (indicating once promulgated through a public notice and comment process and approved by the Commission, the Board's standards will supersede current industry standards.); *see also* Establishment of Interim Professional Auditing Standards, PCAOB Release No. 2003-006 (Apr. 18, 2003) (describing in the interim, the Board (with the

adopt specific rules pertaining to auditing, quality control, and ethics.[161]

Auditors of public companies are required to register with the Board.[162] Non-U.S. auditors are required to submit to the jurisdiction of the Board and are correspondingly subject to the enforcement authority of the U.S. courts.[163] In addition to registering public accounting firms and

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Commission's approval) has required auditors to comply with the existing AICPA Code of Professional Conduct and the current SAS).

Subsequently, the Board proposed new auditing standards. Under § 404(b) of the Act, the Board is given the authority to issue standards governing auditors attestations regarding management's assessment of the effectiveness of internal controls. *Id.* On October 7, 2003, the Board published for public comment proposed rules, which, if adopted, would replace Interim Rule 3300T, which had adopted existing standards in the interim. The proposed rules would require an auditor to communicate in writing to the audit committee all significant deficiencies and material weaknesses of which the auditor is aware. The proposed rule identifies a number of circumstances as significant deficiencies, for example ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee, material misstatement in financial statements not initially identified by the company's internal controls, and significant deficiencies communicated to the audit committee that remain uncorrected after a reasonable period of time. *See* Proposed Auditing Standard—An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, PCAOB Release No. 2003-017 (Oct. 7, 2003); *see also* Press Release, PCAOB, *Board Proposed Auditing Standards for Internal Control Over Financial Reporting* (Oct. 7, 2003), *available at* http://www.pcaobus.org /pcaob_news_10-07-03b.asp (last visited Feb. 16, 2004).

On November 21, 2003, the Board published proposed rules regarding audit documentation under its authority pursuant to § 103(a)(2)(A)(I). Proposed Auditing Standard on Audit Documentation and Proposed Amendment to Interim Auditing Standards, PCAOB Release No. 2003-023 (Nov. 21, 2003); *see also* Press Release, PCAOB, Board Proposed Two Auditing Standards, Amendment to Interim Auditing Standards (Nov. 12, 2003) (In addition to proposed new standards for audit documentation, the Board also voted to propose an auditing standard that requires firms to attest in audits that the audits were performed in accordance with Board standards; however, this proposed rule has not yet been published. [as of January 13, 2004])

161. *See* Act § 103(a)(1) (describing the rules the PCAOB must adopt); *see also* Act § 103(a)(2)(A) (explaining the Board must require auditors to prepare and maintain documents for at least seven years, have a concurring or second partner not associated with the audit review the auditor's work, and describe the audit procedures and evaluation of the client's internal controls); *see also* Act § 103(a)(2)(B) (2002) (indicating the Board also must adopt quality control requirements, meaning that accounting firms must monitor professional ethics and maintain independence from the companies they audit, consult with their clients on accounting questions, supervise audit work, and continue to inspect auditors' work.).

162. *See* Act § 102(a) (stating that on July 17, 2003, the Board launched its registration system for public accounting firms); *see also* Board announcement *at* www.pcaobus.org/pcaob_news_7-17-03.asp (describing the launch of the registration system for public accounting firms). According to the Board, as of October 2003, 598 firms were registered with the PCAOB. Press Release, PCAOB, Board Approves Registration of 598 Accounting Firms (Nov. 12, 2003)). A list of registered firms is available on www.pcaobus.org. On October 7, 2003, the Board adopted final rules regarding the inspection of public accounting firms. Inspection of Registered Public Accounting Firms, PCAOB Release No. 2003-019 (Oct. 7, 2003).

163. *See* Act § 106(b)(1) (indicating that foreign firms are deemed to consent to the jurisdiction of U.S. courts and to produce their audit papers to the PCAOB and the Commission upon request when a foreign firm "issues an opinion or otherwise performs materials services upon which a registered public accounting firm relies in issuing all or part of any audit report or opinion contained therein"). These provisions regarding non-U.S.

establishing auditing standards, the Board's duties also include the inspection of registered accounting firms, as well as the power to levy sanctions against accounting firms and associated persons who fail to adequately live up to its standards.[164]

Section 107 of the Act sets the PCAOB squarely under the oversight and supervision of the Commission. The SEC may accept, reject, or modify any rule proposed by the Board.[165] Under the Act, final authority over accounting principles is reserved for the Commission, although the Commission may continue to rely on the FASB.[166]

B. New Restrictions on Auditors

As it does with corporate executives, the Act imposes restrictions on auditors in an effort to eliminate potential conflicts of interest. With few exceptions, auditors are precluded from performing consulting work or other "non audit" services for their auditing clients.[167] Section 201(a) of the Act provides in part that:

> [i]t shall be unlawful for a registered public accounting firm . . . that performs for any issuer any audit . . . to provide to that issuer, contemporaneously with the audit, any non-audit service, including
>
> (1) bookkeeping or other services . . .
>
> (2) financial information systems design and implementation;
>
> (3) appraisal or valuation services, fairness opinions . . .
>
> (4) actuarial services;
>
> (5) internal audit outsourcing services;
>
> (6) management functions . . .

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auditors had been criticized previously by the SEC and later adopted by Sarbanes-Oxley. Former SEC Enforcement Chief John Fedders wrote a number of articles discussing this idea long before enactment of Sarbanes-Oxley. *See, e.g.*, John M. Fedders, *Policing Trans-Border Fraud in the United States Securities Markets: The "Waiver by Conduct" Concept—A Possible Alternative or a Starting Point for Discussions?*, 11 BROOK. J. INT'L L. 477, 478 (1985) (discussing the inadequate system of treaties and mechanisms for policing trans-border fraud); John M. Fedders, *"Waiver by Conduct" vs. Fraud*, WALL ST. J. Dec. 21, 1984, at 18 (indicating strategies must be developed to monitor trans-border securities fraud); John M. Fedders, *Interdependence and Cooperation: The SEC's 'Waiver by Conduct' Concept Release*, INT'L FIN. L. REV. 10 (Sept. 1984); John M. Fedders, *Waiver by Conduct Idea Deserves a Closer Look*, LEGAL TIMES 10 (Sept. 3, 1984); John M. Fedders, *Waiver by Conduct—A Possible Response to the Internationalization of the Securities Markets*, 6 J. COMP. BUS. AND CAP. MARKET L. 1, 3 (1984).

164. *See* Act § 101(c) (describing the Board's inspection duties and power to sanction).

165. *See* Act § 107 (describing the PCAOB falls under control of the Commission and the SEC's ability to accept, reject, or modify any rule proposed by the Board).

166. *See* Act § 108(a) (explaining the Commission has final authority over accounting principles).

167. *See* Act § 201(b) (explaining that auditors may only perform auditing services unless another function is proven "necessary or appropriate in the public interest" by the Board).

(7) legal services . . .

(8) broker or dealer, investment adviser, or investment banking services; and

(9) any other service that the Board determines . . . is impermissible.

Even if a service is not prohibited by the Act, such as tax services, only the auditor upon approval of the audit committee may perform it.[168] Any approval by the audit committee must be disclosed in the issuer's periodic filings.[169] The Commission also requires issuers to disclose the fees paid for audit and non-audit services.[170]

In addition, the Act reduces the potential for cozy auditor/client relationships by requiring that the audit or engagement partner be rotated every five years under section 203. Likewise, a registered public accounting firm is prohibited, under section 205, from auditing a public company if the firm previously employed a current member of senior management and participated in the issuer's audit during the previous year. The recently issued SEC rule bolsters these provisions by requiring that the lead and concurring partners rotate off the client's audit engagement for five years.[171] The Commission noted that the Act was silent on this "time out" period. The SEC chose five years because it considers a "fresh look" at the books important.[172]

C. Reporting: The Expanded Audit Opinion

The expanded obligations of auditors are reflected by the information required to be in the opinion regarding an auditor's testing of the internal controls and procedures of the issuer.[173] The traditional audit opinion stated that the auditor had performed his work under GAAS.[174] In contrast, under the Act, an audit opinion must now specify:

- the scope of the auditor's testing of the internal control structure of the issuer;

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168. *See* Act § 201(a) (indicating that if an act is not prohibited it must be approved by the audit committee).

169. *See* Act § 201(g) (describing approval by the committee must be disclosed).

170. *See* Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6030-31 (Feb. 5, 2003) (SOA Rule) ("While the rules we are adopting continue to require issuers to disclose fees paid to the principal accountant for audit services, we are expanding the types of fees that should be included in this category to include fees for services that normally would be provided by the accountant in connection with statutory and regulatory filings or engagements.").

171. *See id.* at 6018 (stating that partners must rotate every five years off client's audits).

172. *See id.* (describing that changing partners every five years gives a new look at the books while maintaining continuity and competence).

173. *See* Act § 103(a)(2)(A)(iii) (describing that each audit report must describe the scope of the auditors testing of the internal control structure and of the issuer procedures).

174. *See, e.g.*, AICPA, STATEMENT ON ACCOUNTING STANDARDS NO. 95, CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES (2001).

- the auditor's findings based on the testing;
- an evaluation stating whether the internal controls/procedures include records sufficient to accurately reflect the transactions and dispositions of the issuer's assets;
- an evaluation as to whether the internal controls/procedures provide "reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles" and that receipts and expenditures are made in accordance with management authorization and direction; and
- a description of "material weaknesses" in internal controls and any "material noncompliance" found during such testing.[175]

Auditors are also obligated to report to the audit committee critical accounting policies and practices used for the audit, as well as any alternative treatments of financial information within GAAP and any "material" written communications between the auditing firm and management of the issuer.[176] The reporting obligations of the auditor supplement the obligations of management under sections 404(b) and 302, which, respectively, require management to report on the internal controls of the issuer and the chief executive and financial officers to execute certifications regarding those controls.[177] The work of the auditor is also subject to review by the newly-empowered audit committee.

To ensure that their work can be reviewed, auditors are required to preserve their work papers for seven years.[178] That obligation extends to foreign auditing firms used by a registered auditing firm in the course of the audit.[179]

D. The Board as SEC Enforcer Over the Auditing Profession

The Act grants the Board enforcement powers similar to those exercised by the Commission over the brokerage industry, which are designed to

175. *See* Act § 103(a)(2)(A)(i)-(iii) (providing a description of what the auditing standards that each registered public accounting firm must adopt).

176. *See* Act § 204 (describing what auditors must report to the audit committee).

177. *See* Act §§ 302 and 404(b) (describing the reporting obligations for corporate responsibility for financial reports and internal control evaluation and reporting); *see also* Act § 906(a)-(b)). Under § 906, periodic reports filed with the SEC by an issuer pursuant to §§ 13(a) or 15(d) of the 1934 Act must be accompanied by a certification by the chief executive and financial officers "that the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of the operations of the issuer." *See also* discussion *supra* Part IV (describing that chief executives and financial officers must make detailed representations about the issuer's financial information and disclosures).

178. *See* Act § 103(a)(2) (explaining that auditors must keep their records for seven years).

179. *See* Act § 106(b)(2) (establishing foreign auditing firms must also maintain records for seven years).

ensure compliance by auditors with their obligations under the Act and rules promulgated by the Board.[180] Under the Act, the Board is given the authority (and the obligation) to:

> Conduct periodic inspections of audit firms; the inspections must be conducted annually for firms that report on more than 100 issuers per year, and at least every 3 years for other firms;[181]
>
> Investigate possible violations of the Act and its rules;[182] [and]
>
> Hold administrative hearings to determine whether a violation has occurred under Section 105(c).[183]

Registrants are required to cooperate with the Board's inspections and investigations.[184] While cooperation is not specifically defined, it includes producing records and witnesses for testimony.[185] Failure to cooperate

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180. *See* 15 U.S.C. §§ 15-78 (indicating the SEC has long had supervisory authority over securities dealers).

181. *See* Act § 104(b)(1) (explaining the Board's authority to conduct inspections of registered public accounting firms); *see also* PCAOB Release No. 2003-013 (describing proposed rules on inspections of public accounting firms issued by the Board on July 28, 2003); *see also id.* (indicating that the deadline for public comment is Aug. 18, 2003).

182. *See* Act § 105(b) (explaining the Board my investigate violations of Act); *see also* Act § 105(b)(1) (indicating that section 105 provides the Board may investigate "any act or practice, or omission to act, by a registered public accounting firm, any associated person of such firm, or both, that may violate any provision of this Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under this Act, or professional standards, regardless of how Act, practice, or omission is brought to the attention of the Board"). Compare this investigative authority with that of the SEC. *See, e.g.*, § 21(a) of the 1934 Act and § 20(a) of the 1933 Act; 15 U.S.C. §§ 77u, 77v (describing that hearings will be public and before the commission and who has jurisdiction for violating Act).

183. *See* Proposed Rules on Investigations and Adjudications, PCAOB Release No. 2003-012 (July 28, 2003) (describing the Board's proposed rules on investigations and adjudications); *see id.* (indicating that the deadline for public comment is Aug. 18, 2003). *See* Act, § 105(c)(2) (indicating these hearings, like those held by the Commission under former Rule 2(e), now 102(e), are required to be non-public, which could cause delay, unless good cause is shown); *see also* Mona L. Hymel, *The Sources and Uses of Protocols in Governing Law Practice*, 44 ARIZ. L. REV. 873, 886 (2002) (describing hearings under Rule 2(e) that were frequently delayed for lengthy periods by audit firms because of their non-public nature). *See* Proposed Rule 4009, PCAOB Release No. 2003-013 (July 28, 2003) (articulating that the Board's proposed rule on inspections will keep the portion of the inspection report containing criticisms on potential defects in quality control systems as long as those deficiencies are addressed within twelve months).

184. *See* Act § 105(b)(2)-(3) (describing registrants must comply with inspection and investigation rules regarding testimony and document production and repercussion for failure to cooperate with investigations).

185. *See* Act § 105(b)(2) (including testimony of a person or documents associated with a registered public accounting firm and production of audit work papers that the Board believes is relevant to an investigation). Under the Board's proposed rules for investigations, the Board may institute disciplinary proceedings for non-cooperation with an investigation where a company "[m]ay have failed to comply with an accounting board demand, may have given testimony that is false or misleading or that omits material information, or may otherwise have failed to cooperate in connection with an investigation . . . ." Proposed Rules on Investigations and Adjudications, PCAOB Release No. 2003-012, Rule 5110(a) (proposed July 28, 2003).

with an inspection or investigation can result in being suspended or barred from practice.[186] Although the Board does not have independent subpoena power, it can issue subpoenas with assistance from the Commission.[187]

E. Sanctions: Barred from Business

As with other sections of the Act, the new auditor obligations are backed up by the threat of multiple sanctions. While the Commission could always bring actions against auditors under the Securities laws[188] or an ethics proceeding under Rule 102(e) or its predecessor Rule 2(e), in reality few such actions have ever been brought—especially against major auditing firms.[189] Under the Act, however, auditors face the threat of multiple sanctions—and the death knell of being debarred from doing business.[190]

Under the Act, both the Commission and the Board can enforce the provisions of the Act and the rules enacted under it with respect to auditors.[191] The Act expressly empowers the Board to sanction auditors, under provisions that are similar to those available under SEC Rule of Practice 102(e).[192] The Board's enforcement authority includes the power to limit the activities of a registrant and to impose monetary fines up to

186. *See* Act § 105(b)(3)(A) (providing the Board with the option of suspending registration of a public accounting firm or barring a person from being associated with the firm).

187. *See* Act § 105(b)(2)(D) (indicating that in order to subpoena documents or compel testimony, the Board must request assistance from the SEC). The SEC's subpoenas are not self-executing, however, so this procedure, in practice, may prove to be cumbersome. *See* SEC v. Jerry T. O'Brien, Inc., 467 U.S. 735, 741 (1984) ("Subpoenas issued by the [SEC] are not self-enforcing, and the recipients thereof are not subject to penalty for refusal to obey."). Rather, the Commission must apply to the appropriate district court to enforce its subpoenas. *Id.* This process has the potential to delay significantly any Board investigation.

188. Securities Exchange Act of 1934, 15 U.S.C. § 78 (1934).

189. *See, e.g.*, James Bandler & Mark Maremont, *KPMG Faces SEC Suit Related to Xerox Work*, WALL ST. J., Jan. 30, 2003, at A2 (stating the recent SEC action against KPMG in January, 2003 was only the second action against one of the major auditing firms in the last twenty years).

190. As with the officer-director bar, since the passage of the Act, the SEC has also succeeded in obtaining permanent debarment of auditors before the Commission. *See, e.g.*, Press Release, SEC, Former Tyco Auditor Permanently Barred From Practicing Before the Commission (Aug. 13, 2003), *at* http://www.sec.gov/news/press/2003-95.htm (last visited Feb. 16, 2004) (announcing settlement of Rule 102(e) proceedings against Price Waterhouse Coopers, auditor for Tyco, under which auditor agreed to permanent debarment from appearing or practicing before the commission); Press Release, SEC, Former Ernst & Young Partner Arrested for Obstruction Charges and Criminal Violations of Sarbanes Oxley Act (Sept. 25, 2003), *available at* http://www.sec.gov/news/press/2003-123.htm (describing SEC administrative proceedings against former E&Y partners in connection with criminal proceedings related to audits of Enron where debarment was one of the remedies sought by the SEC; in accepting a plea, one of the E&Y partners also consented to a bar on practicing before the commission).

191. *See* Act §§ 105, 107, 602 (outlining the roles of the Commission and the Board regarding investigations and disciplinary proceedings, authorization of appropriations, and appearance and practice before the Commission).

192. *See* Act § 105(c)(4) (providing list of possible sanctions for violations).

$100,000 for an individual and $2 million for a firm.[193] For intentional, knowing, reckless, or repeated instances of negligence, these fines can be increased up to $750,000 for an individual and $15 million for a firm, in addition to the possibility of censure.[194] The Board can also require additional training and impose other sanctions deemed appropriate.[195] If sanctions are imposed, the Board is required to report the sanction to the SEC and any appropriate state regulatory authority or foreign accountancy licensing board.[196] Board-imposed sanctions can be appealed to the SEC.[197]

Finally, the SEC's authority to sanction professionals is bolstered by the Act. Section 602 of the Act essentially codifies SEC Ethics Rule 102(e), which applies to all professionals who practice before the SEC, including—accountants, chief financial officers, and attorneys.[198] Section 802 of the

193. Act § 105(c)(4)(D)(i).
194. Act § 105(c)(4)(D)(ii).
195. Act §§ 105(c)(4)(F)-(G).
196. *See* Act § 105(d)(1) (requiring the Board to report to the public when a stay on the imposition of a sanction is lifted).
197. *See* Act § 105(e) (noting an appeal acts as a stay of disciplinary action until the Commission terminates the stay). On December 5, 2003, the SEC published proposed rules that authorize the Commission to review disciplinary actions imposed by the Board and additional amendments to its rules of practice regarding review of Board proceedings. Proposed Amendments to the Rules of Practice and Related Provisions, 68 Fed. Reg. 68,186 (Dec. 5, 2003) (to be codified at 17 C.F.R. pts. 200-01, 240).
198. *See* Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. § 205.6(a) (2003) (stating that under the Final Rules promulgated by the Commission, "[a] violation of this part [205] by any attorney appearing and practicing before the Commission in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder").

The SEC has long claimed the authority to discipline professionals who practice before it under current Rule of Practice 102(e) and its predecessor Rule 2(e). *See* Rules of Practice, 17 C.F.R. § 201.102(e) (2003) ("The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission to have committed certain violations."). This rule, however, has been highly controversial.

The debate over Rule 102(e) was resolved when then-General Counsel Edward Greene, in a 1982 speech to the New York County Lawyers' Association, announced his view that the SEC would not bring administrative proceedings against lawyers except in cases where a court had already found that the lawyer had committed a substantive violation of the federal securities laws. *See* Edward F. Greene, *SEC General Counsel's Remarks on Lawyer Disciplinary Proceedings Before the Securities and Exchange Commission*, Remarks to the N.Y. County Lawyers Association (Jan. 18, 1982), *reported in* 14 SEC. REG. & L. REP. (BNA) 168, 170 (Jan. 20, 1982) (explaining that Rule 2(e) proceedings are usually based on "charges of violating or aiding and abetting violations of the securities laws"). The SEC later issued a release stating that it "generally utilized Rule 2(e) proceedings against attorneys only where the attorney's conduct has already provided the basis for a judicial or administrative order finding a securities law violation in a non-Rule 2(e)(3) proceeding," further noting that its "practice of premising attorney Rule 2(e) proceedings on judicial orders minimizes the risk . . . that public disciplinary proceedings may have a chilling effect on zealous representation of a client." *See* Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission, 53 Fed. Reg. 26,431 (July 13, 1988) (to be codified at 17 C.F.R. pt. 201) (emphasizing that

Act also creates the new crime of destroying audit work papers within five years of an audit.[199] It adds that "whoever knowingly and willfully" violates this section shall either be fined, imprisoned for a maximum sentence of ten years, or both.[200] All of these sections are designed to force compliance with the new ethics sought by the Act.

V. ANOTHER NEW SHERIFF? CORPORATE WRONGDOING AND THE LAWYER'S REPORTING DUTIES

As with corporate executives and auditors, the Act also conscripts outside counsel in its efforts to usher new ethics into the corporate marketplace.[201] Attorneys have long had ethical obligations under state codes of conduct to report wrongful conduct.[202] Those obligations varied by state and were largely monitored by sometimes less than zealous state regulators.[203] In addition, under SEC Rule of Practice 102(e) and its predecessor, the Commission claimed the power to enforce ethical standards for attorneys who practice before it. Enforcement under that rule, which has long been mired in controversy over the SEC's authority to issue it, has been virtually non-existent in recent years.[204] Under the Act, however, the SEC is given specific authority to impose ethical obligations on attorneys and the authority to enforce those obligations with sanctions.

A. New Obligations

The Act, for the first time, gives the SEC explicit authority to issue rules concerning the ethical conduct of attorneys, expressly directing the Commission to issue rules setting forth "minimum standards" for attorneys practicing before the SEC.[205] At a minimum those rules must require that

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Rule 2(e) proceedings rarely involve questions regarding the professional standard of attorney conduct).

While the few court decisions that have considered the question have upheld the SEC's authority in this area, its exercise remained controversial and its application has been episodic at best. *See* Davy v. SEC, 792 F.2d 1418, 1421 (9th Cir. 1986) (upholding Rule 2(e)); Touche Ross & Co. v. SEC, 609 F.2d 570, 582 (2d Cir. 1979) (concluding Rule 2(e) falls within the SEC's rulemaking powers); Polydoroff v. ICC, 773 F.2d 372, 374 (D.C. Cir. 1985) (using similar rule in other administrative context).

199. *See* Act § 802(a) (requiring maintenance of all relevant workpapers for that five year period).

200. Act § 802(b).

201. *See* Act § 307 (listing rules of professional responsibility for attorneys).

202. See Paul M. Barrett, *Silent Partners: When Lawyers See Fraud at a Company, What Must They Do?*, WALL ST. J., Aug. 22, 1997, at A1 (detailing a "patchwork of ethics codes adopted by states" that generally require lawyers to maintain client confidences but also require disclosure when wrongdoing occurs).

203. *See id.* (explaining the inconsistencies of state enforcement).

204. *See supra* note 198 and accompanying text (elaborating on the debate regarding the SEC's authority under Rule of Practice 102(e)).

205. *See* Act § 307 (providing protection for investors and the public interest).

counsel "report evidence of a material violation of securities law or breach of fiduciary duty or similar violation" to the chief legal counsel or chief executive officer of the company,[206] or, if an "appropriate response" is not obtained, to the audit committee, another independent committee of the board of directors, or the board of directors itself.[207] Under Section 307 of the Act, the SEC may also add other appropriate ethical rules governing the conduct of attorneys who practice before it.

Under this section, the SEC issued proposed rules on November 21, 2002, and adopted final rules on January 29, 2003,[208] while extending the comment period for other rules at the same time. The rules as adopted implement the mandatory provisions of the statute by requiring counsel to report evidence of material violations of the federal securities laws either up the corporate ladder, as dictated by the statute, or to a special committee called the "qualified legal compliance committee" formed for that purpose.[209] Neither the rules nor the statute state what, if anything, counsel should do if the entity fails to act on the report of wrongful conduct. Presumably that situation would be governed by state ethical rules.[210]

In adopting its final rules, the SEC extended for additional comment some of the more controversial provisions contained in its initial proposals and dropped others. The SEC extended for additional comment its proposals concerning the obligation of counsel to affect a "noisy withdrawal" in certain circumstances.[211] As initially proposed, the rules

206. Act § 307(1).

207. *See* Act § 307(2) (defining an appropriate response as the adoption of remedial measures or sanctions).

208. Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670 (proposed Nov. 21, 2002) (to be codified at 17 C.F.R. pt. 205); Final Rule on Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. § 205 (2003).

209. *See* 17 C.F.R. §§ 205.3(b)(1)-(3), (c)(1) (providing the alternative of reporting to the "qualified legal compliance committee" rather than to the chief legal officer or chief executive officer).

210. *See id.* § 205.1 (stating only "[w]here the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern").

211. This provision is based on a March 7, 2002, letter to then-SEC Chairman Harvey Pitt from forty professors specializing in securities regulation and/or professional responsibility. The letter was signed by, among others, Richard W. Painter from the University of Illinois. In 1998, Professor Painter had urged the ABA to adopt a similar proposal. The ABA rejected the suggestion. The SEC responded in a Mar. 28, 2002, letter from then-General Counsel, David Becker, by stating that the Commission had not used its Rule 102(e) power to discipline lawyers for over twenty years based on the views of the bar and that the question was better addressed to state bar associations. An ABA letter to Senator Sarbanes submitted prior to conference objected strenuously to this provision. *See* Audrey Strauss, *Up-the-Ladder Reporting Under Sarbanes-Oxley*, N.Y.L. J., (Sept. 5, 2002, at 5 (citing letter strenuously arguing against allowing "'the SEC to adopt a sweeping set of new lawyer ethical standards that could conflict with the state-court issued ethical rules that currently bind all attorneys'"). Citing this March 7, 2002 letter and the SEC's response, Senator John Edwards (D-N.C.) offered an amendment to the Senate Corporate Fraud and

would have required counsel to affect such a withdrawal when the issuer failed to take corrective action after receiving a report concerning a material violation of the federal securities laws—that is, effectively call the SEC and tell them, making counsel the ultimate sheriff in town. As reissued for comment, the proposed rules would have either required a noisy withdrawal or required the issuer to disclose the facts concerning the claimed material violation.[212]

In adopting its final rule, the SEC dropped key controversial provisions of its proposed rules that would have fortified corporate counsel's role as the ultimate sheriff in town. For example, as initially proposed, the rules would have required an attorney to take reasonable steps to document his or her report of a material violation and the response to the report, and retain that documentation.[213] Another deleted provision provided that it was not a waiver of attorney client privilege to provide the SEC with privileged documents. This provision, coupled with the requirement that

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Accounting Reform Act, which proposed the "duty to report." Then-SEC Chairman Harvey Pitt had called for the addition of a similar provision prior to Act. *See* WALL ST. LAWYER, Apr. 2002, at 1. ABA Model Rule 1.13 specifies that lawyers have the professional responsibility to respond to a corporate client's violation of law as reasonably necessary and in the best interest of the company. Up-the-ladder reporting to the board is one of several courses of possible action depending on the circumstances. The rule, however, allows the lawyer to evaluate the course of action and does not prescribe any particular steps. *See* Strauss, *supra* note 211, at 5-6 (comparing Rule 1.13 with section 307 of Act).

212. The proposed "noisy withdrawal" rule was widely criticized. *See, e.g.*, Richard B. Schmitt, *Lawyers Pressed to Report Fraud Under New Law*, WALL ST. J., July 25, 2002, at B1 (explaining sweeping reporting reforms proposed by SEC). *See also* Strauss, *supra* note 211, at 6 (citing ABA letter).

213. *See* Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,684 (proposed Nov. 21, 2002) (to be codified at 17 C.F.R. pt. 205) (explaining this procedure would protect an attorney at a proceeding where his compliance with the rule is at issue). The SEC has not acted any further on its proposed "noisy withdrawal" provision. Even aside from the proposed "noisy withdrawal" provision, the final rules on the implementation of standards of professional conduct for attorneys have not been without controversy. In particular, the rules permit an attorney to disclose confidential information to the Commission without the issuer's consent to: (1) prevent the commission of a material violation likely to cause substantial financial injury to issuer/investors; (2) prevent the issuer from committing or suborning perjury or committing an act likely to perpetrate a fraud on the commission; and (3) to rectify the consequences of a material violation that caused or may cause substantial financial injury to the issuer/investors in the furtherance of which the attorney's services were used. 17 C.F.R. § 205.3(D)(2). Disclosures permitted under the SEC rules, however, may not be permitted under state codes of ethics. In a Washington state ethics opinion, while concluding that the SEC's regulations regarding disclosure of client confidences do not conflict with the Washington rules of professional conduct (Washington RPC), the opinion acknowledges that the SEC rules would authorize (although not require) disclosure in circumstances where disclosure would not be permitted under the Washington RPC. Under the opinion, a Washington lawyer can only reveal confidences as permitted under the Washington RPC, regardless of whether it might be allowed under the SEC rules. Further, complying in good faith with the SEC regulations is not a defense against a Washington RPC violation. *See* Interim Ethics Opinion, The Effect of the SEC's Sarbanes-Oxley Regulations on Washington Attorney's Obligations Under the RPCs (July 26, 2003), *at* http://www.wsba.org/lawyers/groups/ethics2003/formalopinion.doc (last visited Feb. 16, 2004).

counsel document his or her findings, could have provided a complete road map for the SEC to investigate potential wrongful conduct. These proposed rules were withdrawn in the wake of extensive criticism and significant questions concerning the SEC's authority to issue them.[214] Although withdrawn, the Commission has affirmed and defended its policy of entering into confidentiality agreements when obtaining information from the issuer would further public interest.[215] That policy, coupled with the SEC's announced policy on cooperation,[216] which in part is premised on issuers providing the staff with privileged materials during an investigation, may in effect implement the intent of the proposed rules: to transform corporate counsel into the new sheriff.

B. Sanctions: Barred from Practice

As with corporate executives and auditors, the obligations of counsel are reinforced by the threat of multiple sanctions. Violations of the final SEC rules under section 307 will subject attorneys to civil penalties and remedies available to the Commission for violations of the federal securities laws. These include the possibility of being suspended or barred

214. *See* Final Rule on Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. §§ 205(b)(2), (e)(3) (Jan. 29, 2003). The SEC has long taken the position that providing it with privileged material under a confidentiality agreement does not waive privilege. Some courts have adopted this position but most have not. *See, e.g., In re* Columbia/HCA Healthcare Corp. Billing Practices Litig., 293 F.3d 289, 294-95 (6th Cir. 2002) (stating general rule that voluntary disclosure of private communications by a corporation waives attorney-client privilege). In evaluating whether an issuer cooperates with an investigation the SEC considers whether privilege was waived. *See, e.g.*, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969; *In re* de Leon-Meredith, Exchange Act Release No. 44970 n.3 (Oct. 23, 2001) ("In some cases, the desire to provide information to the Commission staff may cause companies to consider choosing not to assert the attorney-client privilege, the work product protection and other privileges, protections and exemptions with respect to the Commission. The Commission recognizes that these privileges, protections, and exemptions serve important social interests. In this regard, the Commission does not view a company's waiver of a privilege as an end in itself, but only as a means (where necessary) to provide relevant and sometimes critical information to the Commission staff.").

215. *See* Final Rule on Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. § 205.3(d)(2) (Jan. 29, 2003) (reporting information would prevent issuer from causing financial injury to investors).

216. The SEC has previously noted that it will consider whether a person has "cooperated" during an investigation in making its enforcement decisions. *See, e.g.*, Report of Investigation Pursuant to § 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969 (Oct. 23, 2001) (considering as one of the criteria in determining whether to give any credit to self-policing and self-reporting efforts is whether or not the company cooperated with regulators). Indicia of cooperation include "whether the company produced "a thorough and probing written report detailing the findings of its review? Did the company voluntarily disclose information our staff did not directly request and otherwise might not have uncovered?" *Id.*

from practice before the SEC.[217]

While the SEC has always claimed the right to sanction or bar attorneys from appearing and practicing before it under Rule 102(e), and could always bring a civil injunctive action or administrative proceeding against counsel, it rarely did so, perhaps in view of the controversial nature of exercising such authority.[218] Now, however, there is no controversy concerning its authority to discipline attorneys. The Act specifically empowers the SEC to bring such actions. Now there will likely be no hesitation on the part of the Commission to use its authority to enforce attorney ethical rules. Now the SEC clearly has the authority to require counsel to act as a type of law enforcement advance person, scouting out wrongdoing, and reporting along with the audit committee, executives and auditors—if that authority is effectively implemented and used.

CONCLUSION

The Sarbanes-Oxley Act may be the most significant securities legislation since the 1933 Securities and 1934 Securities and Exchange Acts. In essence, Sarbanes-Oxley attempts to answer the question raised in *Lincoln Savings* over a decade ago by requiring executives, accountants, and lawyers to be at the forefront of protecting shareholders and the public. While conscripting this new "advance team" as local sheriffs has long been advocated by the SEC, it remains to be seen whether calling attention to existing obligations and imposing new ones on management and professionals—in many ways legislating what is simply the best existing practice in the industry—will truly bring a new ethical standard to the marketplace.

The implementation of the Act is still at best a work in progress. Indeed the Act raises almost as many questions as it answers. For example:

Will the-newly emboldened audit committee rise to the challenge? The audit committee is a key player and central to many of the reforms contemplated by the Act. It is essentially recreated as a separate entity from the issuer, with the monitoring of the financial health of the company as its *raison d'être*. Executives, auditors, and, potentially, counsel will report to it. It remains to be seen whether audit committees will awaken from the traditionally sleepy posture of the past.

Will officer certifications force corporate executives to more closely monitor financial matters and result in better financial reporting? Without

217. *See* Final Rule on Implementation of Standards of Professional Conduct for Attorneys, 17 C.F.R. § 205.6(a), (b) (Jan. 29, 2003) (stating that sanctions will apply even if the attorney is also subject to sanctions in the jurisdiction where he practices).

218. *See supra notes* 198 and 211 (discussing the controversy regarding the SEC's authority under Rule 102(e)).

a doubt, the officer certification requirements will force issuers to create extensive and costly procedures in order to provide a basis on which officers can execute the section 302 and 906 certifications. Such procedures, however, may simply create more "check lists" for issuers and executives, and more costs for shareholders. It is open to debate whether or not detailed certifications will actually improve financial reporting and disclosure as compared to the previous simple signatures on periodic reports in the past.

Will the Public Company Accounting Oversight Board prove an effective enforcer? Although the Board has been given ample powers over the auditing profession, the key measure of success will be whether the Board can effectively administer that authority. Will the SEC step back in this area and allow the Board to establish its authority in promulgating new auditing standards, conducting investigations, and enforcing compliance, or will the Commission take a more aggressive role, particularly in enforcement? If the SEC takes on a more prominent role, what role, if any, will be left for an independent Board? The Board's effective use of its enforcement authority also remains to be seen. At first blush, the Board's enforcement powers are impressive. However, all of its administrative proceedings are non-public unless good cause is shown. Past non-public hearings under the old SEC Ethics Rule 2(e) often proved ineffective in part because the non-public nature of the hearings encourage well-healed and litigious defendants to delay repeatedly the resolution of proceedings to keep them from becoming public—a fact that might have caused the SEC to expend less and less of its scarce resources in bringing such actions.[219]

Will new obligations on lawyers curb corporate wrongdoing? Although implementation of the "noisy withdrawal" provisions may be delayed for now, the question remains whether the "up the ladder" reporting requirements on attorneys will prove more effective at curbing (or unearthing) corporate wrongdoing than do the existing ethical standards for attorneys. The SEC's initial attempts to draft rules under Section 307 have already generated serious consternation from the private bar, causing the SEC either to revise, rethink, or throw out altogether its more controversial proposals.[220] Whether attempting to codify what many have long thought to be the best practice in the counseling of public companies will be, in the

219. *See, e.g.*, Paul R. Brown & Jeanne A. Calderon, *An Analysis of SEC Disciplinary Proceedings*, CPA J. ONLINE, July 1993, at 54 (describing relatively low number of Rule 2(e) disciplinary proceedings); *see also* Checkosky v. SEC, 23 F.3d 452, 462 (D.C. Cir. 1994) (stating in a decision highly critical of the SEC that Rule 2(e) could not be enforced due to the SEC's persistent failure in explaining its interpretation of the rule).

220. *See supra* notes 212 through 215 and accompanying text (describing proposed provisions regarding documentation of violations, "noisy withdrawal," and the waiver of attorney-client privilege that were ultimately dropped).

final analysis, of any material help in preventing wrongful conduct, or at least lead to its discovery earlier, is an open question.

Finally, portions of the Act remain to be written, whether in the form of implementing regulations or studies commissioned under it. The impact of newly-issued regulations and studies, as well as those still in process, will not be known for some time. What is clear, however, is that the Act represents an effort not only to revitalize the spirit of the Securities Act and the Exchange Act, but also to bring a new ethics to the corporate marketplace through personal responsibility and enforced self-policing by the key players in it—directors, executives, accountants, and attorneys. Success may lie in whether the Act can effectively answer's Judge Sporkin's question in *Lincoln Savings*: "[w]here also were the outside accountants and attorneys when these transactions were effectuated?"[221] If Sarbanes-Oxley succeeds, it will indeed fulfill its promise as the most significant piece of securities legislation since the Exchange Act of 1933 and the Securities Exchange Act of 1934.

221. *See* Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990) (Judge Sporkin's words setting off a wave of comment about the obligations of professionals); *see also* Kevin G. Salwen, *House Bill Requires Accountants to Tell the SEC of Companies' Illegal Acts*, WALL ST. J., Oct. 5, 1990, at A2. (discussing how judge's animosity for professionals' conduct sparked outrage and potential legislation).

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