

RECENT DEVELOPMENTS

SARBANES-OXLEY ACT

Since December 2001, when Enron filed the largest bankruptcy in United States history, the accuracy of corporate financial reports and the conduct of high-ranking executives have been subject to intense public scrutiny.¹ The scrutiny seemed well-placed, as thereafter a series of corporate scandals unfolded, involving several prominent companies such as WorldCom, Global Crossing, Adelphia Communications, and Tyco.² The disclosures shook the public's confidence and contributed to a sharp decline in the stock market.³

In the aftermath of the disclosures of corporate wrongdoing,⁴ Congress passed the Sarbanes-Oxley Act,⁵ signing it into law on July 30,

¹ See Patrick McGeehan, *Goldman Chief Urges Reforms in Corporations*, N.Y. TIMES, June 6, 2002, at A1 (quoting Henry M. Paulson, Jr., Chairman and CEO of Goldman, Sachs & Co., in a speech at the National Press Club) ("I cannot think of a time when business over all has been held in less repute The business community has been given a black eye by the activities and behavior of some C.E.O.'s and other notable insiders who sold large numbers of shares just before dramatic declines in their companies' share prices." (internal quotations omitted)); Mark Gimein, *The Enforcer*, FORTUNE, Sept. 16, 2002, at 76, 78 (citing a Pew Research Center for the People & the Press poll conducted in February 2002 showing that sixty-six percent of Americans thought business executives had low ethical standards, below those of journalists and Washington politicians).

² See Simon Romero, *WorldCom Facing Charges of Fraud*, N.Y. TIMES, June 27, 2002, at A1 [hereinafter Romero, *WorldCom Facing Charges*]; Simon Romero & Alex Berenson, *WorldCom Says It Hid Expenses, Inflating Cash Flow \$3.8 Billion*, N.Y. TIMES, June 26, 2002, at A1 (describing the corporate scandals that unfolded at WorldCom, Global Crossing and Adelphia); Andrew Ross Sorkin, *Sweeping Charges Expected for Tyco's Ex-Chief and 2 Others*, N.Y. TIMES, Sept. 12, 2002, at C1.

³ See, e.g., 148 CONG. REC. H5462 (daily ed. July 25, 2002) (statement of Rep. Oxley) (stating that "our capital markets . . . have unquestionably suffered a series of blows . . . which have truly damaged the public's faith in the integrity of corporate America"). The Dow Jones Industrial Average ("Dow") was at 11252.84 on August 28, 2000. See *Markets Diary*, WALL ST. J., Aug. 29, 2000, at C1. The Dow had dropped to 7702.34 by July 23, 2002, during the height of the corporate scandals and a week before passage of the Sarbanes-Oxley Act. See *Markets Diary*, WALL ST. J., July 24, 2002, at C1. The Dow is a price-weighted average of thirty component companies, representing over twenty-nine percent of the publicly investable American stock market, that serves as a model portfolio used by financial professionals as a barometer of market activity. See Dow Jones & Co., Inc., *Dow Jones Averages: Key Benefits*, at <http://www.djindexes.com/jsp/avgKeyBene.jsp>. The corporate scandals, combined with an economy already in the process of slowing, had a substantial impact on the stock market. See *Federal Reserve's Second Monetary Policy Report to Congress for 2002: Oversight Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Alan Greenspan, Chairman, Board of Governors, Federal Reserve System) ("[I]nvestor skepticism about earnings reports has . . . depressed the valuation of equity shares . . ."), available at <http://www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm>.

⁴ The need for any reform legislation as extensive as the Sarbanes-Oxley Act was unimaginable even through the first half of 2002, despite a dropping stock market that hurt the retirement savings of millions of Americans. See, e.g., Kate Zernike, *Stocks' Slide is Playing Havoc with Older Americans' Dreams*, N.Y. TIMES, July 14, 2002, at A1.

⁵ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

2002.⁶ Among other far-reaching changes, the Sarbanes-Oxley Act creates the Public Company Accounting Oversight Board (“Oversight Board”) that will supervise the accounting process,⁷ and sets out new requirements for the independence of both corporate auditing committees⁸ and outside auditors.⁹ The Act also prohibits auditors from providing certain consulting services to their clients,¹⁰ orders chief executive officers (“CEOs”) and chief financial officers (“CFOs”) to certify the accuracy of corporate financial statements,¹¹ and mandates that corporations establish internal controls to guarantee the accuracy of internal financial data.¹² Finally, the Act restricts corporate executives from selling stock during “blackout periods,”¹³ requires corporations to disclose certain off-balance-sheet transactions,¹⁴ and restrains corporations from giving personal loans to executives.¹⁵

The fundamental principles behind the Sarbanes-Oxley Act are not new. The Act builds on a regulatory system originally established by Congress in response to an almost total lack of corporate accountability in the first three decades of the twentieth century.¹⁶ In the midst of the Great Depression, Congress passed a law mandating that corporations selling securities to the public disclose to investors any important material facts about the company.¹⁷ The following year, Congress established the Securities and Exchange Commission (“SEC”)¹⁸ on the fundamental principle that securities markets should operate fairly and honestly.¹⁹ The Sarbanes-Oxley Act is based on a similar belief that corporations should be monitored by law to ensure they act in a fair, transparent and accountable manner. The Act is a measured law that will help restore and maintain confidence in the market by curbing corporate abuses and increasing transparency. President Bush’s signing of the law does not mean that the work of reform is over. The Sarbanes-Oxley Act, however expansively its

⁶ See Press Release, White House Office of the Press Secretary, President Bush Signs Corporate Corruption Bill (July 30, 2002), available at <http://www.whitehouse.gov/news/releases/2002/07/20020730.html>.

⁷ See *infra* text accompanying notes 50–68.

⁸ See *infra* text accompanying notes 69–72.

⁹ See *infra* text accompanying notes 73–75.

¹⁰ See *infra* text accompanying notes 76–88.

¹¹ See *infra* text accompanying notes 89–100.

¹² See *infra* text accompanying notes 101–108.

¹³ See *infra* text accompanying notes 109–110.

¹⁴ See *infra* text accompanying notes 111–114.

¹⁵ See *infra* text accompanying notes 115–123.

¹⁶ See DAN A. BAVLY, CORPORATE GOVERNANCE AND ACCOUNTABILITY: WHAT ROLE FOR THE REGULATOR, DIRECTOR, AND AUDITOR? 67 (1999).

¹⁷ See Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a–77aa (2000)).

¹⁸ See Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78 (2000)).

¹⁹ See JOHN W. GRAHAM, U.S. SECURITIES AND EXCHANGE COMMISSION: A RESEARCH AND INFORMATION GUIDE 3 (1993).

provisions are interpreted, does not by itself lead to effective corporate governance reforms. The effectiveness of the Act depends substantially on the resources available to the SEC for enforcement, the leadership of the Oversight Board and other regulatory bodies that will enforce the new audit rules, the commitment of both political parties to true and lasting reforms, and, perhaps most importantly, the public's continued support for vigilant corporate oversight. Steady public support is essential to counter the political uncertainties that surround the implementation of any major legislation. Effective implementation of the Sarbanes-Oxley Act will happen only if Congress knows that the public will hold it responsible for failing to produce the reforms promised in the Act.

Although the recent scandals brought much attention to corporate accounting practices, concern over and unhappiness with the accounting profession is not a uniquely post-Enron phenomenon. Disenchantment with the profession has been building steadily over the years, with a large increase in suits against accountants since at least the 1980s.²⁰ An experienced audit executive²¹ made the following prescient remarks in 1999:

Especially discomfoting . . . are instances where certain companies receive clean audit reports just a short time before collapsing. These fiascoes have led to calls for closer financial accounting and auditing regulations, some of which could involve radical change. They include . . . a ban on accountants performing consultancy work for audit clients . . . [and] limits on auditor tenure.²²

The author further predicted that such reform proposals would meet strong opposition that may make their adoption unlikely.²³ Indeed, it took the Enron scandal and other multi-billion-dollar debacles to provide the driving force behind the passage of reforms.²⁴

Enron's fall had far-reaching economic, political, and legislative consequences. While 20,000 Enron employees lost \$1.2 billion from their 401(k) plans as Enron's stock price fell from almost ninety dollars to

²⁰ See BAVLY, *supra* note 16, at 163.

²¹ *Id.* at 216. Dan Bavly, the author, is a retired partner of the Israeli accounting firm Bavly Millner. See Press Release, Harvard University John F. Kennedy School of Government, Center for Business and Government Announces Global Gathering of Fellows (Dec. 13, 2000), available at http://www.ksg.harvard.edu/cbg/news/fellows_rls.htm. He was also a Fellow at the Center for Business and Government at Harvard University's John F. Kennedy School of Government. See *id.*

²² BAVLY, *supra* note 16, at 164. Section 203 of the Sarbanes-Oxley Act requires that any audit partner with either primary responsibility for conducting the audit, or responsibility for reviewing the audit, must rotate off of the audit every five years. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 203, 116 Stat. 745, 773.

²³ BAVLY, *supra* note 16, at 164.

²⁴ See Lee Walczak et al., *Let the Reforms Begin*, Bus. WK., July 22, 2002, at 26, 26–31.

pennies,²⁵ Enron executives sold \$994 million in company stock between January 1999 and May 2002.²⁶ The public's call for reform²⁷ was further fueled by the fact that Enron had been deceiving the public for years about the strength of its balance sheet.²⁸ Investors and regulators blamed, among others: Enron's auditor Arthur Andersen, who not only failed to detect Enron's shaky accounting practices, but also destroyed thousands of Enron-related documents;²⁹ investment bank analysts, who continued to make "buy" recommendations to investors even as Enron stock was plummeting;³⁰ and Enron executives, who deceived the public regarding the true condition of Enron's financial health.³¹ For example, Enron hid billions of dollars in liabilities in off-balance-sheet subsidiaries using loopholes in accounting rules.³²

The magnitude of Enron's collapse and the acuteness of the public reaction made corporate governance reforms seemingly inevitable.³³ By the early summer of 2002, however, post-Enron reform efforts had stalled in Congress.³⁴ Moreover, few Americans thought the reforms were a top priority. A Harris poll taken in that period showed that only one percent of Americans thought Enron and related issues were among the most important issues facing government.³⁵ Strong lobbying efforts by businesses to dampen reforms and the lack of public pressure to push reforms

²⁵ See Wendy Zellner et al., *The Fall of Enron*, BUS. WK., Dec. 17, 2001, at 30, 30–31 (noting that Enron's stock traded at \$90 per share on August 17, 2000 and at \$1.01 per share on December 5, 2001).

²⁶ Mark Gimein, *You Bought, They Sold*, FORTUNE, Sept. 2, 2002, at 64, 68.

²⁷ See, e.g., John A. Byrne, *Restoring Trust in Corporate America*, BUS. WK., June 24, 2002, at 30, 31; Joseph Nocera et al., *System Failure*, FORTUNE, June 24, 2002, at 62, 62.

²⁸ See David Henry et al., *Who Else is Hiding Debt*, BUS. WK., Jan. 28, 2002, at 36, 36.

²⁹ See Indictment, U.S. v. Arthur Andersen, L.L.P., No. CRH-02-121 (S.D. Tex. filed Mar. 7, 2002), available at <http://news.findlaw.com/hdocs/docs/enron/usandersen030702ind.pdf>; Consolidated Complaint for Violations of the Federal Securities Laws, In re Enron Corp. Sec. Litig., No. H-01-3624, at 95–96 (S.D. Tex. filed Apr. 8, 2002), available at http://www.enronfraud.com/pdf/consolidated_complaint.pdf. See also Kurt Eichenwald, *Arthur Andersen Guilty In Effort to Block Inquiry on Enron*, N.Y. TIMES, June 16, 2002, at A1.

³⁰ See Consolidated Complaint for Violations of the Federal Securities Laws, In re Enron Corp. Sec. Litig., No. H-01-3624, at 101–05 (S.D. Tex. filed Apr. 8, 2002), available at http://www.enronfraud.com/pdf/consolidated_complaint.pdf.

³¹ See *id.* at 55–95.

³² See Henry et al., *supra* note 28, at 36.

³³ *Under the Board Talk: American Companies Need Stronger Independent Auditors*, ECONOMIST, June 15, 2002, at 13, 13 [hereinafter *Under the Board Talk*] ("Earlier in the year, Congress was breathing fire about audit reform, including tougher regulation of accountants and banning firms from doing consulting work for their audit clients.")

³⁴ *Id.* ("The shameful prospect now is that Congress may not enact any auditor reforms at all.")

³⁵ See Jeffrey H. Birnbaum, *D.C. Declares Enron's 15 Minutes of Fame Over*, FORTUNE, June 10, 2002, at 38, 38. But see Lydia Saad, *National Issues May Play Bigger-Than-Usual Role in Congressional Elections*, GALLUP NEWS SERV., Oct. 31, 2002, available at <http://www.gallup.com/poll/releases/pr021031.asp> (analyzing data from October 21–22 poll showing that thirty-three percent of registered voters consider corporate corruption "extremely important" to their 2002 election decision).

through caused both accounting and pension reforms to stall in Congress.³⁶ Meanwhile, Democrats raised questions over whether SEC Chairman Harvey Pitt, who as a private sector lawyer had represented the largest accounting firms, was serious about implementing far-reaching reforms.³⁷

In addition to doubts about the SEC's true intentions and the public's apparent apathy, many Republicans and others whose faith in the self-correcting ability of the market was greater than that of the reformers warned that overreacting to Enron's collapse would further harm the economy.³⁸ These opponents of reform argued that the cumulative effect of restatements of corporate financial reports would further erode investor confidence.³⁹ Another argument against reform was that risk is part of the free market, and Enron employees who lost their life savings assumed that risk in pooling all of their savings in only Enron stock.⁴⁰ While such an investment strategy may have been lucrative when Enron's stock price was very high,⁴¹ it was a risky strategy nonetheless and, according to opponents of reform, the government should not interfere with the freely made choices of investors.⁴² Those who wanted the market to correct it-

³⁶ *Under the Board Talk*, *supra* note 33, at 13 (“[T]he fire [of reform] has been deftly extinguished by deep-pocketed corporate lobbyists.”).

³⁷ See Stephen Labaton, *Democrats Want Change at SEC*, N.Y. TIMES, Oct. 10, 2002, at C1 (stating that Democrats have called for the replacement of Pitt because his “pattern of behavior . . . is steadily eroding the credibility of the SEC”). Pitt was ultimately driven to resign on Election Day 2002 over criticism surrounding his conduct in championing former Director of the Central Intelligence Agency and the Federal Bureau of Investigations, William Webster, as a candidate for Chairman of the Oversight Board. See Stephen Labaton, *SEC's Embattled Chief Resigns in Wake of Latest Political Storm*, N.Y. TIMES, Nov. 6, 2002, at A1. See also *infra* text accompanying notes 64–68.

³⁸ See 148 CONG. REC. H1541 (daily ed. Apr. 24, 2002) (statement of Rep. Jeff Sessions (R-Tex.)) (“When something such as Enron happens, we as Members of Congress must fight the temptation to react by overlegislating, thus doing more harm than good.”); Gabor Garai, *History as a Guide to the Accounting Mess: Let's Cure the Disease Without Killing the Patient*, 13 NO. 1 ANDREWS MERGERS & ACQUISITIONS LITIG. REP. 27 (2002), available at WL 13 No. 1 ANMALR 27.

³⁹ See, e.g., Garai, *supra* note 38 (“The cascading effect of this second wave of financial ‘corrections’ would further erode investor confidence and destroy the value of our portfolios . . .”).

⁴⁰ See 148 CONG. REC. H1543 (daily ed. Apr. 24, 2002) (statement of Rep. Sessions) (“[W]e have heard a lot of political rhetoric about how the Federal Government should be engaged in the oversight of companies, the oversight of CEOs But the fact of the matter is that we live in an environment where the free market has an opportunity to have success and have failure.”). The efficient capital markets theory says that market share prices are an accurate measure of a stock's levels of risk and value. See ROBERT C. CLARK, CORPORATE LAW 281 n.2 (1986).

⁴¹ See *supra* note 25.

⁴² See, e.g., *Enron, Bankruptcy, and Easy Credit*, RON PAUL'S TEXAS STRAIGHT TALK (Office of U.S. Rep. Ron Paul, Washington, D.C.), Dec. 17, 2001, available at <http://www.house.gov/paul/tst/tst2001/tst121701.htm>. Representative Ron Paul (R-Tex.) argued that “investing carries risk, and it is not the role of the federal government to bail out every investor who loses money. In a true free market, investors are responsible for their own decisions, good or bad.” *Id.* An investor who embraces risk should have no complaints when he loses his investment to inferior execution of a business strategy or superior

self argued that the market is already ahead of government reform efforts; for example, Arthur Andersen lost hundreds of clients following revelations of its role in the Enron scandal.⁴³ Even Federal Reserve Board Chairman Alan Greenspan sounded a note of caution against increased regulation, saying that market forces were inciting higher ethical standards.⁴⁴

Prospects of passing a reform bill closely mirrored the shifting political strengths of those championing reform and those opposed to it. The accounting industry's powerful lobbying against sweeping reform efforts influenced Congress, especially attempts to ban auditors from providing non-audit services.⁴⁵ Still, the weight of corporate scandals that were increasingly hurting the stock holdings and pension funds of tens of millions of Americans⁴⁶ pushed corporate reform legislation through Congress on a bipartisan basis.⁴⁷ Politicians who were reluctant to support reforms must have realized the public backlash that would have resulted from government inaction.⁴⁸ The political climate changed dra-

competition. *Cf. id.* Nevertheless, even this risk-taking investor has a legitimate grievance when his losses stem from outright fraud or corporate theft. *See* 148 CONG. REC. S6496 (daily ed. July 9, 2002) (statement of Sen. Jon Corzine (D-N.J.)) (arguing that reform is "about making sure corporate fraud is properly dealt with in the legal system, [by putting] everyone on notice that they [sic] have serious responsibilities to certify that what is reported is real, and if it is not real, then people are held accountable").

⁴³ *See* Stephen Labaton & Richard A. Oppel, Jr., *Enthusiasm Waning in Congress for Tougher Post-Enron Controls*, N.Y. TIMES, June 10, 2002, at A1. Senator Phil Gramm (R-Tex.), a leading opponent of reform, has argued that regulators and the market are already correcting the kind of abuses found in Enron and Arthur Andersen. *See id.*

⁴⁴ *See* Elizabeth Baird et al., *Criminalizing Business Judgment Could Stagnate U.S. Economy*, LEGAL BACKGROUND (Wash. Legal Found., Washington, D.C.), June 7, 2002, at 1, available at http://www.omm.com/webdata/content/newsevents/criminalizing_business_judgment.pdf.

⁴⁵ *See* Labaton & Oppel, *supra* note 43 (arguing that "the drift in Congress largely reflects the power of the accounting profession"); Jackie Spinner, *Sullied Accounting Firms Regaining Political Clout*, WASH. POST, May 12, 2002, at A1; Jeremy Kahn, *Deloitte Restates Its Case*, FORTUNE, Apr. 29, 2002, at 64, 68 (quoting a Deloitte auditor accusing former SEC Chairman Arthur Levitt of "deliberately misleading the public into thinking that there is a conflict between auditing and consulting"). For a discussion of the prohibition on accounting firms from performing consulting services for the same client, see *infra* text accompanying notes 76–88.

⁴⁶ *See, e.g.*, Zernike, *supra* note 4, at A1. The drop in stock prices that resulted in part from corporate scandals had a particularly severe impact on older Americans who were close to retirement age. *See id.* Many older Americans were forced to return to work from retirement or delay their retirement. *See id.*

⁴⁷ *See* David E. Sanger & Richard A. Oppel, Jr., *Senate Approves a Broad Overhaul of Business Laws*, N.Y. TIMES, July 16, 2002, at A1 (stating that during the peak of corporate scandal revelations, volatile markets prompted unanimous support for reform of some kind from both parties).

⁴⁸ *See* Walczak et al., *supra* note 24, at 27 (describing how "WorldCom's \$4 billion stunner;" coming after a wave of accounting scandals that weakened the economy, motivated both parties to join the reform drive). The financial collapse of WorldCom, the nation's second-largest long distance carrier, scared investors in other companies and led to an immediate market drop. *See* Romero & Berenson, *supra* note 2. The SEC said that the WorldCom announcement "confirmed 'accounting improprieties of unprecedented magnitude.'" *Id.*

matically when the succession of scandals burst into the media coverage.⁴⁹ Even if some lawmakers believed that the scandals did not reflect the overall health of American corporations, it became politically risky to oppose reform measures. The Sarbanes-Oxley Act is substantially the product of this swift change in the political landscape.

The Sarbanes-Oxley Act's first major provision is the creation of the Oversight Board, which will "oversee the audit of public companies,"⁵⁰ establish standards for auditors,⁵¹ and conduct inspections of public accounting firms.⁵² The Oversight Board will conduct annual quality inspections of firms that audit more than one hundred companies and triennial inspections of all other auditing firms.⁵³ Additionally, under the Act either the SEC or the Oversight Board can order a special inspection of any firm at any time.⁵⁴ The Oversight Board can impose sanctions such as censure, additional professional education, or a temporary or permanent suspension from accounting activities on an accountant or accounting firm if the Board finds an unreasonable failure to supervise any person associated with auditing or quality control standards.⁵⁵

The composition of the Oversight Board reflects the Sarbanes-Oxley Act's emphasis on the need for those charged with assuring the validity and fairness of corporate accounting to be independent. Only two of the five members of the Oversight Board, all of whom must have "demonstrated commitment to the interests of investors and the public,"⁵⁶ can be current or former certified public accountants ("CPAs").⁵⁷ This provision reflects lawmakers' desire to end or at least curtail the system of self-regulation of accountants.⁵⁸

The SEC will have comprehensive authority over the Oversight Board.⁵⁹ It must approve all Oversight Board-proposed rules for them to become effective.⁶⁰ The Commission can "censure or impose limitations upon the . . . operations of the [Oversight] Board" if it finds that the Oversight Board has violated the Sarbanes-Oxley Act or the securities

⁴⁹ *See id.*

⁵⁰ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101(a), 116 Stat. 745, 750.

⁵¹ *Id.* § 103(a).

⁵² *Id.* § 104(a).

⁵³ *Id.* § 104.

⁵⁴ *Id.*

⁵⁵ *Id.* §§ 105(c)(4), 105(c)(6)(A)(i).

⁵⁶ *Id.* § 101(e)(1).

⁵⁷ *Id.* § 101(e)(2).

⁵⁸ *See* 148 CONG. REC. S7351 (daily ed. July 25, 2002) (statement of Sen. Sarbanes) (stating that the Sarbanes-Oxley legislation "establishes a strong independent accounting oversight board, thereby bringing to an end the system of self-regulation in the accounting profession which, regrettably, has not only failed to protect investors . . . but which has in effect abused the [public's] confidence in the markets"); 148 CONG. REC. H5463 (daily ed. July 25, 2002) (statement of Rep. John LaFalce (D-N.Y.)) ("No longer will the accounting industry be able to set the rules for itself without regard for the interests of shareholders.")

⁵⁹ Sarbanes-Oxley Act of 2002 § 107.

⁶⁰ *Id.* § 107(b)(2).

laws, or if the Oversight Board has failed to ensure the compliance of accounting firms without reasonable justification or excuse.⁶¹ Any member of the Oversight Board can be removed from office or censured by the SEC for failing to enforce the laws.⁶² The SEC can also enhance or reduce the Oversight Board's sanctions if the Commission finds them inadequate or excessive.⁶³

The effectiveness of the Oversight Board in performing the functions assigned to it by the Sarbanes-Oxley Act largely depends on the character of its leadership. It is not surprising, then, that not long after the Act's passage, a political fight ensued over who would be nominated to chair the Oversight Board.⁶⁴ SEC Chairman Pitt and other members of the SEC had favored John H. Biggs, the Chairman and CEO of the pension investment plan Teachers Insurance and Annuity Association College Retirement Equities Fund ("TIAA-CREF").⁶⁵ Pitt subsequently withdrew his support from Biggs, and proponents of reform claimed the reason was pressure from accounting executives and some Republican lawmakers who felt Biggs was too antagonistic to the accounting industry.⁶⁶ Biggs has been a strong proponent of stricter regulation of the accounting profession, supporting reforms such as requiring companies to rotate their auditors every few years and prohibiting accounting firms from performing consulting services for a client.⁶⁷ When further controversy erupted around the Republicans' replacement candidate for Chairman of the Oversight Board, mounting criticism ultimately forced Pitt to resign on Election Day 2002.⁶⁸ Whatever the merits of this criticism, the fight over nominations to the Oversight Board is indicative of how large a role it has in determining how vigorously the Sarbanes-Oxley Act is implemented.

The Sarbanes-Oxley Act also seeks to increase the quality and independence of an audit by giving more authority to the audit committee of

⁶¹ *Id.* § 107(d)(2).

⁶² *Id.* § 107(d)(3).

⁶³ *Id.* § 107(c)(3).

⁶⁴ See Stephen Labaton, *S.E.C. Chief Hedges on Accounting Regulator*, N.Y. TIMES, Oct. 4, 2002, at C1.

⁶⁵ See *id.* TIAA-CREF provides investment services for faculty and staff of schools and research institutions. See TIAA-CREF, *About TIAA-CREF*, at http://www.tiaa-cref.org/a_company/index.html.

⁶⁶ See Labaton, *supra* note 64, at C1. Lynn E. Turner, a former chief accountant at the SEC, said at the time that Republicans, accounting firms, and Pitt were "trying to circumvent the [Sarbanes-Oxley Act] by making certain that the [Oversight Board] does not include any reform-minded persons." *Id.* She continued, "If we lose Biggs, we lose a reform-minded board." *Id.*

⁶⁷ See *id.*

⁶⁸ See Labaton, *supra* note 37, at C1. The Republicans' favored candidate was William Webster. See *id.* Webster's candidacy became controversial upon revelations that he had ties to the ailing corporation U.S. Technologies and that Pitt had withheld information concerning those ties from both the White House and the SEC. See *id.*

a company's board of directors.⁶⁹ Under the Act, the audit committee will hire and receive reports from the company's outside accounting firm, and it will be responsible for the work and payment of the firm.⁷⁰ Perhaps most importantly, the Act further provides that each member of the audit committee must be "independent": a member of the committee may not accept consulting fees or be affiliated with the company other than in his or her capacity as a member of the board of directors.⁷¹ In contrast, prior to the Act's passage, no state or federal legal provisions addressed the duties of the audit committee (or even mandated its existence). These decisions concerning internal corporate organization were instead left to the discretion of the corporation's board of directors.⁷²

In a similar vein, the Sarbanes-Oxley Act declares that if a company's CEO, Controller, CFO, or Chief Accounting Officer was employed by the company's outside accounting firm during a one-year period preceding the audit, that auditing firm has a conflict and is not independent.⁷³ An accounting firm found to lack independence cannot serve as the auditor of the company to which it has ties.⁷⁴ These rules will help prevent situations where the highest-ranking executives of companies have ties to their accounting firms that can lead to biased audits overlooking ethically questionable or outright illegal activities.⁷⁵

The Sarbanes-Oxley Act's prohibition on auditing firms performing non-audit functions⁷⁶ is also part of the effort to strengthen accountants' independence. Auditors voiced strong opposition to this provision, making two main arguments against the ban.⁷⁷ First, they argued that per-

⁶⁹ The audit committee will most likely be one of many committees of a company's board of directors; the board may create any committees it deems proper to manage the "business and affairs of [the] corporation." *E.g.*, DEL. GEN. CORP. L. § 141(a) (1991). This right is a sweeping one, as the board of directors can create committees, including an audit committee, that can exercise "all the powers and authority of the board of directors in the management of the business and affairs of the corporation." *E.g.*, DEL. GEN. CORP. L. § 141(c)(1) (1991 & Supp. 2000).

⁷⁰ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301(2), 116 Stat. 745, 776.

⁷¹ *Id.* § 301(3).

⁷² *See supra* note 69.

⁷³ Sarbanes-Oxley Act of 2002 § 206. The Act also requires accounting firms to rotate their lead auditors every five years. *Id.* § 203.

⁷⁴ *Id.* § 203.

⁷⁵ BAVLY, *supra* note 16, at 207.

⁷⁶ Sarbanes-Oxley Act of 2002 § 201(a). The Act prohibits provision of the following services: bookkeeping; financial information systems design; appraisal, actuarial, and internal audit services; management functions or human resources; investment banking or brokerage services; legal or expert services unrelated to the audit; and any other services the Oversight Board deems impermissible. *Id.* On a case-by-case basis, the Act does allow companies to seek an exemption from the Oversight Board to hire their auditors for non-audit services. *Id.* § 201(b). The Oversight Board may grant an exemption to the extent that it is "necessary or appropriate in the public interest and is consistent with the protection of investors . . ." *Id.* Like other decisions of the Oversight Board, these exemptions are subject to SEC review. *Id.*

⁷⁷ *See, e.g.*, Kahn, *supra* note 45, at 72 (noting that Deloitte's CEO believes restricting non-audit services will "make audits worse").

forming non-audit services gives accounting firms the comprehensive expertise necessary to understand their clients' businesses, and such understanding is necessary to perform an effective audit.⁷⁸ Second, the added income generated through non-audit services can lead to greater financial stability for the accounting profession, which in turn arguably leads to greater independence.⁷⁹ Nevertheless, the argument for greater financial stability does not address the seemingly inevitable conflict of interest that would arise if the auditing and consulting fees paid by a client to an accounting firm are significant.⁸⁰ Perhaps the most important advantage of eliminating accountants' conflicts of interest is preventing a situation where a company functionally "buys off" its accountant through "bribes" in the form of lucrative consulting fees to prevent an accurate financial picture from emerging.⁸¹ Thus a tension exists between, on the one hand, "the real insights, synergies, and efficiencies obtained by audit firms"⁸² from non-auditing services, and, on the other hand, the costs of providing those services in terms of potential conflicts of interest that could lead to inaccurate, or even fraudulent, accounting.⁸³ In weighing whether a ban on non-auditing services is likely to be beneficial overall, "it is hard to predict which effect will be bigger."⁸⁴

Even if the cost of an audit increases because accounting firms cannot use knowledge gained from consulting, this price may still be worth paying for effectively addressing the conflict of interest issues that played such a central role in recent corporate scandals. For example, Arthur Andersen earned \$27 million in consulting fees and \$25 million in accounting fees from Enron in 2000.⁸⁵ In this situation, Andersen likely felt pressure to produce favorable audits in exchange for retaining Enron as a lucrative consulting client. The effects of the loss of revenues from discontinuation of non-audit services may also worsen the negative ef-

⁷⁸ See Dan L. Goldwasser, *The Accounting Profession's Regulatory Dilemma*, CPA J., May 2002, at 8. Additional knowledge gained by an auditor about a client's business through consulting work, which involves financial analysis of the client's business, is thought to improve the auditor's accounting work. See *id.*

⁷⁹ See *id.* at 8, 10.

⁸⁰ See *id.* at 8; Bernard Wolfman, *Auditors: Stick to Your Auditing*, 96 TAX NOTES 298 (2002), available at <http://www.tax.org/Communications/Wolfman> (supporting the prohibition on accounting firms from providing non-audit services).

⁸¹ See 148 CONG. REC. S6563 (daily ed. July 10, 2002) (statement of Sen. Carl Levin (D-Mich.)). By 1999, fifty percent of revenues at the Big Five accounting firms came from consulting, while only thirty-four percent came from auditing. *Id.* By 2002, almost seventy-five percent of the fees earned came from non-audit services. *Id.* Evidence indicates that accounting firms were using their market position in accounting to gain additional consulting business by lowering audit fees for companies that agreed to a consulting contract. See *id.*

⁸² Robert Bricker, *The Accounting Profession After Sarbanes-Oxley: For Better or For Worse*, 13 No. 1 ANDREWS MERGERS & ACQUISITIONS LITIG. REP. 25 (2002), WL 13 No. 1 ANMALR 25.

⁸³ See *id.*

⁸⁴ *Id.*

⁸⁵ John A. Byrne, *Fall From Grace*, BUS. WK., Aug. 12, 2002, at 50, 52.

fects of intense competition among auditing firms.⁸⁶ Price competition and underbidding to maintain and attract clients have led auditors to devote very little time to the actual audit.⁸⁷ Quite simply, CPAs currently do not serve their important if informal function as watchdogs of the public trust.⁸⁸

The Sarbanes-Oxley Act seeks to increase the effectiveness of its accounting provisions by placing new obligations on corporate executives in the form of certifications. One of the most publicized provisions of the Sarbanes-Oxley Act requires the principal executive and financial officers to “certify in each annual or quarterly report filed” that “based on the officer’s *knowledge*, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made . . . not misleading.”⁸⁹ If an audit firm has to prepare a restatement because of material noncompliance with any financial reporting requirement, the CEO and CFO must forfeit any bonus received in the twelve months following the first public issuance of the financial statement.⁹⁰ Moreover, willfully certifying an inadequate report is punishable by a fine of up to \$5 million, or imprisonment of not more than twenty years, or both.⁹¹

Critics of the Sarbanes-Oxley Act’s certification provision express concern that it will weaken the Business Judgment Rule (“BJR”), which is the rule used by courts to review the decisions of corporate directors and officers.⁹² The BJR recognizes the need for risk-taking by directors and officers to produce economic innovation and growth.⁹³ Under this rule, a court will not substitute its judgment for that of a company’s board of directors if the board’s decision can be “attributed to any rational business purpose.”⁹⁴ When senior executives and the board of di-

⁸⁶ See Goldwasser, *supra* note 78, at 8, 10.

⁸⁷ See BAVLY, *supra* note 16, at 162.

⁸⁸ See *id.* CPAs have played this role in America’s free market system for years: “Auditors are capitalism’s handmaidens. Unless they provide, and are seen to provide, accurate, honest, and impartial information on companies, the whole structure of market economies will be threatened. There is therefore a strong public interest in ensuring that accountancy firms themselves are in good health.” *Who Will Audit the Auditors?*, ECONOMIST, July 15, 1989, at 18.

⁸⁹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302(a)(2), 116 Stat. 745, 777 (emphasis added). For a discussion of the significance of a knowledge standard for officer liability, see *infra* text accompanying notes 97–100, 107.

⁹⁰ Sarbanes-Oxley Act of 2002 § 304(a)(1).

⁹¹ *Id.* § 906(a).

⁹² See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Sinclair Oil Corp. v. Levien*, 230 A.2d 717, 720 (Del. 1971)).

⁹³ See, e.g., *Joy v. North*, 692 F.2d 880, 886 (2d. Cir. 1982) (“[B]ecause potential profit often corresponds to potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions.”).

⁹⁴ See *Unocal*, 493 A.2d at 954; *Int’l Ins. Co. v. Johns*, 874 F.2d 1447, 1458 n.20 (11th Cir. 1989) (stating that directors are “[m]ore qualified to make business decisions than judges”); *Kumpf v. Steinhaus*, 779 F.2d 1323, 1325 (7th Cir. 1985) (“The press of market forces . . . will more effectively serve interests of all participants than will an error-prone judicial process.”).

rectors have acted in good faith, their “decisions will be regarded as ‘business judgments’ and [they] will not be personally liable for damages even if a decision proves to be detrimental to the corporation. This holds true even if, in hindsight, these decisions proved to be unwise or inexpedient.”⁹⁵ Thus, courts have consistently held that a CEO, protected by the BJR, is allowed to rely on the representations of those who report to him, including outside auditors, and is allowed to assume that they are carrying out their professional duties honestly.⁹⁶

Some of those opposed to reforms have argued that the certification provisions have the potential to cause the most harm out of all the Act’s provisions because they amount to a *de facto* strict liability standard for corporate officers that would effectively abrogate the BJR in this context.⁹⁷ Without the BJR, corporate executives would more often than not turn away from business opportunities that are likely to be profitable but present some risk of failure because executives will be held responsible for bets that fail.⁹⁸ When business opportunities with higher chances of success than failure are turned down, the aggregate wealth of society decreases.⁹⁹ Whatever the merits of this argument, opponents of the certification requirements are wrong to argue that the BJR is in danger; while the requirements place substantial responsibilities on corporate officers, they are not equivalent to a strict liability standard. The Sarbanes-Oxley Act does not seek to punish good faith corporate decisions; it punishes only fraudulent corporate actions such as knowingly falsifying financial statements.¹⁰⁰

⁹⁵ Baird et al., *supra* note 44, at 2. *See also* Grobow v. Perot, 526 A.2d 914, 928 (Del. Ch. 1987), *aff’d*, 539 A.2d 180 (Del. 1988), *aff’d on other grounds sub nom.* Levine v. Smith, 591 A.2d 194 (Del. 1991) (holding that under the BJR, directors will not be held liable for conduct that turns out to be “controversial, unpopular, or even wrong”).

⁹⁶ *See, e.g.*, Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) (“[D]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong.”). Under Delaware law, the board of directors shall

be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented . . . by any of the corporation’s officers or employees . . . or by any other person as to matters the member reasonably believes are within such other person’s professional or expert competence

DEL. GEN. CORP. L. § 141(e) (1991 & Supp. 2000).

⁹⁷ *See* Baird et al., *supra* note 44, at 2 (arguing that reform proposals such as those contained in the Sarbanes-Oxley Act “effectively sound the death knell for the [BJR]”).

⁹⁸ *See, e.g.*, In re Consumers Power Co. Derivative Litig., 132 F.R.D. 455, 464 (E.D. Mich. 1990) (stating that the BJR “protects directors from undue fear of personal liability and encourages the innovation, quick decision, and occasional risk-taking that are important to a corporation’s success” (citing CLARK, *supra* note 40, at 641)).

⁹⁹ *See* Gagliardi v. TriFoods Int’l, Inc. 683 A.2d 1049, 1052–53 (Del. Ch. 1996) (stating that the BJR protects against “sub-optimal risk acceptance” that results from second-guessing managers’ risk-taking).

¹⁰⁰ *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302(a)(2), 116 Stat. 745,

The Sarbanes-Oxley Act also contains internal controls requirements that complement its certification provisions. These provisions operate in tandem to force CEOs not only to certify that they know of no wrongdoing, but also to take steps to guarantee that if there were any wrongdoing, they would be likely to know about it. Those who sign financial reports must establish internal controls¹⁰¹ to ensure the flow of financial information to them and evaluate the effectiveness of the internal controls within ninety days prior to the publication of the report.¹⁰² Before the Sarbanes-Oxley Act, corporate law statutes did not mandate the creation of internal controls, much less create standards for their effectiveness.¹⁰³ Without accurate internal controls to gather and sort a corporation's financial data, no amount of vigilance by outside accountants can completely correct numbers tainted at the source.¹⁰⁴ Those officers who must comply with the Act's certification requirements must also certify that they have disclosed both to the company's outside auditor and to the auditing committee of the board of directors any "significant deficiencies" or "material weaknesses" in the company's internal controls.¹⁰⁵ This new responsibility on corporate officers puts them on notice that they carry heavy responsibilities for ensuring the accuracy of their company's financial statements.

If the Sarbanes-Oxley Act certification provisions are to be effective, the Oversight Board and the SEC must put real teeth behind the requirement of effective internal controls.¹⁰⁶ It is unclear how much force the

777 (stating that penalties are based "on the officer's *knowledge*" and thus are not based on strict liability) (emphasis added).

¹⁰¹ Internal controls are mechanisms that help ensure the accurate flow of a company's financial information for collection and publication for investors and the regulatory agencies. See Roger W. Mills, *Internal Control Practices within Large UK Companies*, in CORPORATE GOVERNANCE: RESPONSIBILITIES, RISKS AND RENUMERATION 124 (Kevin Keasey & Mike Wright eds., 1997).

¹⁰² Sarbanes-Oxley Act of 2002 § 302(a)(4).

¹⁰³ *But see* *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). *Caremark* represents an earlier, judicial attempt to create internal controls obligations. See generally *id.* The Chancery Court of Delaware said that a board must meet its obligation to be "reasonably informed" about the corporation's affairs by assuring . . . that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with the law and its business performance. *Id.* at 970.

¹⁰⁴ See, e.g., BAVLY, *supra* note 16, at 200 (arguing that when outside accountants work alone without the benefit of internal controls, the effectiveness of their audit is reduced); 148 CONG. REC. S6748 (daily ed. July 15, 2002) (statement of Sen. Chuck Grassley (R-Iowa)) (arguing that recent scandals "further demonstrated that the problem does not rest entirely with a company's external auditors[,] whose best efforts may not detect financial misrepresentations if fraud is repeatedly covered up by corporate insiders or contrived to defeat established internal controls").

¹⁰⁵ Sarbanes-Oxley Act of 2002 § 302 (a)(5).

¹⁰⁶ See 148 CONG. REC. S6748 (daily ed. July 15, 2002) (statement of Sen. Grassley) (arguing that "addressing [the accounting scandals] requires additional oversight[,] and not just of a company's external accountants but of the internal accounting function itself").

penal provisions for false financial statements can have under a knowledge standard, and it may be relatively easy for a corrupt corporate officer to claim lack of knowledge when he in fact falsified financial statements.¹⁰⁷ With the requirement of reasonably effective internal controls, however, these officers may not so easily escape punishment.¹⁰⁸ It remains to be seen whether the combination of certification and internal controls provisions will be adequate to ensure the efficient flow of accurate financial data to investors and regulatory bodies.

Several other Sarbanes-Oxley Act reforms are responses to problems in corporate law that were revealed in the Enron scandal and other recent corporate scandals. Many Enron employees could not sell their Enron stock during “blackout” periods, while no rule prohibited executives, who were not subject to the blackout, from selling their own Enron stock.¹⁰⁹ The Sarbanes-Oxley Act prohibits any director or executive officer from trading in company stock acquired “in connection with his or her service or employment” during any pension fund blackout period.¹¹⁰

Off-balance sheet accounts were also revealed as a major problem for investors who had invested in Enron. Enron hid millions of dollars in losses in off-balance-sheet accounts and thereby painted a false picture of profitability that led investors to buy Enron stock.¹¹¹ The Sarbanes-Oxley Act requires the disclosure of all “off-balance sheet transactions . . . that may have a material current or future effect on financial condition”¹¹² This new disclosure requirement seeks to prevent companies from contriving their accounting practices to keep investment losses off their balance sheets.¹¹³ The Act also mandates that the SEC determine the extent of off-balance sheet transactions and whether generally accepted accounting rules result in financial statements that accurately reflect the financial conditions of such transactions to investors.¹¹⁴

¹⁰⁷ See, e.g., *Terrydale Liquidating Trust v. Barness*, 611 F. Supp. 1006, 1027 (S.D.N.Y. 1984) (stating that, for a knowledge standard, “[a]ctual knowledge of a breach of duty is required; mere suspicion or even recklessness as to the existence of a breach is insufficient”).

¹⁰⁸ Cf. *supra* note 104 and accompanying text.

¹⁰⁹ See Press Release, U.S. Dep’t of Labor, President Bush Calls for Action to Protect American Workers’ Retirement (Feb. 1, 2002), available at <http://www.dol.gov/pwba/newsroom/fs020102.html>. A blackout period is the time when employers change pension plan rules or administrators, during which employees cannot access or sell their retirement accounts. See *id.*

¹¹⁰ Sarbanes-Oxley Act of 2002 § 306(a)(1).

¹¹¹ See Henry et al., *supra* note 28, at 36.

¹¹² Sarbanes-Oxley Act of 2002 § 401(a).

¹¹³ See 148 CONG. REC. S6690 (daily ed. July 12, 2002) (statement of Sen. Charles Schumer (D-N.Y.)) (stating that off-balance sheet entities “have been used to take losses off the books, and then shareholders, and everybody else, don’t know much about them”).

¹¹⁴ Sarbanes-Oxley Act of 2002 § 401(c).

Another reform that is tied to a specific recent scandal is the Sarbanes-Oxley Act's prohibition on personal loans to executives.¹¹⁵ According to media reports, former Tyco chief executive L. Dennis Kozlowski received a \$19 million no-interest loan from the company that was later forgiven.¹¹⁶ This kind of loan was permissible under Delaware corporate law, for example, which allowed corporations to make loans to officers and directors if the board of directors decides that such assistance will benefit the corporation.¹¹⁷ The Sarbanes-Oxley Act, as a federal law, will supercede Delaware's approval of personal loans to executives.¹¹⁸ The Act's prohibition on personal loans will help prevent the abuse of corporate funds for personal purposes.¹¹⁹

Nevertheless, there are some good reasons to allow firms to lend money to executives. First, firms may want to lend money to a new CEO relocating from across the country.¹²⁰ The CEO may want to have some loan money from the company to cover legitimate expenses, such as buying a new home while waiting to sell his old one and paying relocation costs.¹²¹ Second, companies may want to lend money to corporate officers so that managers can buy the company's stock.¹²² The interests of executives who hold company stock may be more closely aligned with shareholders than those executives who do not own company shares.¹²³ Allow-

¹¹⁵ *Id.* § 402(a).

¹¹⁶ *See* Sorkin, *supra* note 2, at C1. Kozlowski received an additional \$13 million from Tyco to pay the income taxes on that loan. *See id.* Loans to high-ranking executives also figured prominently in several other recent corporate scandals. *See, e.g.*, 148 CONG. REC. S6690 (daily ed. July 12, 2002) (statement of Sen. Schumer). Senator Schumer cited the following examples of abuse of this practice:

Bernard Ebbers, CEO of WorldCom, borrowed a mind-boggling \$408 million from the corporation over several years, while receiving a compensation package valued at over \$10 million annually, all the while the company was facing massive losses. In the case of Adelphia, the Rigas Family received loans and other financial benefits totaling a staggering \$3.1 billion, while that company has also reported huge financial losses.

Id.

¹¹⁷ DEL. GEN. CORP. L. § 143 (1991).

¹¹⁸ *See* U.S. CONST. art. VI. Under the Supremacy Clause, a federal law will override the state law occupying the field. *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 210-11 (1824) (Marshall, C.J.).

¹¹⁹ *See* 148 CONG. REC. S7361 (daily ed. July 25, 2002) (statement of Sen. Schumer) (stating that under the prohibition "CEOs will have to go to the bank, just like everyone else, to acquire a loan; which, [sic] will reduce the risk of CEOs ability to use company funds for personal purposes").

¹²⁰ *See* Mark J. Roe, Delaware's Competition 37 (Oct. 20, 2002) (unpublished manuscript, on file with author).

¹²¹ *See id.*

¹²² *See id.*

¹²³ *See* WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARY AND CASES ON CORPORATE LAW, ch. 9, 36 (2002) (unpublished manuscript, on file with author). Nevertheless, equity-based compensation may also create new possibilities for executive abuse. *See id.* Executives may use their influence over corporate decision making to engage in actions

ing loans only for these purposes may have preserved the advantages of executive loans while limiting their abuse.

Although the Sarbanes-Oxley Act addresses the role of auditors, executives, and members of the audit committee, one weakness of the Act is that it does not address the role of the board of directors generally, nor does it specify any minimum qualifications board members need to have in order to serve. As Enron, Tyco, and other scandals have shown, “too often directors are [not] really independent. Even so-called outsiders end up having some ties to the CEO.”¹²⁴ CEO Ken Lay selected everyone on Enron’s board of directors; thus, they were each likely to be too “cowed to question his leadership.”¹²⁵ Better board performance may be based on requiring board members to have a fairly comprehensive knowledge of the company’s business and on setting aside a certain number of board seats for those with expertise in finance, accounting, and management.¹²⁶ Board membership qualifications deserve continued scrutiny and should be a high priority in the next phase of corporate governance reforms.

Vigorous enforcement of the provisions of the Sarbanes-Oxley Act is crucial to their effectiveness. To this end, the Act calls for an increase in the SEC’s funding from \$438 million in fiscal year 2002¹²⁷ to \$776 million for fiscal year 2003.¹²⁸ The Act also calls for the addition of no fewer than 200 qualified professionals to the SEC staff to facilitate greater oversight of auditors.¹²⁹ While the SEC is in charge of reviewing the financial statements of 17,000 public companies, only one in fifteen annual reports was reviewed in 2000.¹³⁰ Moreover, SEC workers are relatively underpaid, earning twenty-five to forty percent less than peers at other federal agencies.¹³¹ To address this earnings gap, the Sarbanes-Oxley Act sets aside over \$100 million for additional employee compensation.¹³² The extent to which the SEC can enforce the Sarbanes-Oxley

that raise the company’s stock price in the short-term but add little real value to the company in the long-term, and then sell their shares before prices fall. *See id.*

¹²⁴ Nocera et al., *supra* note 27, at 72.

¹²⁵ *Id.*

¹²⁶ *See id.*

¹²⁷ *See Appropriations for 2002: Hearings Before the Subcomm. on Commerce, Justice, State and Judiciary of the Senate Comm. on Appropriations*, 107th Cong. 346 (2001) (statement of Laura S. Unger, Acting Chairman, SEC), available at <http://www.sec.gov/news/testimony/062801tslu.htm>.

¹²⁸ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 601, 116 Stat. 745, 793.

¹²⁹ *Id.*

¹³⁰ Nocera, *supra* note 27, at 68.

¹³¹ *Id.*

¹³² Sarbanes-Oxley Act of 2002 § 601. *See also* 148 CONG. REC. S7351 (daily ed. July 25, 2002) (statement of Sen. Sarbanes). According to Senator Sarbanes,

the SEC cannot offer its attorneys and accountants the same level of salary and benefits that their counterparts receive at the five Federal bank regulatory agencies. Talented and dedicated staff attorneys and accountants can increase their compensation by as much as one-third simply by moving to another agency. This is an intolerable situation. Pay parity has been authorized and now must be

Act also depends on the resources that it is appropriated.¹³³ The SEC's capacity for oversight is particularly important to the fate of the Oversight Board.¹³⁴

The public, corporations, and government agencies should not rest with the signing of the Sarbanes-Oxley Act into law. Legislators and the public must be willing to revise and improve the Sarbanes-Oxley Act in response to changing regulatory needs. Congress should not be afraid to modify or strike aspects of the law that turn out to hinder its goals of corporate accountability and transparency. The ultimate challenge is to anticipate corporate governance problems in order to prevent devastating collapses such as that of Enron, which destroyed the savings of thousands of workers. In that sense, some may say that the Sarbanes-Oxley Act is merely a rear-guard action that addresses yesterday's problems. Even though it took a sequence of corporate scandals to pass comprehensive reform legislation, however, that does not detract from the real substance of the reforms.

Nevertheless, the Sarbanes-Oxley Act by itself accomplishes very little in the absence of vigorous enforcement of its provisions and effective leadership by the SEC and the Oversight Board. Political debate and maneuvering over these issues will never cease. The SEC will always depend on Congress for its funding to fill its expanded role under the Sarbanes-Oxley Act. The constant variables of politics will shape the implementation of the Act. However strong the public's support for the passage of the Sarbanes-Oxley Act may have been, public interest in corporate governance may recede if economic performance improves and recent scandals become distant memories. Therefore, arguably the most important determinant in the success of the Sarbanes-Oxley Act is the public's vigilance. If the public does not want the effectiveness of the Sarbanes-Oxley Act to rise and fall with the political climate, it should continually be willing to reward or punish candidates running for office based on their degree of support for corporate governance reforms.

funded; this legislation specifically provide[s] the necessary funding.

Id.

¹³³ The political debate over the funding of the SEC did not cease with the passage of the Sarbanes-Oxley Act. See Stephen Labaton, *Bush Seeks to Cut Back on Raise for S.E.C.'s Corporate Cleanup*, N.Y. TIMES, Oct. 19, 2002, at A1 (describing a White House proposal to give the SEC a thirty percent increase in funding for Fiscal Year 2003, as opposed to the seventy-seven percent increase called for in the Sarbanes-Oxley Act). Democrats charge that the White House has decided that corporate scandals have receded in importance among political issues and seeks to take advantage of this situation. See *id.* Proponents of reform argue that a smaller increase would not provide enough money for the SEC's expanded role, for raising SEC salaries up to the level of other government agencies, for increasing the SEC's overwhelmed staff, and for financing the start-up of the Oversight Board. See *id.*

¹³⁴ See *supra* text accompanying notes 59–63.

No amount of rules and enforcement mechanisms can prevent all corporate abuses. In any free society, there will always be a large role for voluntary compliance. This freedom can mean greater ability to commit fraud, but it is also necessary for the entrepreneurialism and innovation that make the free-market system an incredible producer of wealth. The goal is to create a vigorous corporate governance structure that fights fraud without shutting out creativity. The Sarbanes-Oxley Act substantially achieves this balance through a combination of stronger rules for, among other things, financial disclosure and independence of auditors and greater oversight and enforcement resources.

—*Brian Kim*