

**NO ONE CAN SERVE TWO MASTERS:
CORPORATE AND SECURITIES LAW
AFTER ENRON**

JOEL SELIGMAN*

Nearly seventy years ago, Supreme Court Justice Harlan Stone memorably observed at the dedication of the University of Michigan Law School Quadrangle:

I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters'. More than a century ago equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it recognition. No thinking man can believe that an economy built upon a business foundation can permanently endure without some loyalty to that principle. The separation of ownership from management, the development of the corporate structure so as to vest in small groups control over the resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper function. Yet those who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent, corporate officers and directors who award to themselves huge bonuses from corporate funds without the assent or even the knowledge of their stockholders, reorganization committees created to serve interests of others than those whose securities they control, financial institutions which, in the infinite variety of their operations, consider only last, if at all, the interests of those whose funds they command, suggest how far we have ignored the

* Dean and Ethan A.H. Shepley Professor, Washington University School of Law; public member of the American Institute of Certified Public Accountants Professional Ethics Executive Committee.

necessary implications of that principle. The loss and suffering inflicted on individuals, the harm done to a social order founded upon business and dependent upon its integrity, are incalculable.¹

The same year, 1934, that Justice Stone offered these observations, the Securities and Exchange Commission (SEC) began operations. By 1940 the SEC enforced six federal securities laws.²

At its core, the primary policy of the federal securities laws involves the remediation of information asymmetries, that is, equalization of the information available to outside investors and insiders. This is most obviously true with respect to the mandatory disclosure system, which compels business corporations and other securities issuers to disseminate detailed, generally issuer-specific information when selling new securities to the public and requires specified issuers³ to file annual and other periodic reports containing similar information. This system was, in essence, a response to the failure of business and foreign government issuers sufficiently to disclose information material to investment decisions in the period preceding the enactment of the Securities Act of 1933, which for one year was enforced by the Federal Trade Commission, and the Securities Exchange Act of 1934.⁴

In the years since the SEC began operations, the United States securities markets have experienced an almost unimaginable growth and vitality.

1. Harlan F. Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 809 (1934).

2. There are now seven federal securities laws: The Securities Act of 1933, 15 U.S.C. § 77a (2000); the Securities Exchange Act of 1934, 15 U.S.C. § 78a (2000); the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79 (2000); the Trust Indenture Act of 1939, 15 U.S.C. § 77aaa (2000); the Investment Company Act of 1940, 15 U.S.C. § 80a-1 (2000); the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 (2000); and the Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa (2000). For general descriptions of these laws, see 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 226-77 (3d ed. 1989).

3. The Securities Exchange Act requires annual, quarterly, and, on occasion, monthly reports to be filed by firms that satisfy specified criteria. Most notably, these firms must have (i) a security registered on a national securities exchange, 15 U.S.C. § 78l(a); (ii) total assets of \$1 million or more and a class of equity security held of record by 500 or more but less than 750 security holders when its securities are not traded on a national securities exchange and are traded in the alternative over-the-counter market, 15 U.S.C. § 78l(g)(1)(B); 17 C.F.R. § 240.12g-1; or (iii) a security registered under the Securities Act, unless and until the security is held by fewer than 300 persons, see § 15(d), 15 U.S.C. § 78(d).

4. See Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983).

The number of United States stockholders has increased from 1.5 million (or 1.2% of the population) in 1930⁵ to 84 million (or 43.6% of the adult population) in 1998.⁶ As long ago as 1980, 133 million United States citizens indirectly owned shares through such intermediaries as mutual funds or pension plans.⁷

When the stock market began its collapse in September 1929, the aggregate value of all shares on the New York Stock Exchange (NYSE) was approximately ninety billion dollars.⁸ By 2000 NYSE capitalization had grown to nearly \$12.4 trillion.⁹ Perhaps most remarkably in 2000 over \$2.3 trillion in new securities was sold in some 16,481 corporate underwritings and 3,540 private placements.¹⁰

Underlying these remarkable numbers was the longest sustained bull market in United States history. Focusing on year-end closing indexes, the Dow Jones Industrial Average rose from 875 in 1981 to 11,497 in 1999, paralleling similar surges in other leading composite indexes.¹¹ To put this in different terms, between 1981 and 1999, the NYSE stock market capitalization increased nearly 11 fold from \$1.1 to \$12.3 trillion.¹²

With this unprecedented success there also appears to have come a lulling of institutional sensibilities. A widespread belief appears to have evolved in the United States financial community that time honored rules such as those that discourage conflicts of interest are quaint and easily circumvented. Too frequently, in recent years, sharp practitioners in business, investment banking, accounting or law appear to have challenged the fundamental tenets of "full disclosure of material information" or "fair presentation of accounting results." A deterioration in the integrity of our corporate governance and mandatory disclosure systems may well have advanced, not because of a novel strain of human cupidity, but because we had so much success, for so long, that we began to forget why fundamental principles of full disclosure and corporate accountability were long considered essential.

5. Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 654 (1995).

6. N.Y. STOCK EXCH., FACT BOOK, 55-56 (2000).

7. Seligman, *supra* note 5, at 658.

8. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 1 (1982).

9. SEC. INDUS. ASSOC., 2001 SECURITIES INDUSTRY FACT BOOK 48 (2001).

10. *Id.* at 12.

11. *Id.* at 54.

12. *Id.* at 48.

No recent case better illustrates this deterioration than Enron. Enron was an extraordinarily fast growing provider, primarily of natural gas, electricity, and communication products and services,¹³ whose total assets quadrupled between 1996 and 2000 from \$16.137 to \$65.503 billion.¹⁴ Its 2000 Form 10-K annual report filed with the SEC was a consistently upbeat review of its many claimed successes, only unusual because of Exhibit twenty-one to the certified financial statements which was a 49 page list of subsidiaries. In 2001 Enron was seventh on the *Fortune 500* list, with revenues in 2000 of \$100.8 billion.¹⁵

Then, abruptly and essentially without warning, Enron melted down. A November 8, 2001 Form 8-K stunningly stated:

Enron intends to restate its financial statements for the years ended December 31, 1997 through 2000 and the quarters ended March 31 and June 30, 2001. As a result the previously-issued financial statements for those periods and the audit reports covering the year-end financial statements for 1997 to 2000 should not be relied upon.¹⁶

13. Enron Corp. Form 10-K Item 1—Business General (filed Apr. 4, 2001), *available at* <http://www.sec.gov/Archives/edgar/data/1024401/000102440101500010/0001024401-01-500010.txt> [hereinafter *Enron Form 10-k*].

14. *Id.* Item 6—Selected Financial Data.

15. *Five-hundred largest U.S. Corporations*, FORTUNE, Apr. 16, 2001 at F-1.

16. Enron Corp., Form 8-K, Item 5 (filed Nov. 8, 2001), *available at* <http://www.sec.gov/Archives/edgar/data/1024401/000095012901503835/0000950129-01-503835.txt> [hereinafter *Enron Form 8-K*]. A July 2002 Report of The Senate Permanent Subcom. on Investigations, The Role of The Board of Directors in Enron's Collapse, 107th Cong., 2d Sess., S. Rep. 107-70 at 7 (2002) amplified:

One of Enron's key corporate achievements during the 1990s was creation of an online energy trading business that bought and sold contracts to deliver energy products like natural gas, oil or electricity. Enron treated these contracts as marketable commodities comparable to securities or commodity futures, but was able to develop and run the business outside of existing controls on investment companies and commodity brokers. The nature of the new business required Enron's access to significant lines of credit to ensure that the company had the funds at the end of each business day to settle the energy contracts traded on its online system. This new business also caused Enron to experience large earnings fluctuations from quarter to quarter. Those large fluctuations potentially affected the credit rating Enron received, and its credit rating affected Enron's ability to obtain low-cost financing and attract investment. In order to ensure an investment-grade credit rating, Enron began to emphasize increasing its cash flow, lowering its debt, and smoothing its earnings on its financial statements to meet the criteria set by credit rating agencies like Moody's and Standard and Poor's.

The Enron Special Investigative Committee Report (Powers Report), chaired by University of Texas Law School Dean William Powers, similarly began:¹⁷

On October 16, 2001, Enron announced that it was taking a \$544 million after-tax charge against earnings related to transactions with LJM2 Co-Investment, L.P. (“LJM2”), a partnership created and managed by Fastow. It also announced a reduction of shareholders’ equity of \$1.2 billion related to transactions with that same entity.

Less than one month later, Enron announced that it was restating its financial statements for the period from 1997 through 2001 because of accounting errors relating to transactions with a different Fastow partnership, LJM Cayman, L.P. (“LJM1”), and an additional related-party entity, Chewco Investments, L.P. (“Chewco”). Chewco was managed by an Enron Global Finance employee, Kopper, who reported to Fastow.

The LJM1- and Chewco-related restatement, like the earlier charge against earnings and reduction of shareholders’ equity, was very large. It reduced Enron’s reported net income by \$28 million in 1997 (of \$105 million total), by \$133 million in 1998 (of \$703 million total), by \$248 million in 1999 (of \$893 million total), and by \$99 million in 2000 (of \$979 million total). The restatement reduced reported shareholders’ equity by \$258 million in 1997, by \$391 million in 1998, by \$710 million in 1999, and by \$754 million in 2000. It increased reported debt by \$711 million in 1997, by \$561 million in 1998, by \$685 million in 1999, and by \$628 million in 2000. Enron also revealed, for the first time, that it had learned that Fastow received more than \$30 million from LJM1 and LJM2.

17. The Powers Report was prepared in a compressed time span, approximately three months, with significant limitations on available information:

We had no power to compel third parties to submit to interviews, produce documents, or otherwise provide information. Certain former Enron employees who (we were told) played substantial roles in one or more of the transactions under investigation—including [Enron Chief Financial Officer Andrew] Fastow, Michael J. Kopper, and Ben F. Glisan, Jr.—declined to be interviewed either entirely or with respect to most issues. We have had only limited access to certain workpapers of Arthur Andersen LLP (“Andersen”), Enron’s outside auditors, and no access to materials in the possession of the Fastow partnerships or their limited partners.

WILLIAMS C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 1-2 (2002).

The Powers Commission counsel, Wilmer Cutler & Pickering, reviewed more than 430,000 pages of documents and interviewed more than 65 people, including nine of the then current Enron directors. *Id.* at 33.

These announcements destroyed market confidence and investor trust in Enron. Less than one month later, Enron filed for bankruptcy.¹⁸

The Powers Committee made a series of significant findings with respect to the debacle.

First, Enron employees involved in the partnerships were enriched “by tens of millions of dollars they should never have received—Fastow by at least \$30 million, Kopper by at least \$10 million, two others by \$1 million each, and still two more by amounts we believe were at least in the hundreds of thousands of dollars.”¹⁹

Second, the partnerships, Chewco, LJM1, and LJM2, “were designed to accomplish favorable financial statement results, not to achieve *bona fide* economic objectives or to transfer risk.”²⁰ These transactions often did not follow applicable accounting rules that would have permitted keeping assets and liabilities off Enron’s balance sheet:

They allowed Enron to conceal from the market very large losses resulting from Enron’s merchant investments by creating an appearance that those investments were hedged—that is, that a third party was obligated to pay Enron the amount of those losses—when in fact that third party was simply an entity in which only Enron had a substantial economic stake. We believe these transactions resulted in Enron reporting earnings from the third quarter of 2000 through the third quarter of 2001 that were almost \$1 billion higher than should have been reported.²¹

Underlying this pivotal aspect of the debacle was a breakdown in the integrity of Enron’s accounting:

Enron’s original accounting treatment of the Chewco and LJM1 transactions that led to Enron’s November 2001 restatement was clearly wrong, apparently the result of mistakes either in structuring the transactions or in basic accounting. In other cases, the accounting treatment was likely wrong, notwithstanding creative efforts to circumvent accounting principles through the complex structuring of transactions that lacked fundamental economic

18. *Id.* at 2-3. In April Enron filed a report with the SEC indicating that its then current management estimated that a writedown of approximately \$14 billion will be required. Enron Form 8-K, *supra* note 16, at 2 (Apr. 22, 2002).

19. *Id.* at 3-4.

20. *Id.* at 4.

21. *Id.* at 4.

substance. In virtually all of the transactions, Enron's accounting treatment was determined with extensive participation and structuring advice from Andersen, which Management reported to the Board. Enron's records show that Andersen billed Enron \$5.7 million for advice in connection with the LJM and Chewco transactions alone, above and beyond its regular audit fees.

Many of the transactions involve an accounting structure known as a "special purpose entity" or "special purpose vehicle" (referred to as an "SPE" . . .). A company that does business with an SPE may treat that SPE as if it were an independent, outside entity for accounting purposes if two conditions are met: (1) an owner independent of the company must make a substantive equity investment of at least 3% of the SPE's assets, and that 3% must remain at risk throughout the transaction; and (2) the independent owner must exercise control of the SPE. In those circumstances, the company may record gains and losses on transactions with the SPE, and the assets and liabilities of the SPE are not included in the company's balance sheet, even though the company and the SPE are closely related. It was the technical failure of some of the structures with which Enron did business to satisfy these requirements that led to Enron's restatement.²²

As a general matter, the Powers Report concluded: "The evidence available to us suggests that Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal controls over the related-party transactions."²³

Specifically, the Powers Report characterized each of the more than 20 asset sales and hedging transactions between Enron and an LJM partnership as flawed.²⁴

Third, there were substantial corporate governance and management oversight failures. For example, Koppers was prohibited by Enron's Code of Conduct of Business Affairs from having a financial or managerial role in Chewco unless Enron's Chairman and CEO determined that such participation "does not adversely affect the best interests of the

22. *Id.* at 5. See *id.* at 36-40 for background on Enron and Special Purpose Entities. For detailed treatment of Chewco, see *id.* at 41-67. For detailed treatment of LJM, see *id.* at 68-147.

23. *Id.* at 24.

24. *Id.* at 13-15.

Company.”²⁵ The Powers Committee reported “no evidence that [Kopper’s] participation was ever disclosed to, or approved by, either Kenneth Lay (who was Chairman and CEO) or the Board of Directors.”²⁶ Koppers received \$2 million in management fees between 1997 and 2000 and received along with a friend more than \$10 million from Enron for the repurchase of Chewco interests he had purchased for \$125,000 in 1997.²⁷

In contrast, the Board of Directors did permit Fastow to participate in LJM “with full knowledge and discussion of the obvious conflict of interest that would result.”²⁸ The Powers Committee characterized this decision as “fundamentally flawed”: “A relationship with the most senior financial officer of a public company—particularly one requiring as many controls and as much oversight by others as this one did—should not have been undertaken in the first place.”²⁹

The Powers Report was particularly critical of Kenneth Lay:

For much of the period in question, Lay was the Chief Executive Officer of Enron and, in effect, the captain of the ship. As CEO, he had the ultimate responsibility for taking reasonable steps to ensure that the officers reporting to him performed their oversight duties properly. He does not appear to have directed their attention, or his own, to the oversight of the LJM partnerships. Ultimately, a large measure of the responsibility rests with the CEO.

Lay approved the arrangements under which Enron permitted Fastow to engage in related-party transactions with Enron and authorized the Rhythms transaction and three of the Raptor vehicles. He bears significant responsibility for those flawed decisions, as well as for Enron’s failure to implement sufficiently rigorous procedural controls to prevent the abuses that flowed from this inherent conflict of interest. In connection with the LJM transactions, the evidence we have examined suggests that Lay functioned almost entirely as a Director, and less as a member of Management.³⁰

25. POWERS ET AL., REPORT OF INVESTIGATION, *supra* note 17, at 8.

26. *Id.*

27. *Id.* See generally *id.* at 46-47, 54-56, 60, 64 (discussing Kopper’s involvement in the Chewco transaction).

28. *Id.* at 9.

29. *Id.*

30. *Id.* at 19-20. The Powers Report generalized:

Management had the primary responsibility for implementing the Board’s resolutions and controls. Management failed to do this in several respects. No one accepted primary responsibility for oversight, the controls were not executed properly, and there were apparent structural defects

In this context it appears there were little internal “checks or balances” when senior managers engaged in questionable transitions. The Powers Report explained:

One of the most serious issues that we identified in connection with the Chewco buyout is a \$2.6 million payment made by Enron to Chewco in mid-September 2001. Chewco first requested the payment after the buyout was consummated—under a Tax Indemnity Agreement between Enron and Chewco that was part of the original 1997 transaction. There is credible evidence that Fastow authorized the payment to Chewco even though Enron’s in-house counsel advised him unequivocally that there was no basis in the Agreement for the payment, and that Enron had no legal obligation to make it.³¹

The Powers Report found no effective check on this question-begging transaction other than a fact conflict as to whether Fastow discussed the transaction with Skilling.³²

The Powers Report was also sharply critical of Enron’s Board of Directors:

With respect to the issues that are the subject of this investigation, the Board of Directors failed, in our judgment, in its oversight duties. . . .

The Board of Directors approved the arrangements that allowed the Company’s CFO to serve as general partner in partnerships that participated in significant financial transactions with Enron. . . . The Board substantially underestimated the severity of the conflict and overestimated the degree to which management controls and procedures could contain the problem.

After having authorized a conflict of interest creating as much risk as this one, the Board had an obligation to give careful attention to the transactions that followed. It failed to do this. It cannot be faulted for the various instances in which it was apparently denied important information concerning certain of the transactions in question. However, it can and should be faulted for failing to demand more information, and for failing to probe and understand

in the controls that no one undertook to remedy or to bring to the Board’s attention. In short, no one was minding the store.

Id. at 165-66. *See generally id.* at 165-72 (discussing management oversight issues).

31. *Id.* at 64-65.

32. *Id.* at 65-66.

the information that did come to it. The Board authorized the Rhythms transaction and three of the Raptor transactions. It appears that many of its members did not understand those transactions—the economic rationale, the consequences, and the risks. Nor does it appear that they reacted to warning signs in those transactions as they were presented, including the statement to the Finance Committee in May 2000 that the proposed Raptor transaction raised a risk of “accounting scrutiny.” We do note, however, that the Committee was told that Andersen was “comfortable” with the transaction. As complex as the transactions were, the existence of Fastow’s conflict of interest demanded that the Board gain a better understanding of the LJM transactions that came before it, and ensure (whether through one of its Committees or through use of outside consultants) that they were fair to Enron.³³

33. *Id.* at 22-23. See background in *id.* at 148-58. A subsequent report of the Senate Permanent Subcommittee on Investigations, *supra* note 16, at 12-13, 38, was more critical:

During their Subcommittee interviews, the Enron Directors seemed to indicate that they were as surprised as anyone by the company’s collapse. But a chart produced at the Subcommittee hearing marks more than a dozen incidents over three years that should have raised Board concerns about the activities of the company. The first listed incident, in February 1999, is an Audit Committee meeting in which Board members were told that Enron was using accounting practices that “push limits” and were “at the edge” of acceptable practice. Three times in 1999 and 2000, the Board was asked to and approved an unprecedented arrangement allowing Enron’s CFO to set up private equity funds, the LJM partnerships, to do business with Enron for the purpose of improving Enron’s financial statements. The Board also approved moving an affiliated company, Whitewing, off the company books, while guaranteeing its debt with \$1.4 billion in Enron stock and helping it obtain funding for the purchase of Enron assets. Committee and Board presentations throughout 1999, 2000 and 2001 chronicled the company’s foray into more and more off-the-books activity. Three times in 2000, the Board was asked to and approved complex transactions called the Raptors, despite questionable accounting and ongoing risk to the company. The Board was also informed that, in six short months, LJM had produced over \$2 billion in funds flow for Enron, and Enron’s gross revenues had jumped from \$40 billion in 1999 to \$100 billion in 2000. These figures are striking, yet apparently no Board member questioned them.

In 2001, evidence began to mount that not all was well at Enron. The company’s stock price began declining. In March 2001, a prominent *Fortune* article questioned the company’s opaque financial statements. In April, Board members were told that 64 percent of Enron’s assets were “troubled” or performing “below expectations.” They were also told of international assets that were overvalued on Enron’s books by \$2.3 billion. In mid 2001, the company’s high profile, extensive broadband investments began to lose value. During the summer, the Board watched Mr. Fastow sell his LJM stake and Mr. Skilling suddenly resign from the company. In her letter to Mr. Lay on the day after Mr. Skilling’s resignation, Sherron Watkins wrote, “Skilling’s abrupt departure will raise suspicions of accounting improprieties and valuations issues The spotlight will be on us, the market just can’t accept that Skilling is leaving his dream job.” But neither Board Chairman Lay nor any other Board member used the Skilling departure as a red flag warranting a hard look at Enron’s operations. Even in early October 2001, when told of an anonymous employee letter warning of company problems and an \$800 million earnings charge from the Raptors termination, the interviewed Board members told the Subcommittee staff they had left the October Board meeting feeling the company was still on track. . . .

Typically committees, often largely or entirely involving outside or nonemployee directors, will aid a board in its review of complex auditing and financial issues. This did not happen here:

In addition to the meetings at which LJM1 and LJM2 were approved, the Audit and Compliance Committee and the Finance Committee reviewed certain aspects of the LJM transactions. The Audit and Compliance Committee did so by means of annual reviews in February 2000 and February 2001. The Finance Committee did so by means of a report from Fastow on May 1, 2000 and an annual review in February 2001.

The Committee reviews did not effectively supplement Management's oversight (such as it was). Though part of this may be attributed to the Committees, part may not. The Committees were severely hampered by the fact that significant information about the LJM relationship was withheld from them, in at least five respects:

First, in each of the two years in which the February annual review occurred, Causey presented to the Committees a list of transactions with LJM1 and LJM2 in the preceding year. The lists were incomplete (though Causey says he did not know this, and in any event a more complete presentation may not have affected the Committee's review): the 1999 list identified eight transactions, when in fact there were ten, and the 2000 list of transactions omitted these "buyback" transactions described earlier. Knowledge of these "buyback" transactions would have raised substantial questions about the nature and purpose of the earlier sales.

Second, Fastow represented to the Finance Committee on May 1, 2000, that LJM2 had a projected internal rate of return on its investments of 17.95%, which was consistent with the returns the Committee members said they anticipated for a "bridge" investor such as LJM2. In contrast, at the annual meeting of LJM2 limited partners on October 26, 2000, Fastow presented written materials showing that their projected internal rate of return on these

Enron's multi-billion dollar, off-the-books activity was disclosed to the Enron Board and received Board approval as a explicit strategy to improve Enron's financial statements. In fact, Enron's massive off-the-book activity could not have taken place without Board action to establish new special purpose entities, issue preferred Enron shares, and pledge Enron stock as the collateral needed for the deals to go forward. In the end, the Board knowingly allowed Enron to move at least \$27 billion or almost 50 percent of its assets off balance sheet.

investments was 51%. While some of this dramatic increase may have been attributable to transactions after May 1—in particular the Raptor transactions—there is no indication that Fastow ever corrected the misimpression he gave the Finance Committee about the anticipated profitability of LJM2.

Third, it appears that, at the meeting for the February 2001 review, the Committees were not provided with important information. The presentation included a discussion of the Raptor vehicles that had been created the preceding year. Apparently, however, the Committees were not told that two of the vehicles then owed Enron approximately \$175 million more than they had the capacity to pay. This information was contained in a report that was provided daily to Causey and Buy, but it appears that neither of them brought it to either Committee's attention.

Fourth, it does not appear that the Board was informed either that, by March of 2001, this deficit had grown to about \$500 million, or that this would have led to a charge against Enron's earnings in that quarter if not addressed prior to March 31. Nor does it appear that the Board was informed about restructuring the Raptor vehicles on March 26, 2001, or the transfer of approximately \$800 million of Enron stock contracts that was part of that transaction. The restructuring was directed at avoiding a charge to earnings. While these transactions may or may not have required Board action as a technical matter, it is difficult to understand why matters of such significance and sensitivity at Enron would not have been brought to the attention of the Board. Causey and Buy, among others, were aware of the deficit and restructuring. Skilling recalls being only vaguely aware of these events, but other witnesses have told us that Skilling, then in his first quarter as CEO, was aware of and intensely interested in the restructuring.

Fifth, recent public disclosures show that Andersen held an internal meeting on February 5, 2001, to address serious concerns about Enron's accounting for and oversight of the LJM relationship. The people attending the meeting reportedly decided to suggest that Enron establish a special committee of the Board of Directors to review the fairness of LJM transactions or to provide for other procedures or controls, such as competitive bidding. Enron's Audit and Compliance Committee held a meeting one week later, on February 12, 2001, which was attended by David B. Duncan and Thomas H. Bauer, two of the Andersen partners who (according to

the public disclosures) had also been in attendance at the Andersen meeting on February 5. We are told (although the minutes do not reflect) that the Committee also conducted an executive session with the Andersen representatives, in the absence of Enron's management, to inquire if Andersen had any concerns it wished to express. There is no evidence that Andersen raised concerns about LJM.

There is no evidence of any discussion by either Andersen representative about the problems or concerns they apparently had discussed internally just one week earlier. None of the Committee members we interviewed recalls that such concerns were raised, and the minutes make no mention of any discussion of the subject. Rather, according to the minutes and to written presentation materials, Duncan reported that "no material weaknesses had been identified" in Andersen's audit and that Andersen's "[o]pinion regarding internal control . . . [w]ill be unqualified." While we have not had access to either Duncan or Bauer, the minutes do not indicate that the Andersen representatives made any comments to the Committee about controls while Causey was reviewing them, or recommended forming a special committee to review the fairness of the LJM transactions, or recommended any other procedures or review.

The Board cannot be faulted for failing to act on information that was withheld, but it can be faulted for the limited scrutiny it gave to the transactions between Enron and the LJM partnerships. The Board had agreed to permit Enron to take on the risks of doing business with its CFO, but had done so on the condition that the Audit and Compliance Committee (and later also the Finance Committee) review Enron's transactions with the LJM partnerships. These reviews were a significant part of the control structure, and should have been more than just another brief item on the agenda.

In fact, the reviews were brief, reportedly lasting ten to fifteen minutes. More to the point, the specific economic terms, and the benefits to LJM1 or LJM2 (or to Fastow), were not discussed. There does not appear to have been much, if any, probing with respect to the underlying basis for Causey's representation that the transactions were at arm's-length and that "the process was working effectively." The reviews did provide the Committees with what they believed was an assurance that Causey had in fact looked at the transactions—an entirely appropriate objective for a Board

Committee-level review of ordinary transactions with outside parties. But these were not normal transactions. There was little point in relying on Audit and Compliance Committee review as a control over these transactions if that review did not have more depth or substance.³⁴

Even when the Finance Committee received information “strongly suggesting, if not making perfectly clear, that the Raptor vehicle was not a true economic hedge,”³⁵ the Committee did not effectively stop a transaction from proceeding, but instead recommended it to the full Board, which approved it the following day.³⁶

Neither the Board nor its Committees were provided the type of critical questioning by the outside auditor, Arthur Andersen, that reasonably could be anticipated. As the Powers Report explained with respect to Andersen’s work concerning the LJM transactions:

[S]everal Directors stated that they believed Andersen would review the transactions to provide a safeguard. The minutes of the Finance Committee meeting on October 11, 1999 (apparently not attended by representatives of Andersen) identify “the review by Arthur Andersen LLP” as a factor in the Committee’s consideration of LJM2. Andersen did in fact (1) provide substantial services with respect to structuring and accounting for many of the transactions, (2) review Enron’s financial statement disclosures with respect to the related-party transactions (including representations that “the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties”), and (3) confirm Andersen’s involvement in representations to the Audit and Compliance Committee at its annual reviews of the LJM transactions. The Board was entitled to rely on Andersen’s involvement in these respects. In addition, one would reasonably expect auditors to raise questions to their client—the Audit and Compliance Committee—if confronted with transactions whose economic substance was in doubt, or in controls required by the Board of Directors were not followed, as was the case here.³⁷

A different type of check and balance is typically provided by outside legal counsel. Shortly after then Enron CEO Jeffrey Skilling’s unexpected

34. POWERS ET AL., REPORT OF INVESTIGATION, *supra* note 17, at 159-63.

35. *Id.* at 106.

36. *Id.* at 107.

37. *Id.* at 153.

resignation in August 2001, Kenneth Lay received an anonymous one page letter, later described as being sent by Enron employee Sherron Watkins raising questions about Enron's "aggressive" accounting and concluding, "I am incredibly nervous that we will implode in a wave of accounting scandals."³⁸ Lay told the Powers Committee that the letter was "thoughtfully written and alarming."³⁹ In response, Enron asked Vinson & Elkins, outside counsel who had helped design the questionable Raptor and LJM transactions, to perform a "preliminary investigation" to determine whether Enron should conduct a full investigation.⁴⁰ The Vinson & Elkins investigation concluded that "none of the individuals interviewed could identify any transactions between Enron and LJM that was not reasonable from Enron's standpoint or that was contrary to Enron's best interests."⁴¹ The Powers Report further found:

On the accounting issues, V&E said that both Enron and Andersen acknowledge "that the accounting treatment on the Condor/Whitewing and Raptor transactions is creative and aggressive, but no one has reason to believe that it is inappropriate from a technical standpoint." V&E concluded that the facts revealed in its preliminary investigation did not warrant a "further widespread investigation by independent counsel or auditors," although they did not note that the "bad cosmetics" of the Raptor related-party transactions, coupled with the poor performance of the assets placed in the Raptor vehicles, created "a serious risk of adverse publicity and litigation."⁴²

The Powers Report was critical of the scope and nature of the Vinson & Elkins investigation:

The result of the V&E review was largely predetermined by the scope and nature of the investigation and the process employed. We identified the most serious problems in the Raptor transactions only after a detailed examination of the relevant transactions and, most importantly, discussions with our accounting advisors—both steps that Enron determined (and V&E accepted) would not be part of V&E's investigation. With the exception of Watkins, V&E spoke only with very senior people at Enron and Andersen. Those people, with few exceptions, had substantial professional and personal

38. *Id.* at 172.

39. *Id.*

40. *Id.* at 173.

41. *Id.* at 175.

42. *Id.* at 175-76.

stakes in the matters under review. The scope and process of the investigation appear to have been structured with less skepticism than was needed to see through these particularly complex transactions.⁴³

Here, the Powers Report may have understated a fundamental issue implicit in both Andersen's auditing of transactions it helped design and Vinson & Elkins' review of its own legal work. Enron systematically seemed indifferent to the extent to which this type of conflict of interest could reduce the critical analysis outside accountants and lawyers are expected to provide.

Fourth, required public disclosure of the LJM partnerships was systematically inadequate:

[T]hese disclosures were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships. The disclosures also did not communicate the nature or extent of Fastow's financial interest in the LJM partnerships. This was the result of an effort to avoid disclosing Fastow's financial interest and to downplay the significance of the related-party transactions and, in some respects, to disguise their substance and import. The disclosures also asserted that the related-party transactions were reasonable compared to transactions with third parties, apparently without any factual basis. The process by which the relevant disclosures were crafted was influenced substantially by Enron Global Finance (Fastow's group). There was an absence of forceful and effective oversight by Senior Enron Management and in-house counsel, and objective and critical professional advice by outside counsel at Vinson & Elkins, or auditors at Andersen.⁴⁴

For a significant example, in Note 16 to the Enron Corp. 2001 Form 10-K, related party transactions are described in these terms:

In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes that the

43. *Id.* at 176-77.

44. *Id.* at 17.

terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties.

In 2000, Enron entered into transactions with the Related Party to hedge certain merchant investments and other assets. As part of the transactions, Enron (I) contributed to newly-formed entities (the Entities) assets valued at approximately \$1.2 billion, including \$150 million in Enron notes payable, 3.7 million restricted shares of outstanding Enron common stock and the right to receive up to 18.0 million shares of outstanding Enron common stock in March 2003 (subject to certain conditions) and (ii) transferred to the Entities assets valued at approximately \$309 million, including a \$50 million note payable and an investment in an entity that indirectly holds warrants convertible into common stock of an Enron equity method investee. In return, Enron received economic interests in the Entities, \$309 million in notes receivable, of which \$259 million is recorded at Enron's carryover basis of zero, and a special distribution from the Entities in the form of \$1.2 billion in notes receivable, subject to changes in the principal for amounts payable by Enron in connection with the execution of additional derivative instruments. Cash in these Entities of \$172.6 million is invested in Enron demand notes. In addition, Enron paid \$123 million to purchase share-settled options from the Entities on 21.7 million shares of Enron common stock. The Entities paid Enron \$10.7 million to terminate the share-settled options on 14.6 million shares of Enron common stock outstanding. In late 2000, Enron entered into share-settled collar arrangements with the Entities on 15.4 million shares of Enron common stock. Such arrangements will be accounted for as equity transactions when settled.⁴⁵

The first paragraph is an exercise in obfuscation. What transactions? How much money is involved? What risk is there to Enron? Who is the senior officer of Enron? How much is he or she paid? Who are the limited partners? What basis is there for management's belief that the terms of these transactions "were reasonable compared to those which could have been negotiated with unrelated parties?"

The second paragraph is more detailed but equally confusing. Why did Enron enter into these transactions? Who is the Related Party? What risk does Enron bear?

45. *Enron Form 10-K*, *supra* note 13, at n.16.

The Powers Report concluded:

Overall, Enron failed to disclose facts that were important for an understanding of the substance of the transactions. The Company did disclose that there were large transactions with entities in which the CFO had an interest. Enron did not, however, set forth the CFO's actual or likely economic benefits from these transactions and, most importantly, never clearly disclosed the purposes behind these transactions or the complete financial statement effects of these complex arrangements. The disclosures also asserted without adequate foundation, in effect, that the arrangements were comparable to arm's-length transactions. We believe that the responsibility for these inadequate disclosures is shared by Enron Management, the Audit and Compliance Committee of the Board, Enron's in-house counsel, Vinson & Elkins, and Andersen.⁴⁶

There were other significant public disclosure issues that the Powers Report did not address in the same detail as it did related party transactions.⁴⁷ The Report, for example, noted that the LJM2 entities had approximately fifty limited partners, "including American Home Assurance Co., Arkansas Teachers Retirement System, the MacArthur Foundation, and entities affiliated with Merrill Lynch, J.P. Morgan, Citicorp, First Union, Deutsche Bank, G.E. Capital, and Dresdner Kleinworth Benson."⁴⁸ Newspaper accounts raised the quite troublesome possibility that Enron had shown at least some of these limited partners different financial statements than Enron publically disclosed.⁴⁹

The Enron debacle has raised fundamental policy and regulatory questions, notably including the following in corporate and securities law:

(1) Perhaps most significant is the empirical question: Was Enron an isolated, but serious, breakdown or are the problems exposed there more widespread? By early February 2002 newspapers were reporting a market wide dampening of stock prices because of uncertainty whether the accounting, auditing, and corporate governance problems at Enron would prove widespread.⁵⁰ On July 23, 2002, the Dow Jones Industrial Average

46. POWERS ET AL., REPORT OF INVESTIGATION, *supra* note 17, at 178.

47. *See id.*

48. *Id.* at 73.

49. Diana B. Henriques & Kurt Eichenwald, *A Fog over Enron, and the Legal Landscape*, N.Y. TIMES, Jan. 27, 2002. Cf. Patrick McGeehan, *Wall Street Found Others Willing to Copy Enron's Deals*, N.Y. TIMES, Feb. 14, 2002, at C1 (noting that some Wall Street investment bankers structured complete partnerships similar to those used by Enron to help companies shift debt from balance sheets).

50. *E.g.*, Alex Berenson, *The Biggest Casualty of Enron's Collapse: Confidence*, N.Y. TIMES,

closed at 7702, after a seemingly unending series of major audit failures involving such companies as Global Crossing, Tyco, Adelphia, and WorldCom.⁵¹ Between 1997 and 2001 the number of earnings restatements grew each year from 116 in 1997, to 158 in 1998, 216 in 1999, 233 in 2000, and 305 in 2001.⁵²

Nonetheless, the hard empirical work to gauge the magnitude of dysfunction either at Enron or generally is far from complete. The more we learn about incidence, types of dysfunction, and the causes of dysfunction, the more intelligently we can consider remedies. We are still very far away from a comprehensive factual analysis even of Enron.

(2) Will the type of problem illustrated by Enron prove self-correcting, at least for the foreseeable future? There soon were underway SEC, Justice Department, and private investigations or litigation. The SEC began a series of regulatory initiatives, including proposed changes in corporate disclosure rules, that, among other things, significantly broaden the list of significant events that require current disclosure on Form 8-K.⁵³

Feb. 10, 2002, § 4, at 1.

51. N.Y. TIMES, July 24, 2002, at C1; ABA, Preliminary Report of Task Force on Corporate Responsibility 3-4 n.2 (2002) (summarizing recent disclosures concerning WorldCom, Adelphia, Tyco, and Global Crossing). In all between March 2000 and July 2002 the Wilshire Total Market Index declined over \$7 trillion, from \$17.25 trillion on March 24, 2000 to \$10.03 trillion on July 18, 2002. *The Incredible Shrinking Stock Market*, N.Y. TIMES, Wk. 14 (July 21, 2002).

52. Arthur Andersen, A Study of Restatement Matters: An Analysis of the Industries and Accounting Issues Underlying Public Company Restatements for the Four Years Ended December 31, 2000 at 6, 10; Huron Consulting Group, A Study of Restatement Matters: For the Five Years Ended December 31, 2001, at 8 (June 11, 2002), cited in Exchange Act Release No. 46,120, 77 SEC Docket 2832, 2837 n.27.

53. SEC to Propose New Corporate Disclosure Rules, Press Rel. 2002-22 (Feb. 13, 2002). Subsequently the Commission proposed to add eleven new disclosure items to Form 8-K, addressing:

- Entry into a material agreement not made in the ordinary course of business;
- Termination of a material agreement not made in the ordinary course of business;
- Termination or reduction of a business relationship with a customer that constitutes a specified amount of the company's revenues;
- Creation of a direct or contingent financial obligation that is material to the company;
- Events triggering a direct or contingent financial obligation that is material to the company, including any default or acceleration of an obligation;
- Exit activities including material write-offs and restructuring charges;
- Any material impairment;
- A change in a rating agency decision, issuance of a credit watch or change in a company outlook;
- Movement of the company's securities from one exchange or quotation system to another, delisting of the company's securities from an exchange or quotation system, or a notice that a company does not comply with a listing standard;
- Conclusion or notice that security holders no longer should rely on the company's previously issued financial statements or a related audit report; and
- Any material limitation, restriction or prohibition, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement and stock ownership plans.

Inevitably, without further legislative action, it is reasonable to anticipate enhanced board review of transactions, more detailed and more precise disclosure in SEC filings, more demanding internal accounting controls and outside audits, and more skeptical investment analyst reports.

A caveat is in order here. Voluntary steps often work well when there is a mood of crisis or a fear of legislation or regulation. There is a different type of uncertainty regarding whether voluntary steps will endure after a crisis mood has abated.

(3) It soon became evident that there was broad support to address auditing regulation. In mid-January 2002 SEC Chairman Harvey Pitt proposed a new industry organization to oversee auditor discipline.⁵⁴ In response, the Public Oversight Board (“POB”) voted to disband because of concern it was being “shunted aside.”⁵⁵ The time was appropriate for a

We also propose to move the following two items from other Exchange Act reports to Form 8-K: Unregistered sales of equity securities by the company; and material modifications to rights of holders of the company’s securities.

Finally, we propose to expand the current Form 8-K item that requires disclosure about the resignation of a director to also require disclosure regarding the departure of a director for reasons other than a disagreement or removal for cause, the appointment or departure of a principal officer, and the election of new directors. We also would combine the current Form 8-K item regarding a change in a company’s fiscal year with a new requirement to disclose any material amendment to a company’s articles of incorporation or bylaws.

Securities Act Release No. 8106, 77 SEC Docket 2579, 2582-83 (2002) (proposal).

The Commission also proposed that domestic issuers subject to § 13(a) or 15(d) must file Form 8-K within two business days of a triggering event. *Id.* at 2599-2600.

In a separate Release the Commission further proposed a new requirement for company principal executive and financial officers to certify to their knowledge the information in company quarterly and annual reports is true in all important respects and that the reports contain all information about the company of which they are aware that they believe is important to a reasonable investor. Exchange Act Release No. 46,079, 77 SEC Docket 2629 (2002) (proposal); *see also* SEC Published List of [945] Companies Whose Officers Are Ordered to Certify Accuracy and Completeness of Recent Annual Reports, Press Rel. 2002-96 (June 28, 2002).

54. *See* Michael Schroeder, *SEC Proposes Accounting Disciplinary Body*, WALL ST. J., Jan. 17, 2002, at C1; *Pitt Elaborates on Proposal for New Board to Govern Accountants, Asks for Dialogue*, 34 Sec. Reg. & L. Rep. (BNA) No. 4, at 153 (Jan. 28, 2002).

55. *In Protest, POB Votes to Disband; Panel to Consider SEC Chief’s Urging Reversal*, 34 Sec. Reg. & L. Rep. (BNA) 154 (2002); POB Final Ann. Rep. (2001).

In its final Annual Report the POB made its own proposal for reform. *Id.* at 50-59. The POB proposal recommended “an independent legislatively mandated oversight structure,” *id.* at 51, called the Independent Institute of Accountancy; with a Board selected by a committee composed of the Chair of the SEC, the Chair of the Federal Reserve Board, and the Secretary of the Treasury. *Id.* The POB recommended that all accounting standard setting should be under one roof, consolidating accounting, auditing, and independence standards. *Id.* at 51-52. The POB recommended disbanding peer review in favor of staff inspections by an independent staff hired by the new Institute for firms that audit more than 100 public corporations each year. *Id.* at 53. The POB also recommended special reviews as necessary. *Id.* The POB further recommended a new Office of Enforcement and Discipline be formed with full legal authority to investigate allegations of wrongdoing by public accounting firms and their personnel, including subpoena power.

The POB proposed that funding for the new Institute be provided through fees imposed or fees on public corporations. *Id.* at 54-55.

systematic review of accounting standard-setting by the Financial Accounting Standards Board (FASB), auditing oversight by the POB and other private and state agencies, and accountant independence.⁵⁶

The need for significant reform of the accounting profession was particularly stressed in Congressional hearings early in 2002.

Former SEC Chairman Roderick M. Hills, for example, testified on February 12, 2002 to the Senate Committee on Banking, Housing & Urban Affairs:

[T]he system itself needs a major overhaul. The head of NYU's Accounting Department, Paul Brown, put it well:

"It's the old adage of a F.A.S.B. rule. It takes four years to write it, and it takes four minutes for an astute investment banker to get around it."

Second, it is increasingly clear that the accounting profession is not able *consistently* to resist management pressures to permit incomplete or misleading financial statements, and the profession has serious problems in recruiting and keeping the highly qualified professionals that are needed.

Third, the audit committees of too many boards are not exercising the authority given to them or the responsibility expected of them. . . .

The financial papers produced dutifully each year by publicly traded companies have become a commodity. Companies produce them largely because they are required to do so. Few CEOs regard this work product as having any intrinsic value. Accounting firms compete for business more on price than on the quality of their personnel or procedures.

The POB recommended the adoption of legislation codifying the SEC regulation governing independence, but emphasized that tax work not involving advocacy and attest work be allowed and that small public businesses as defined by the SEC should not be subject to any restrictions on nonaudit services. *Id.* at 55-57.

The POB also proposed audit rotation every seven years. *Id.* at 57. See also GAO, *The Accounting Profession: Status of Panel on Audit Effectiveness: Recommendation to Enhance the Self-Regulation System* (GAO-02-411 May 2002).

56. See, e.g., *Accounting Debacles Spark Calls for Change: Here's the Rundown*, WALL ST. J., Feb. 6, 2002, at C1; *Former SEC Chairman Levitt Renews Call for Additional Restrictions on Auditing Firms*, 34 Sec. Reg. & L. Rep. (BNA) No. 4, at 155 (Jan. 28, 2002); David Leonhardt, *How Will Washington Read the Signs? The Race is on for Tougher Regulation of Business*, N.Y. TIMES, Feb. 10, 2002, at 1.

If a company does take an interest in the structure of its balance sheet and profit and loss statement, it is far more likely to be caused by a desire to be innovative in how they report their profits than in the quality of the auditor's work. They hire bankers and consultants to design corporate structures that will give them a stronger looking balance sheet and, perhaps, keep the profits and losses of related companies off of their financial papers.⁵⁷

It is worth disaggregating several specific issues.

First, the off balance sheet transactions that Enron employed were made in accordance with generally accepted accounting standards. This appropriately focused attention on the quality of the existing accounting standard setting organization, the FASB. Long before Enron, the political and financial weaknesses of the FASB were much discussed. As former SEC Chairman David Ruder has stated:

The Chairman of the SEC and others have recently complained that the FASB process for creating standards is too slow, citing the Board's failure to deal extensively with lease financing, special purpose entities, and other off balance sheet financing vehicles. Delays in promulgation are in part due to the care taken by the Board to hear the views of affected parties, especially the business community. The Board can increase the speed of its deliberations, and it is considering ways to do so. It must continue to assess the effects of its proposed standards on business operations.

Despite its attempts to seek the views of the business community, the FASB faces difficulty in obtaining financing from business, which often objects to FASB standards that affect business interests. The FASB is financed through sales of its work product and through contributions by accounting firms and businesses. When businesses do not like the FASB's standards or its process for creating them, they sometimes withdraw financial support, or fail to provide it in the first place. The FASB continually faces difficulties in financing its operations. The accounting profession is supportive, but generally speaking business is not. Institutional investors and investment bankers, who benefit greatly

57. *Accounting and Investor Protection Issues Raised in Enron and Other Public Companies: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 107th Cong. 1-2 (2002) (testimony of Roderick M. Hills), available at <http://www.senate.gov/~banking102-02hr/021202/hills.htm> [hereinafter *Hearing*].

from financial statement disclosures, contribute little to the FAF, creating a classic free rider problem.

I believe the solution to the financial pressures on the FASB would be to provide a system of financing . . . FASB should be financed by payments by preparers and users of financial statements. If a voluntary system cannot be established, Congress should enact legislation creating financing for the FASB.⁵⁸

Paul A. Volcker, now Chair of the International Accounting Standards Committee Foundation, similarly has testified:

[P]roblems, building over a period of years, have now exploded into a sense of crisis. That crisis is exemplified by the Enron collapse. But Enron is not the only symptom. We have had too many restatements of earnings, too many doubts about “pro forma” earnings, too many sudden charges of billions of dollars to “good will”, too many perceived auditing failures accompanying bankruptcies to make us at all comfortable. To the contrary, it has become clear that some fundamental changes and reforms will be required to provide assurance that our financial reporting will be accurate, transparent, and meaningful.⁵⁹

Congress or the SEC should systematically review the process and substance of accounting standard setting. It is urgently necessary to restore and strengthen the fundamental premise that financial statements will provide a “fair presentation” of an entity’s financial position. This both involves addressing specific disclosure items such as off balance sheet transactions, stock options, and derivatives, and strengthening the independence of accounting standard setting.

The key here, as elsewhere, is money. You can not expect a government agency or private entity to be truly independent without an assured source of funds. Congress should explore means to legislate a user or accounting firm fee system that will provide such independence.

Second, enveloping the generally accepted accounting principles today largely adopted by the FASB is the SEC mandatory disclosure system. The mandatory disclosure system deserves to be under sharp question. How could financial reporting practices sufficient to bankrupt the seventh largest industrial firm in the country so long go undisclosed? Is this simply an isolated instance of bad disclosure or is Enron suggestive of more

58. *Id.* at 5-6 (testimony of David S. Ruder).

59. *Id.* at 1 (testimony of Paul A. Volcker Feb. 14, 2002).

systematic failure?

The SEC began to grapple with the latter, more disturbing possibility. In December 2001 the Commission issued a cautionary Release on “pro forma” financial information,⁶⁰ rapidly followed by a similar statement regarding the selection and disclosure of critical accounting policies and practices,⁶¹ and a consequential and broad new interpretation of the pivotal management discussion and analysis disclosure item.⁶²

More needs to be done. The Commission should carefully review whether SEC oversight of the generally accepted accounting principles and the context of its mandatory disclosure system has unacceptably deteriorated.

The Commission also needs to seriously and patiently review whether we currently have the right construct of disclosure requirements, proceeding item by item, and whether changes in timing and delivery of data would be appropriate given evolving changes in technology and international securities trading.

Finally, at its core, Enron involved an audit failure. The outside auditor both appeared to operate with significant conflicts of interest and to have been too beholden to a highly aggressive corporate management.

Several aspects of the Enron audit failure deserve particularized attention.

First, the POB, primarily responsible for overseeing SEC auditors, was much criticized. Former SEC Chairman Harold Williams, for example, stated:

The Public Oversight Board was created by the profession during my chairmanship as an effort at self-regulation. We expressed concern at the time whether the peer review process administered by the profession would be adequate. But, as believers in the principle of self-regulation, we concluded that the Board

60. Securities Act Release No. 8039, 76 SEC Docket 896 (Dec. 4, 2001).

61. Securities Act Release No. 8040, 76 SEC Docket 983 (Dec. 12, 2001). In 2002 the Commission proposed amendments to the MD&A Item to require a new Application of Critical Accounting Policies section in company reports. The new section both would include disclosure about accounting estimates that result from application of critical accounting principles *and* the initial adoption of accounting policies that have a material impact on a company’s financial presentation. Securities Act Release No. 8098, 77 SEC Docket 1631 (2002) (proposal).

62. Securities Act Release No. 8056, 76 SEC Docket 1770 (2002). This Commission statement delineated additional disclosure that should occur concerning (1) off balance sheet arrangements; (2) commodity contracts, including those indexed to measures of weather, commodity prices, or quoted prices of service capacity, such as energy and bandwidth capacity contracts; and (3) related party transactions. The Commission statement was premised on the assumption that Item 303(a) of Regulation S-K already requires disclosure of “known trends” or “known uncertainties” that could result in a registrant’s liquidity or capital resources increasing or decreasing in a material way.

should have the opportunity to prove itself. In my opinion, the events over the intervening years have demonstrated that it does not meet the needs and is not adequate. Under the peer review system adopted in 1977, the firms periodically review each other. To my knowledge, there has never been a negative review of a major firm. However, the peer review is not permitted to examine any audits that are subject to litigation. The reviews focus on the adequacy of quality control procedures and do not examine the audits of companies to see if the peer would have arrived at a different conclusion. Peer review has proved itself insufficient. Particularly as the Big Eight has become only the Big Five, peer review in its present form becomes too incestuous. A system needs to be established which is independent of the accounting profession, transparent and able to serve both effective quality control and disciplinary functions.

Further, the Board is not adequately funded and is beholden for its funding to the very people it is supposed to oversee. I suggest that the SEC consider a requirement that a percentage of the audit fees of public companies be assessed to pay for independent oversight, whether it is the Public Oversight Board or a successor body, so that its funding is assured.⁶³

Former SEC Chairman David Ruder went further and urged replacement of the POB with “a new body which will be separate from the AICPA and whose board will be composed entirely of public members who have no connection to the accounting profession.”⁶⁴

63. *Hearing, supra* note 57, at 3 (testimony of Harold M. Williams).

64. *Hearing, supra* note 57, at 4 (testimony of David S. Ruder).

In June 2002 the SEC also criticized the accounting profession’s disciplinary program’s inherent weaknesses in Exchange Act Release No. 46,120, 77 SEC Docket at 2832, 2838-39 (2002).

Peer reviews may not consistently be as thorough as necessary. Peer review is the process by which other accountants assess and test compliance with quality control systems for the accounting and auditing practices of SEC Practice Section (“SECPS”) members. The objectives of peer review are to determine whether the reviewed firm: (i) designed its system to meet Quality Control Standards established by the AICPA; (ii) complied with its quality control system to provide reasonable assurance of complying with professional standards; and (iii) complied with SECPS membership requirements. Upon the completion of a review the peer reviewer prepares a report and a letter of comments, which may recommend improvements to the firm’s system of compliance. . . .

The disciplinary process is voluntary. The disciplinary program is conducted within the auspices of the AICPA, which is a voluntary private sector organization dominated by accounting firms.

There is no independent and dependable funding source. During discussions about the POB’s reviews of the firms’ systems of quality controls over auditor independence, the SECPS took the unprecedented step of threatening to halt the funding for the POB’s reviews.

In March 2002 I testified to the Senate Banking, Housing & Urban Affairs Committee that a new auditing self-regulatory organization is necessary.⁶⁵ It should replace not just the POB, but a byzantine structure of accounting disciplinary bodies that generally have lacked adequate and assured financial support; clear and undivided responsibility for discipline; and an effective system of SEC oversight.

The success of such a new SRO will be in careful attention to detail. I recommended:

- A legal structure similar to that in sections 15A and 19 of the Securities Exchange Act which apply to the securities associations and other securities industry self-regulatory organizations and addresses such topics as purposes, powers, and discipline.⁶⁶

- A clear scope provision articulating which auditors should be subject to the new SRO and a mandate that they be subject to the SRO.

- A privilege from discovery of investigative files to facilitate auditing discipline during the pendency of other government or private litigation.

- Crucially, the new SRO should be permitted, subject to SEC oversight, to adopt new auditing standards that can evolve over time. These rules would be limited by SEC rulemaking and, of course, Congressional legislation.

- As with the accounting standard-setting body, a pivotal decision involves funding. To effectively operate over time, any new auditing SRO must have an assured source of funding. The most logical basis of such funding may prove to be a Congressionally mandated fee on covered auditing firms.

- The new SRO will need to draw on the expertise of the accounting profession to ensure technical proficiency. A supervisory board with a minority of industry representatives and a majority of public representatives may prove to be an appropriate balance. The chair of such a board, however, should be a public member.

The disciplinary process relies solely on information gathered from accountants. The process is generally limited to reviewing information obtained from the accountants and does not include obtaining information from third parties, such as management of the audit client

Sanctions are weak. The most stringent sanction in an AICPA proceeding is expulsion from the AICPA, which does not directly affect an accountant's ability to practice before the Commission or elsewhere.

The disciplinary proceedings are not public. AICPA disciplinary proceedings are conducted behind closed doors and, while improvements have been made in the public reporting of sanctions, limited information is available regarding the results of its proceedings.

Id. (internal citations omitted).

65. *Hearing, supra* note 57 (testimony of Joel Seligman).

66. 6 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 2692-2723, 2787-2830 (3d ed. 1990).

• I believe the most significant issue may prove to be who conducts periodic examinations and inspections. To paraphrase the classical adage: Who will audit the auditors? I urged serious consideration be devoted to replacing peer review with a professional examination staff in the new SRO. Peer review has been, to some degree, unfairly maligned. But even at its best it involves competitors reviewing competitors. The temptation to go easy on the firm you review lest it be too critical of you is an unavoidable one. While the inspection processes of the New York Stock Exchange and the National Association of Securities Dealers are not panaceas, they suggest a workable improvement.

• Finally it would be wise to statutorily replicate § 15(b)(4)(E) of the Securities Exchange Act, which can impose liability on a broker-dealer who has “failed reasonably to supervise.” Particularly in firms with as many offices as the leading auditing firms, a clearly delineated supervision standard strikes me as vital to effective law compliance.

By July 2002 there were three significant proposals with respect to auditing oversight, the third of which, popularly known as the Sarbanes-Oxley Act,⁶⁷ was enacted in late July.

(1) *The Oxley Bill*: On April 24, 2002, the House adopted H.R. 3763, sponsored by House Financial Services Committee Chair Michael G. Oxley,⁶⁸ by a vote of 334 to 90.⁶⁹

Section 2(a) of the Oxley Bill would have required the SEC not to accept a financial statement unless the accountant is subject to a system of review by a public regulatory organization in compliance with section 2 and SEC rules.⁷⁰

Section 2(b)(1) would have authorized creation of a five-member board, two of whom “have recent experience in auditing public companies”; two may be licensed to practice public accounting; and one of whom has never been licensed to practice public accounting.

Section 2(b) would have required the Public Regulatory Organization (PRO):

(2) . . .

67. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., and 29 U.S.C.) [hereinafter Sarbanes-Oxley Act].

68. H.R. 3763, 107th Cong. (2000) (reported in House), at § 2(a) [hereinafter Oxley Bill].

69. *CARTA Accounting Bill Passes House; First Comprehensive Bill Since Enron*, 34 Sec. Reg. & L. Rep. (BNA) 691 (Mar. 29, 2002).

70. Oxley Bill, *supra* note 68, § 2(a).

(A) to be able to carry out the purposes of this section and to comply, and to enforce compliance by accountants and persons associated with accountants, with the provisions of this Act, professional ethics and competency standards, and the rules of the organization;

(B) to perform a review of the work product (including the quality thereof) of an accountant or a person associated with an accountant; and

(C) to perform a review of any potential conflicts of interest between an accountant (or a person associated with an accountant) and the issuer, the issuer's board of directors and committees thereof, officers, and affiliates of such issuer, that may result in an impairment of auditor independence.

(3) Such organization shall have the authority to impose sanctions, which, if there is a finding of knowing or intentional misconduct, may include a determination that an accountant is not qualified to certify a financial statement, or any categories of financial statements, required by the securities laws, or that a person associated with an accountant is not qualified to participate in such certification

...

(5) Any such organization shall have in place procedures to minimize and deter conflicts of interest involving the public members of such organization, and have in place procedures to resolve such conflicts.

(6) Any such organization shall have in place procedures for notifying the boards of accountancy of the States of the results of reviews and evidence under paragraphs (2) and (3).

(7) Any such organization shall have in place procedures for notifying the Commission of any findings of such reviews, including any findings regarding suspected violations of the securities laws.

...

(9) Any such organization shall have in place a mechanism to allow the organization to operate on a self-funded basis. Such funding mechanism shall ensure that such organization is not solely dependent upon members of the accounting profession for such funding and operations.

(10) Any such organization shall have the authority to request, in a manner established by the Commission, that the Commission, by subpoena or otherwise, compel the testimony of witnesses or the production of any books, papers, correspondence, memoranda, or other records relevant to any accountant review proceeding or necessary or appropriate for the organization to carry out its purposes. . . .⁷¹

The Oxley Bill was much criticized for the membership of its board; the weakness of its enforcement mechanisms; the effect to which its overall operation would subsequently be provided by SEC rule; and for its limited approach to auditor conflicts of interest.

(2) *The SEC Rulemaking Proposal*: In June 2002 the SEC proposed rule changes to Regulation S-X and Item 401 of Regulation S-K.⁷² The Commission rulemaking proposal was striking for the vehemence of its premise:

The current system of oversight has not produced a credible result. Flaws in the system have contributed to the confluence of several factors that have undermined investor confidence in financial information and market efficiency. Those factors include:

- The dramatic and sometimes sudden reversals of public companies' financial conditions, with corresponding significant losses by investors and pensioners;
- Revelations of accounting irregularities at public companies, including large and seemingly well-regarded companies;
- The number of restatements of financial information by public companies;
- Increasing pressures on company management and auditors in today's economic environment;
- Continuing concerns about the oversight of the accounting profession, including issues regarding the independence and effectiveness of the current peer review and disciplinary processes; and

71. *Id.* § 2(b)(1)-(10).

72. Exchange Act Release No. 46,120, *supra* note 64, at 2832. The Commission further explained of its proposed rules: "We will implement any legislation that is enacted. The Commission must proceed with its proposal under its existing statutory mandate, however, to strengthen investor confidence in the oversight of the auditing process and assure investors of comprehensive reform in the event that no legislation is passed." *Id.* at 2841.

- The ineffectiveness of the Public Oversight Board (“POB”) that had overseen the peer review system of public accountants.⁷³

The core of the Commission proposal was a new Article 13 of Regulation S-X that proposes Public Accountability Boards (PABs). Under proposed § 13-03 the Commission would be required to approve each PAB.⁷⁴ Each PAB would be required to submit for Commission review specified documents such as its organizational structure and proposed budget.⁷⁵ The Commission would review PAB submissions to determine whether each PAB satisfies criteria specified in §§ 13-04(b)-(i).⁷⁶

73. *Id.* at 2833 (internal citations omitted).

74. *Id.* § 210.13-03.

75. *Id.* § 210.13-03(c).

76. These provisions would have addressed:

(b) Organizational structure, board membership, and budget. A PAB shall:

(1) Have a fixed number of board members:

(i) None of whom may be, or have been at any time in the two-year period immediately preceding his or her PAB term, an employee of any accountants’ professional organization;

(ii) No more than one-third of whom, and in any event no more than three of whom, may:

(A) Be, or have been at any time in the ten-year period immediately preceding his or her PAB term, an accountant or a partner, principal, shareholder, or managerial employee of an accounting firm; or

(B) Be a retired partner, principal, shareholder, or managerial employee of an accounting firm, eligible to receive benefits under an accounting firm’s partner retirement plan or a comparable plan; and

(iii) The remainder of whom shall be designated as “public board members;”

(2) Have staggered terms for board members;

(3) Have a Chairman and Vice Chairman who are selected from among the public board members, and at least one of whom shall serve on a full-time basis; and

(4) Have the means, capacity and plan to obtain the resources to employ a professional staff that includes a sufficient number of professionals with expertise in the audit process and quality control reviews to structure and supervise the quality control reviews required under paragraph (f) of this section, to conduct the supplemental reviews and disciplinary proceedings described in paragraph (g) of this section, and to engage consultants and other representatives and advisers necessary to carry out the purposes of this § 210.13.

(C) Charter and bylaws. A PAB’s charter and bylaws shall:

(1) Provide that the entity shall be a not for profit entity,

(2) Include quorum provisions that insure that the public board members will have the ability to control the outcome of any matter submitted to a vote of the board;

(3) Provide that the entity shall be subject to and shall act in accordance with Commission oversight as described in paragraph (i) of this section; . . .

(d) Rules, membership requirements, systems, and procedures. A PAB shall have in place rules, membership requirements, systems, and procedures designed to further the goals described in § 210.13-03(c)(3), and sufficient to accomplish, at a minimum, the following:

...

(ii) Require members and adjunct members to agree to be bound by the PAB’s rules and membership requirements;

(2) Require that members accountants maintain a system of quality control for the accountant's accounting and auditing practice designed to meet the requirements of quality controls set or designated as authoritative by the PAB, but encompassing, at a minimum, the requirements described in paragraph (e) of this section;

...

(4) Have a continuing program of review of each member firm's quality control systems concerning accounting practices, auditing practices, and adherence to Commission and professional auditor independence requirements; and administer that program according to the criteria described in paragraph (f) of this section;

(5) Direct member firms to make and keep for specified periods of time records that:

(i) Are required by professional standards in connection with each audit, review, or attest of a registrant's financial statements or reports; or

(ii) Otherwise document the procedures performed and the resolution of material issues during each audit or review engagement;

...

(8) Adopt appropriate policies to address any conflicts or potential conflicts of interest that may arise involving the PAB's board members, employees, contractors, and professional representatives;

(9) Collect from each registrant that is an adjunct member of the PAB, and from each member accounting firm, reasonable fees and charges, which fees may be assessed by the PAB according to schedules specifying different fees for different classes of registrants and accounting firms, sufficient:

(i) To fund the operation and administration of the PAB; and

(ii) To fund the operation and administration of an accounting standards-setting body endorsed by the Commission as the primary source for generally accepted accounting principles;

(10) Collect from each member accounting firm reasonable fees and charges sufficient to recover the costs and expenses of conducting or overseeing quality control reviews of that firm as described in paragraph (f) of this section;

(11) Provide fair procedures for disciplining and sanctioning accountants and for resolving disputes with member accountants and adjunct members concerning fees, document requests and requests for testimony, including procedures providing for appropriate notice to the member accountant or adjunct member, the Commission, and the public of any action that could result or has resulted in suspension or bar of a member accountant or a loss of good standing by a member accountant or adjunct member;

(12) Set, or rely on designated private sector bodies to set, auditing, ethical or quality control standards for its members and, to the extent it relies on private sector bodies to set such standards, oversee such bodies and request that such matters as the PAB deems appropriate be added to the standard-setting agendas of such private sector bodies, and notify the Commission of each such request;

(13) Request that matters be added to the agenda of private sector bodies that set accounting or independence standards, and notify the Commission of each such request;

...

(16) Provide for extending full faith and credit to the sanctions and good standing requirements of any other PAB, such that an accountant sanctioned by, or an accountant or registrant in violation of the good standing requirements of, one PAB may not evade any sanction, inquiry, or failure of good standing by switching its membership to a different PAB;

(17) Provide or require training for accountants in matters related to accounting, auditing, attestation, assurance, ethics, independence, and quality controls; and

(18) Perform such other duties or functions as shall be provided in any rule or order that the Commission may adopt or issue in furtherance of the public interest or for the protection of investors and to carry out the purposes of this § 210.13.

...

(g) Supplemental reviews and disciplinary proceedings. (1) A PAB shall have rules, membership requirements, systems, and procedures, incorporating the criteria described in paragraphs (g)(2) through (g)(9) of this section, pursuant to which a PAB may:

(i) Institute public proceedings (hereinafter "disciplinary proceedings") to determine whether an accountant has engaged in any act or practice, or omitted to act, in violation of the rules or membership requirements adopted by the PAB or professional standards, and to impose remedial or disciplinary sanctions for any such act, practice, or omission; and

(ii) On the basis of information suggesting the possibility of any such act, practice, or omission, engage in a nonpublic practice of requesting and reviewing information (hereinafter "supplemental reviews") to determine whether to institute disciplinary proceedings;

(2) If a PAB, at any time, becomes aware of information indicating that a violation of the securities laws has or is likely to have occurred, then the PAB promptly shall notify the Commission of that information. A PAB may initiate a disciplinary proceeding regarding that information only after notifying and consulting with the Commission;

(3) A PAB shall establish fair procedures for supplemental reviews and for disciplinary proceedings. In any disciplinary proceeding, a PAB shall bring specific charges, notify such firm or person of those charges, give such firm or person an opportunity to defend against those charges, and keep a record. Disciplinary proceedings shall be public unless otherwise ordered by the PAB with the prior approval of the Commission;

(4) For purposes of supplemental reviews or disciplinary proceedings, a PAB may request that any person provide testimony or documents relevant to the review or proceeding;

(5) PAB board members who are not public board members may be consulted in connection with supplemental reviews and disciplinary proceedings but shall not have a vote in the PAB's determination whether to institute a disciplinary proceeding, what findings to make in a disciplinary proceeding, or what sanctions to impose;

(6) If, as the result of a disciplinary proceeding, a PAB finds that an accountant has engaged in any act or practice, or omitted to act, in violation of the rules or membership requirements adopted by the PAB or professional standards, then the PAB may impose any appropriate disciplinary or remedial sanctions including revocation or suspension of membership, or expulsion from, the PAB; limitations on activities, functions, and operations, including requiring a member firm to resign a specific audit, review or attestation engagement; suspending or barring an accountant from participating in any way in any audit, review or attest engagement for any Commission registrant; fine; censure; or any other appropriate sanction;

(7) Whenever a PAB imposes a disciplinary sanction against an accountant, the PAB shall report such sanction in writing to the accountant against whom the sanction is imposed, to the Commission, to the appropriate State or foreign financial regulatory authority or authorities with which such firm or such person is licensed, registered, or certified to practice public accounting, and to the public.

...

(8) In the event that a PAB is unable to conduct or complete a proceeding under this section because of the refusal of any person to testify, produce documents, or otherwise cooperate with the PAB, the PAB shall report such refusal to the Commission. If the uncooperative party is a registrant, the PAB shall also report such refusal to any market or exchange where the registrant's securities are traded or listed. A PAB may refer any other matter to the Commission, as the PAB deems appropriate; and

(9) PAB rules shall require member accounting firms:

(i) To notify the PAB in the event that the member firm employs or becomes associated with an individual accountant during any period in which that individual accountant is subject to a sanction, order or ruling issued by a PAB; and

(ii) To undertake procedures to ensure that the individual accountant does not violate the terms of the sanction, order or ruling.

(h) Public reporting. A PAB shall report to the Commission and to the public at least annually,

...

Significantly, each audited or reviewed financial statement contained in a report or financial statement filed with the SEC would have to be prepared by an accountant who is a member in good standing of a PAB.⁷⁷

Of particular consequence under the SEC proposal was the requirement that no more than one-third of a PAB's members during the ten years preceding a PAB term could be accountants.⁷⁸ Somewhat oddly the Commission proposal did not specify the number of members of the PAB, but contemplated that a PAB with nine members would meet the objectives of the proposal.⁷⁹ The proposal was also question-begging in only proposing that the PAB chair would be full time.⁸⁰

Funding would not be discretionary for the accounting profession but would be provided by PAB-imposed fees on accounting firms and SEC registrations who would be denominated adjunct members of the PAB.⁸¹

(i) Commission oversight. A PAB shall consent to, and act in compliance with, Commission oversight as follows:

(1) The Commission, by rule, may abrogate, add to, and delete from the rules of a PAB as the Commission deems necessary or appropriate to ensure the fair and efficient administration of the PAB, to conform its rules to requirements of the securities laws or the rules and regulations thereunder, or otherwise in furtherance of the purposes of the securities laws. The Commission shall notify the PAB of any such action prior to publication of the notice of proposed rulemaking in the Federal Register;

(2) The Commission staff periodically may inspect and monitor the operations, records, and results of a PAB to ensure the PAB is operating in the public interest and for the protection of investors and fulfilling the purposes of the Commission in adopting this § 210.13.

(3) The PAB shall, in accordance with paragraphs (g)(7) and (d)(11) of this section, promptly notify the Commission whenever it imposes any final disciplinary sanction on any member accountant or determines any member accountant or adjunct member to be delinquent. The Commission may review that sanction . . .

(4) The Commission, by order, may remove from office or censure any board member of a PAB if the Commission finds, on the record after notice and opportunity for hearing, that such member has willfully violated any provision of the securities laws, the rules or regulations thereunder, or the rules of the PAB, willfully abused his or her authority, or without reasonable justification or excuse has failed to enforce compliance with any such provision or any professional standard by any accountant that is a member of the PAB.

(5) If the Commission finds that a PAB has failed or is failing to comply with any of the conditions of recognition described in this § 210.13-04, the Commission may, by order, withdraw recognition of such PAB

Id. §§ 210.13-04(b)-(i).

Section 13-05 then would have authorized the confidentiality of PAB proceedings and PAB immunity from civil liability; § 13-06 would have authorized Commission exemptions; and § 13-07 would have created a specific exemption for foreign accountants. *Id.* at §§ 210.13-05 to 13-07.

77. *Id.* §§ 210.13-01(a) and 210.13-02(b).

78. *Id.* § 210.13-03(b)(1).

79. Exchange Act Release No. 46,120, *supra* note 64, at 2850-52.

80. *Id.* § 210.13-03(b)(3). "We envision that the remaining PAB members would devote approximately 20 to 25 percent of their professional time to PAB activities." *Id.* at 2852.

81. *Id.* § 210.13-03(d)(9). Under § 13-03(d)(10) each accounting firm would bear the cost of its own quality control review. *Id.* § 210.13-03(d)(10).

Professional audit, quality control, and ethics standards could either be set by a PAB or a designated private sector body.⁸² The SEC proposal generally did not address new accounting independence standards.

To replace POB, the proposal would build on the most successful part of the AICPA's SEC Practice Section Peer Review Process "to create a stronger, more diligent, and independent system."⁸³ Section 13-04(f), however, is notable for its limitations to accounting firms with more than seventy SEC clients, which the Commission believed then meant ten accounting firms.⁸⁴ Significantly § 13-04(a) then went well beyond the POB to authorize the PAB to engage in supplementary reviews and disciplinary proceedings.⁸⁵

Unaddressed by the Commission's proposal was the fundamental question of whether the Commission was authorized, in the absence of new legislation, to adopt these new rules.⁸⁶

In July 2002, after WorldCom announced a \$3.85 billion restatement of its financial reports,⁸⁷ the Senate, on July 15, 2002, adopted the Public Company Accounting Reform and Investor Protection Act—the Sarbanes Bill—by a vote of 97 to 0.⁸⁸ Within ten days a House-Senate Conference Committee largely acceded to the substance of the Sarbanes Bill and in late July Congress enacted what was ultimately styled the Sarbanes-Oxley Act.⁸⁹ The new Act is in eleven titles.

Title I begins with § 101(a) which establishes the Public Company Accounting Oversight Board. This Board, subject to SEC review under § 107, is empowered to:

82. *Id.* §§ 210.13-03(d)(12)-(13).

83. *Id.* at 2859.

84. *Id.*

85. However, the PAB would be required to consult with the SEC before instituting a disciplinary proceeding. *Id.*

86. See *SEC v. American Banker's Ass'n*, 804 F.2d 739 (D.C. Cir. 1986) and *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990), which provide the basis for skepticism as to whether or not the SEC has such authority. See generally AMERICAN BAR ASSOCIATION, ABA SPECIAL STUDY ON MARKET STRUCTURE, LISTING STANDARDS AND CORPORATE GOVERNANCE 30-39 (May 17, 2002) (characterizing the *Business Roundtable* case as consistent with a narrow interpretation of SEC authority under § 19(c) of the Securities Exchange Act).

87. See, e.g., *WorldCom Record Restatement Prompts More Probes; SEC Fraud Suit*, 34 *Sec. Reg. & L. Rep.* (BNA) 1064; *President, Lawmakers Express Outrage at WorldCom News as SEC Brings Suit*. *Id.* at 1065.

88. S. 2673, 107th Cong., 2d Sess. (2002); see also S. Res. 107-205, 107th Cong., 2d Sess. (2002).

89. Oxley Bill, *supra* note 68. The vote was overwhelming, 99 to 0 in the Senate, 423 to 3 in the House. *Corporate-Oversight Bill Passes, Eases Path for Investor Lawsuits*, WALL ST. J., July 26, 2002, at A1.

- (1) register public accounting firms that prepare audit reports for issuers, in accordance with section 102;
- (2) establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers, in accordance with section 103;
- (3) conduct inspections of registered public accounting firms, in accordance with section 104 and the rules of the Board;
- (4) conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms, in accordance with section 105;
- (5) perform such other duties or functions as the Board (or the Commission, by rule or order) determines are 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, or otherwise to carry out this Act, in order to protect investors, or to further the public interest;
- (6) enforce compliance with this Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, by registered public accounting firms and associated persons thereof; and
- (7) set the budget and manage the operations of the Board and the staff of the Board.⁹⁰

The Board has five full-time members, no more than two of whom “shall be or have been certified public accountants.”⁹¹ Selection would be made by the SEC, after consultation with the Chairman of the Board of Governors and the Secretary of the Treasury.⁹² Board members would

90. Sarbanes Bill, *supra* note 68, § 101(c). The Senate report accompanying the Sarbanes Bill notably explained: “The bill requires the Board to establish or adopt auditing, quality control, and ethics standards for the audit of public companies. The Committee has concluded that the Board’s plenary authority in this area is essential for the Board’s effective operation . . .” Public Company Accounting Reform and Investor Protection Act of 2002, Report of Senate Comm. on Banking, Hous. & Urban Affairs, S. REP. NO. 107-205, 107th Cong., 2d Sess. 12 (2002) [hereinafter Senate Comm. Rep.].

91. Sarbanes Bill, *supra* note 68, § 101(c)(2).

92. *Id.* § 101(e)(4).

serve staggered five year terms with a two term limit.⁹³

The Board, among other powers, would be authorized by § 101(f):

(4) to appoint such employees, accountants, attorneys, and other agents as may be necessary or appropriate, and to determine their qualifications, define their duties, and fix their salaries or other compensation (at a level that is comparable to private sector self-regulatory, accounting, technical, supervisory, or other staff or management positions);

(5) to allocate, assess, and collect accounting support fees established pursuant to section 109, for the Board, and other fees and charges imposed under this title

Section 101(g) then authorizes the Board to establish rules for (1) its operation and administration; (2) delegation of function; (3) ethics and conduct of the Board and its members; and (4) other requirements of the Act.

Under § 102 each public accounting firm that prepares or issues any audit report must register with the Board on such form as the Board may prescribe;⁹⁴ file periodic reports; and pay registration and annual fees.

93. *Id.* § 101(e)(5).

94. Section 102(b)(2) provides:

Each public accounting firm shall submit, as part of its application for registration, in such detail as the Board shall specify—

(A) the names of all issuers for which the firm prepared or issued audit reports during the immediately preceding calendar year, and for which the firm expects to prepare or issue audit reports during the current calendar year;

(B) the annual fees received by the firm from each such issuer for audit services, other accounting services, and non-audit services, respectively;

(C) such other current financial information for the most recently completed fiscal year of the firm as the Board may reasonably request;

(D) a statement of the quality control policies of the firm for its accounting and auditing practices;

(E) a list of all accountants associated with the firm who participate in or contribute to the preparation of audit reports, stating the license or certification number of each such person, as well as the State license numbers of the firm itself;

(F) information relating to criminal, civil, or administrative actions or disciplinary proceedings pending against the firm or any associated person of the firm in connection with any audit report;

(G) copies of any periodic or annual disclosure filed by an issuer with the Commission during the immediately preceding calendar year which discloses accounting disagreements between such issuer and the firm in connection with an audit report furnished or prepared by the firm for such issuer; and

(H) such other information as the rules of the Board or the Commission shall specify as necessary or appropriate in the public interest or for the protection of investors.

Id. § 102(b)(2).

Section 103(a)(1) directs the Board, by rule, to

establish, including, to the extent it determines appropriate, through adoption of standards proposed by 1 or more professional groups of accountants designated pursuant to paragraph (3)(A) or advisory groups convened pursuant to paragraph (4), and amend or otherwise modify or alter, such auditing and related attestation standards, such quality control standards, and such ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by this Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors.

Specifically § 103(a)(2) requires the Board's rules

(A) shall include in the auditing standards that it adopts, requirements that each registered public accounting firm shall—

(i) prepare, and maintain for a period of not less than 7 years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report;

(ii) provide a concurring or second partner review and approval of such audit report (and other related information), and concurring approval in its issuance, by a qualified person (as prescribed by the Board) associated with the public accounting firm, other than the person in charge of the audit, or by an independent reviewer (as prescribed by the Board); and

(iii) describe in each audit report the scope of the auditor's testing of the system of the internal control structure and procedures of the issuer required by section 404(b),⁹⁵ and present (in such

95. Section 404(b) provides:

With respect to the internal control assessment required by subsection (a), 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. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Id. § 404(b).

Section 404(a) directs the SEC to:

prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78(m) or 78(o)(d)) to contain an internal control report, which shall –

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

report or in a separate report)—

(I) the findings of the auditor from such testing;

(II) an evaluation of whether such internal control structure and procedures—

(aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

(bb) 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 being made only in accordance with authorizations of management and directors of the issuer; and

(III) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing.

(B) shall include, in the quality control standards that it adopts with respect to the issuance of audit reports, requirements for every registered public accounting firm relating to—

(I) monitoring of professional ethics and independence from issuers on behalf of which the firm issues audit reports;

(ii) consultation within such firm on accounting and auditing questions;

(iii) supervision of audit work;

(iv) hiring, professional development, and advancement of personnel;

(v) the acceptance and continuation of engagements;

(vi) internal inspection; and

(vii) such other requirements as the Board may prescribe, subject to subsection (a)(1).⁹⁶

(2) 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.

Id. § 404(a).

96. Section 103(a)(3) authorizes the Board to adopt other standards, including in § 103(a)(3)(B),

Under §§ 104(a) and (b) the Board is directed to conduct a continuing program of inspections, annually with respect to each registered public accounting firm and associated persons of that firm⁹⁷ that regularly provides audit reports for more than 100 issuers, and not less frequently than once every three years, for other registered public accounting firms.

Under § 104(d), in conducting an inspection, the Board shall

- (1) inspect and review selected audit and review engagements of the firm (which may include audit engagements that are the subject of ongoing litigation or other controversy between the firm and 1 or more third parties), performed at various offices and by various associated persons of the firm, as selected by the Board;
- (2) evaluate the sufficiency of the quality control system of the firm, and the manner of documentation and communication of that system by the firm; and
- (3) perform such other testing of the audit, supervisory, and quality control procedures of the firm as are necessary or appropriate in light of the purpose of the inspection and the responsibilities of the Board.

The Board is required to prepare a written report of inspection findings.⁹⁸ A registrant may seek Commission review of these reports.⁹⁹

Section 105 authorizes Board investigations and disciplinary proceedings of any act or practice, or omission to act, by a registered

initial and transitional standards. *Id.* § 103(a)(3).

Section 103(c) directs the Board to:

cooperate on an ongoing basis with professional groups of accountants designated under subsection (a)(3)(A) and advisory groups convened under subsection (a)(4) in the examination of the need for changes in any standards subject to its authority under subsection (a), recommend issues for inclusion on the agendas of such designated professional groups of accountants or advisory groups, and take such other steps as it deems appropriate to increase the effectiveness of the standard setting process.

Id. § 103(c).

97. Section 2(a)(9)(A) defines a person associated with a public accounting firm to mean:

any individual proprietor, partner, shareholder, principal, accountant, or other professional employee of a public accounting firm, or any other independent contractor or entity that, in connection with the preparation or issuance of any audit report—

- (i) shares in the profits of, or receives compensation in any other form from, that firm; or
- (ii) participates as agent or otherwise on behalf of such accounting firm in any activity of that firm.

Id. § 2(a)(9)(A).

Section 2(a)(9)(B) authorizes the Board to exempt persons “engaged only in ministerial tasks” from the definition in Section 2(a)(9)(A). *Id.* § 2(a)(9)(B).

98. *Id.* § 104(g).

99. *Id.* § 104(h).

public accounting firm, or any associated person of the firm. Section 105(b)(2) authorizes Board rules to

(A) require the testimony of the firm or of any person associated with a registered public accounting firm, with respect to any matter that the Board considers relevant or material to an investigation;

(B) require the production of audit work papers and any other document or information in the possession of a registered public accounting firm or any associated person thereof, wherever domiciled, that the Board considers relevant or material to the investigation, and may inspect the books and records of such firm or associated person to verify the accuracy of any documents or information supplied;

(C) request the testimony of, and production of any document in the possession of, any other person, including any client of a registered public accounting firm that the Board considers relevant or material to an investigation under this section, with appropriate notice, subject to the needs of the investigation under this section, with appropriate notice, subject to the needs of the investigation, as permitted under the rules of the Board; and

(D) provide for procedures to seek issuance by the Commission, in a manner established by the Commission, of a subpoena to require the testimony of, and production of any document in the possession of, any person, including any client of a registered public accounting firm, that the Board considers relevant or material to an investigation under this section.

Failure to cooperate may result in suspension or bar of any person from being associated with a registered public accounting firm; suspend or revoke the registration of the public accounting firm; or invoke other lesser sanctions.¹⁰⁰

The Board may refer any investigation to the SEC, other federal functional regulator (as defined in § 509 of the Gramm-Leach-Bliley Act), or at the direction of the SEC, to the United States Attorney General, a state attorney general, or other appropriate state regulatory authority.¹⁰¹ Section 104(b)(5) addresses document confidentiality and availability of

100. *Id.* § 104(b)(3). Under § 104(b)(4)(A) the Board must notify the SEC of any pending investigation involving a potential violation of the securities laws. *Id.* § 104(b)(4)(A).

101. *Id.* § 104(b)(4)(B).

documents to government agencies; § 104(b)(6) addresses immunity.

Disciplinary procedure, including sanctions, are proposed in § 104(c); notably, § 104(c)(6) addresses failure to supervise. These parallel existing SEC standards under § 15(b)(4) of the 1934 Act.

Section 106 addresses foreign public accounting firms. They would be subject to Board rules “in the same manner as a [domestic] accounting firm,” but § 106(c) authorizes SEC and Board exemption.

All Board rules and disciplinary action, other than initial or transitional standards, are subject to Commission oversight.¹⁰²

Section 109 is a pivotal funding provision both for the new Board and also for accounting principles standard setting boards, as delineated in § 108. Both boards are authorized to establish annual budgets,¹⁰³ subject to SEC approval, § 109(c)(1)(e), which are to be funded from annual accounting support fees from issuers, which itself is subject to SEC approval.¹⁰⁴ Section 109(g) established a market capitalization formula for allocation of support fees among issuers. Section 109(c)(2) is a novel and unexpected provision to allocate funds collected by the Board from monetary penalties to fund merit scholarships for undergraduate and graduate accounting students.

Section 203 would amend § 10A of the 1934 Act to require audit partner rotation every five years.

Section 204 specifies auditor reports to audit committees concerning: (1) critical accounting policies and practices; (2) alternative treatments of financial information discussed with management of an issuer; and (3) other written communications with management.

A separate, not mutually exclusive approach to accounting discipline and independence, would be to require mandatory rotation of auditors at specific intervals such as five or seven years. Former SEC Chairman Harold Williams advocated this approach:

I would urge the Commission to consider a requirement that a public company retain its auditor for a fixed term with no right to terminate. This could be for five years or perhaps the Biblical seven.

102. *Id.* § 107. This Section treats the Board as a registered securities association under §§ 17(a)(1) and (b)(1) of the 1934 Act and applies §§ 19(b)-(e) to proposed rules; SEC authority to all rules; and SEC review of disciplinary actions and sanctions. In addition, § 107(d) authorizes the SEC to censure the Board; rescind its authority; or remove Board members from office. “The rules for SEC oversight of the Board are generally the same as those that apply to SEC oversight of the National Association of Securities Dealers, under section 19 of the Securities Exchange Act.” Senate Comm. Rep., *supra* note 90, at 19.

103. Oxley Bill, *supra* note 68, § 109(b).

104. *Id.* § 109(d)-(e).

After that fixed term, the corporation would be required to change auditors. As a consequence of such a requirement, the auditor would be assured of the assignment and, therefore, would not be threatened with the loss of the client and could exercise truly independent judgment. Under such a system the client would lose its ability to threaten to change auditors if in its judgment the assigned audit team was inadequate. It would also reduce the client's ability to negotiate on fees, and almost certainly the audit would cost more. The required rotation of auditors would also involve the inefficiency of the learning curve for the new auditor. I view all of these potential costs acceptable if it reinforces the auditor's independence and makes the work more comprehensive. The client could be given a right to appeal to a reconstituted independent oversight organization if it believes that it is not well served by its auditor and needs some relief.¹⁰⁵

Section 207 of the Sarbanes-Oxley Act directs the Comptroller General within one year of enactment to conduct a study of the potential effects of requiring the mandatory rotation of registered public accounting firms.

In Congressional hearings preceding the Sarbanes-Oxley Act, particular attention was devoted to the wisdom of separating accounting firm audit services from consulting. One early result of Enron had been an acceleration of this process by voluntary means in the Big Five accounting firms. Former Chairman David Ruder thoughtfully explained:

One of the substantial worries regarding the Andersen audit of Enron has been that Andersen not only audited Enron, but also was paid approximately the same amount for non-audit services. It has been reported that in the year 2000 Andersen was paid audit fees of approximately \$25 million and non-audit fees of approximately \$27 million. Comparisons of the amounts of audit fees to non-audit fees for a range of companies and auditors have revealed ratios of non-audit to audit fees ranging as high as nine to one. The expressed general concern is that an audit cannot be objective if the auditor is receiving substantial non-audit fees.

The accounting profession seems to have recognized that management consulting services, which involve accounting firms in helping management make business decisions, should not be performed for an audit client. Three of the Big Five accounting

105. *Hearing, supra* note 57 (testimony of Harold M. Williams).

firms (Andersen, Ernst & Young, and KPMG) have now separated their management consulting units from their audit units by contractual splits and spinoffs, and a fourth (PricewaterhouseCoopers) has announced its intention to split off its management consulting unit in a public offering. (Wall Street Journal, p3, January 31, 2002) The fifth firm should also do so, or at least refrain from offering management consulting services to audit clients.¹⁰⁶

The Oxley Bill largely deferred to SEC rulemaking.¹⁰⁷ For this it was much criticized.

The Sarbanes-Oxley Act is far more prohibitive. Section 201 would amend § 10A of the 1934 Act to provide:

(g) PROHIBITED ACTIVITIES.—Except as provided in subsection (h), it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this title or the rules of the Commission under this title or, beginning 180 days after the date of commencement of the operations of the Public Company Accounting Oversight Board . . . to provide to that issuer, contemporaneously with the audit, any non-audit service, including—

106. *Id.* (testimony of David S. Ruder).

107. Section 2(c) of the Oxley Bill addresses the conflict between audit and consulting services:

(1) MODIFICATION OF REGULATIONS REQUIRED—The Commission shall revise its regulations pertaining to auditor independence to require that an accountant shall not be considered independent with respect to an audit client if the accountant provides to the client the following nonaudit services, as such terms are defined in such regulations as in effect on the date of enactment of this Act, and subject to such conditions and exemptions as the Commission shall prescribe:

- (A) financial information system design or implementation; or
- (B) internal audit services.

(2) REVIEW OF PROHIBITED NONAUDIT SERVICES—The Commission is authorized to review the impact on the independence of auditors of the scope of services provided by auditors to issuers in order to determine whether the list of prohibited nonaudit services under paragraph (1) shall be modified. In conducting such review, the Commission shall consider the impact of the provision of a service on an auditor's independence where provision of the service creates a conflict of interest with the audit client.

(3) ADDITIONS BY RULE—After conducting the review required by paragraph (2) and at any other time, the Commission may, by rule consistent with the protection of investors and the public interest, modify the list of prohibited nonaudit services under paragraph (1).

- (1) bookkeeping or other services related to the accounting records or financial statements of the audit client;
- (2) financial information systems design and implementation;
- (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- (4) actuarial services;
- (5) internal audit outsourcing services;
- (6) management functions or human resources;
- (7) broker or dealer, investment adviser, or investment banking services;
- (8) legal services and expert services unrelated to the audit; and
- (9) any other service that the Board determines, by regulation, is impermissible.

(h) **PREAPPROVAL REQUIRED FOR NON-AUDIT SERVICES.**—A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer, in accordance with subsection (i).

The Board is authorized in § 201(b) to exempt any person, issuer, public accounting firm or transaction from the prohibitions in § 10A(g) on a case by case basis.

Section 202 then adds a new § 10A(i) to create a preapproval requirement for audit committees both with respect to audit and nonaudit services provided to the issuer by an auditor. Under the new § 10A(i)(B) preapproval is waived with respect to nonaudit services that constitute not more than 5% of the total amount of revenues paid by the issuer to the auditor.

Section 206 further prohibits a public accounting firm from performing any audit service for an issuer if a senior officer of the issuer was employed by the auditor within the prior year.

In essence the Sarbanes-Oxley Act does not so much totally prohibit auditors from providing nonaudit services, but does limit such services to immaterial amounts.

To the Senate Committee on Banking, Housing & Urban Affairs, “[t]he issue of auditor independence is at the center of this legislation.”¹⁰⁸ The Senate Committee Report emphasized it took a middle course neither completely prohibiting all nonaudit consulting services nor totally leaving the issue to the SEC or the new Board:

The intention of this provision is to draw a clear line around a limited list of non-audit services that accounting firms may not provide to public company audit clients because their doing so creates a fundamental conflict of interest for the accounting firms. The list is based on simple principles. An accounting firm, in order to be independent of its audit client, should not audit its own work, which would be involved in providing bookkeeping services, financial information systems design, appraisal or valuation services, actuarial services, and internal audit outsourcing services to an audit client. The accounting firm should not function as part of management or as an employee of the audit client, which would be required if the accounting firm provides human resources services such as recruiting, hiring, and designing compensation packages for the officers, directors, and managers of an audit client. The accounting firm should not act as an advocate of the audit client, which would be involved in providing legal and expert services to an audit client in legal, administrative, or regulatory proceedings, or serving as a broker-dealer, investment adviser, or investment banker to an audit client, which places the auditor in the role of promoting a client’s stock or other interests.¹⁰⁹

108. Senate Comm. Rep., *supra* note 90, at 21:

Public confidence in the integrity of financial statements of publicly-traded companies is based on belief in the independence of the auditor from the audit client

The statutory independent audit requirement has two sides. It grants a franchise to the nation’s public accountants—their services, and only their services, and certification, must be secured before an issuer of securities can go to market, have the securities listed on the nation’s stock exchanges, or comply with the reporting requirements of the securities laws. This is a source of significant private benefit to the public accountants.

But the franchise is conditional. It comes in return for the CPA’s assumption of a public duty and obligation. As a unanimous Supreme Court noted nearly 20 years ago: “In certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a *public* responsibility. * * * [That auditor] owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to 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.” *United States v. Arthur Young*, 465 U.S. 805, 817-18 (1984) (emphasis added).

109. *Id.* at 18; *see generally id.* at 15-18.

Perhaps of greatest consequence is the fact that the Sarbanes-Oxley Act does not require the division of an accounting firm into an audit firm and a separate nonaudit firm. It requires instead that for each audit client there is a prohibition of nine nonaudit services and a preapproval requirement for other nonaudit services. This means an audit firm can continue to provide nonaudit services to other clients.

A key SEC reform of the 1970s, the Board of Directors audit committee, was also sharply criticized for its ineffectuality. Former SEC Chairman Roderick Hills, during whose term in 1977 the New York Stock Exchange adopted the requirement of the independent audit committee, was both detailed in his delineation of shortcomings and in his proposed solutions:

- Audit committees may consist of people who satisfy the objective criteria of independence, but their election to the board is too often the whim of the CEO, who decides each year who will sit on the audit committee and who will chair it.
- Audit committees too often seek only to reduce the cost of the audit rather than to seek ways to improve its quality. They do not play a sufficient role in determining what the fair fee should be.
- Audit committees seldom ask the auditor if there is a better, fairer, way to present the company's financial position.
- Audit committees seldom play a role in selecting a new audit firm or in approving a change in the partner in charge of the audit. They may well endorse an engagement or the appointment of a new team, but they are not seen as material to the selection process.
- Audit committees seldom establish themselves as the party in charge of the audit. . . .

Congress may wish . . . to require that:

- Corporations of a certain size with publicly traded stock have an effective, independent audit committee in order to avoid a finding that there is a material weakness in the corporation's internal controls;
- Corporations of a certain size have an independent nominating committee with the authority to secure new directors and appoint all members of the audit committee;

- Audit committees be solely responsible for the retention of accounting firms and be responsible for the fees paid them.¹¹⁰

The New York Stock Exchange (NYSE) Corporate Accountability and Listing Standards Committee “in the aftermath of the ‘meltdown’ of significant companies due to failures of diligence, ethics, and controls,” recommended a broader set of corporate governance reforms to the New York Stock Exchange Board of Directors, which generally adopted the recommendations and proposed them to the SEC for approval.¹¹¹

110. *Hearing, supra* note 57 (testimony of Hills), at 5, 8.

111. The NYSE Corporate Accountability and Listing Standards Committee (July 26, 2002) recommended to the NYSE Board of Directors in its final report:

1. Require listed companies to have a majority of independent directors.

...

A company of which more than 50% of the voting power is held by an individual, a group or another company need not have a majority of independent directors on its board or have nominating/governance and compensation committees composed of independent directors. However, controlled companies must have at least three directors who meet the standards of independence for the audit committee, and the audit committee must be composed entirely of independent directors.

2. Tighten the NYSE definition of “independent director.”

- No director qualifies as “independent” unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations.

- In addition:

- No director who is a former employee of the listed company can be “independent” until five years after the employment has ended.
- No director who is, or in the past five years has been, affiliated with or employed by a (present or former) auditor of the company (or of an affiliate) can be “independent” until five years after the end of either the affiliation or the auditing relationship.
- No director can be “independent” if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that employs the director.
- Directors with immediate family members in the foregoing categories must likewise be subject to the five-year “cooling-off” provisions for purposes of determining “independence.”

...

3. Empower non-management directors to serve as a more effective check on management.

- The non-management directors of each company must meet at regularly scheduled executive sessions without management.
- The independent directors must designate, and publicly disclose the name of, the director who will preside at the executive sessions.

...

4. Require listed companies to have a nominating/corporate governance committee composed entirely of independent directors.

...

The nominating/corporate governance committee must have a written charter that addresses:

- the committee's purpose—which, at minimum, must be to: identify individuals qualified to become board members, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; and develop and recommend to the board a set of corporate governance principles applicable to the corporation.
- the committee's goals and responsibilities—which must reflect, at minimum, the board's criteria for selecting new directors, and oversight of the evaluation of the board and management.
- an annual performance evaluation of the committee.

5. Require listed companies to have a compensation committee composed entirely of independent directors.

The compensation committee must have a written charter that addresses:

- the committee's purpose—which, at minimum, must be to discharge the board's responsibilities relating to compensation of the company's executives, and to produce an annual report on executive compensation for inclusion in the company's proxy statement, in accordance with applicable rules and regulations.
- the committee's duties and responsibilities—which, at minimum, must be to:
 - review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and set the CEO's compensation level based on this evaluation. In determining the long-term incentive component of CEO compensation, the committee should consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company's CEO in past years.
 - make recommendations to the board with respect to incentive-compensation plans and equity-based plans.
- an annual performance evaluation of the compensation committee.

6. Add to the "independence" requirement the following new requirements for audit committee membership at listed companies:

- Director's fees are the only compensation an audit committee member may receive from the company.
- A director who meets the definition of "independence" mandated for all audit committee members, but who also holds 20% or more of the company's stock (or who is a general partner, controlling shareholder or officer of any such holder) cannot chair, or be a voting member of, the audit committee.
- The audit committee chair must have accounting or related financial management expertise.

7. Increase the authority and responsibilities of the audit committee, including granting it the sole authority to hire and fire independent auditors, and to approve any significant nonaudit relationship with the independent auditors.

The audit committee must have a written charter that addresses:

- the committee's purpose—which, at minimum, must be to: (a) assist board oversight of (i) the integrity of the company's financial statements, (ii) the company's compliance with legal and regulatory requirements, (iii) the independent auditor's qualifications and independence, and (iv) the performance of the company's internal audit function and independent auditors; and (b) prepare the report that SEC rules require be

included in the company's annual proxy statement.

- the duties and responsibilities of the audit committee—which, at minimum, must be to:

- retain and terminate the company's independent auditors (subject, if applicable, to shareholder ratification).

- at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company.

- discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations."

- discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.

- as appropriate, obtain advice and assistance from outside legal, accounting or other advisors

- discuss policies with respect to risk assessment and risk management

- meet separately, at least quarterly, with management, with internal auditors (or other personnel responsible for the internal audit function), and with independent auditors

- review with the independent auditor any audit problems or difficulties and management's response

- set clear hiring policies for employees or former employees of the independent auditors

- report regularly to the board of directors

- an annual performance evaluation of the audit committee.

8. Increase shareholder control over equity-compensation plans.

- Shareholders must be given the opportunity to vote on all equity-compensation plans.

- A broker may not vote a customer's shares on any equity-compensation plan unless the broker has received that customer's instructions to do so.

9. Require listed companies to adopt and disclose their corporate governance guidelines.

The following subjects should be addressed in the corporate governance guidelines:

- Director qualification standards

- Director responsibilities

- Director access to management and, as necessary and appropriate, independent advisors

- Director compensation

- Director orientation and continuing education

- Management succession

- Annual performance evaluation of the board

Title III of the Sarbanes-Oxley Act adds § 10A(m) of the 1934 Act and expressly directs:

The audit committee of each issuer, in its capacity as a committee of each issuer, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each registered public accounting firm shall report directly to the audit committee.¹¹²

...
10. Require listed companies to adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.
...

Each company may determine its own policies, but all listed companies should address the most important topics, including the following:

- Conflicts of interest
- Corporate opportunities
- Confidentiality
- Fair dealing
- Protection and proper use of company assets
- Compliance with laws, rules and regulations (including insider trading laws)
- Encouraging the reporting of any illegal or unethical behavior

11. Require listed foreign private issuers to disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.
...

12. Require each listed company CEO to certify to the NYSE each year:

- that the company has established procedures for verifying the accuracy and completeness of the information provided to investors; that those procedures have been carried out; and that, based upon the CEO's assessment of the adequacy of those procedures and of the diligence of those carrying them out, the CEO has no reasonable cause to believe that the information provided to investors is not accurate and complete in all material respects. The CEO must further certify that he or she has reviewed with the board those procedures and the company's compliance with them.
- that he or she is not aware of any violation by the company of NYSE listing standards.

...
13. Enable the NYSE to issue a public reprimand letter to any listed company that violates an NYSE listing standard.

Id. (boldface in original). See also Business Roundtable, Principles of Corporate Governance (May 2002) (recommending audit, corporate governance, and compensation committees comprised solely of independent directors and board evaluations).

112. Sarbanes-Oxley Act, *supra* note 67, § 301 (§ 10A(m)(2)).

The audit committee is required to be comprised entirely of independent directors¹¹³ and be authorized to engage independent counsel and other advisors.¹¹⁴

A separate principal culprit at Enron was a dysfunctional corporate management, also including senior executives, the outside auditor, and both internal and outside legal counsel.¹¹⁵ The genius of United States corporate law, if genius there be, is its redundant systems of corporate accountability. The Board is intended to monitor the principal executives. Outside accountants and outside legal counsel are supposed to buttress this accountability system, as are a series of legal devices, most notably including potential board and executive liability for false and misleading filings with the SEC and state corporate law negligence liability.

The overlapping accountability systems can individually fail. What made Enron unusual is that they all appeared to fail simultaneously.

113. Section 10A(m)(3)(B) defines independence for the purposes of § 10A(m) to mean that a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee –

- (i) accept any consulting, advisory, or other compensatory fee from the issuer; or
- (ii) be an affiliated person of the issuer or any subsidiary thereof.

Id.

114. *Id.*

115. As Former SEC Chairman David Ruder testified:

The primary fault in the Enron failure seems to be poor management. From all accounts it appears that Enron became overly aggressive in its efforts to dominate the energy trading markets, engaged in highly leveraged off balance sheet financing, engaged in extremely aggressive accounting, overstated its earnings, failed to disclose the true nature of its corporate and financial structure, and eventually lost the confidence of its creditors and trading counter parties. Enron management appears to be primarily to blame . . .

. . . the Enron problems represent a failure in corporate governance. One striking aspect of this failure is Enron's apparent lack of respect for the accounting system that underlies financial reporting. Enron seems to have purposely attempted to avoid disclosure of its true finances. Instead it should have utilized the accounting system as a means of assisting it to make sound management decisions and as a source of information helping it to provide the securities markets with a truthful statement of financial condition.

Hearing, supra note 57 (testimony of Ruder), at 6-7.

Similarly Former Chairman Hills observed:

Finally, it must be said on this point that unless one has been subjected to a serious corporate meltdown, you cannot possibly appreciate the enormous discretion that management has under GAAP to present its financial position. By changing depreciation schedules, by using different estimates or by adopting different strategies or assumptions, a company can make enormous changes in its annual income. Management too often makes these "top-level" adjustments without adequate disclosure to the public about how much their current earnings depend on such adjustments. A corporate meltdown in which I was involved three years ago was caused by top-level adjustments that accounted for 40% of the company's total income and led to a corporate admission that billions of dollars of income had been improperly reported.

Id. at 3 (testimony of Hills).

I am skeptical that similar simultaneous dysfunction will prove widespread.

I am also mindful that poorly designed new regulatory solutions could stultify the type of product innovation and risk-taking that has been consequential to the recent growth of the United States economy. I am also aware that corporate governance has largely been addressed by state corporate law.

Much of the Sarbanes-Oxley Act addressed breakdowns in the system of corporate responsibility. As the fervor of Congress increased in late July 2002, the dimensions of the legislative response increased exponentially.

Section 302 of the new Act requires each quarterly and annual report filed under § 13(a) or 15(d) of the 1934 Act to be certified by the principal executive officer or officers and the principal financial officer or officers. Each signing officer must certify that

- (1) the signing officer has reviewed the report;
- (2) 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, in light of the circumstances under which such statements were made, not misleading;
- (3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
- (4) the signing officers—
 - (A) are responsible for establishing and maintaining internal controls;
 - (B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
 - (C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(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

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.¹¹⁶

The personal responsibility imposed on the signing officers in this Section makes this among the most draconian sections of the new Act. While the Act does not go so far as to require certification by board chairs, as earlier considered, the demand for personal responsibility virtually screams from the legislative page. In this instance, Congress may have gone too far. While personal responsibility in the abstract is commendable, the way in which this burden was imposed may prove either to be unduly burdensome or satisfied by pro forma responses. Why, for example, must a signing officer "design" an internal control system if an effective system was earlier designed by another? Is it realistic that a signing officer will always be able to identify every significant deficiency? Can a signing officer rely on an outside accountant to evaluate internal controls?¹¹⁷

116. *Id.* § 302.

117. The Senate Committee Report accompanying the Sarbanes was relatively terse in discussing § 302. The Report stressed personal responsibility:

The Committee believes that management should be held responsible for the financial representations of their companies. The bill therefore clearly establishes that CEOs and CFOs are responsible for the presentation of material in their company's financial reports.

Senate Comm. Rep., *supra* note 90, at 25.

There are, however, countervailing considerations. At many corporations the chief executive officers of late have characterized themselves as “salespersons in chief.” The certification requirement is a powerful personal reminder of the need for chief executive and financial officers to be personally involved with a significant compliance system. Certification also has the collateral advantage of signaling the securities market that it is less likely that covered corporations will have future earnings restatements.

Section 303 similarly creates a new violation for any officer or director or any person acting under the direction of any officer or director to take *any* action in contradiction of SEC rules “to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.”¹¹⁸

Section 304 requires the forfeiture by the chief executive and financial officers of bonuses or other incentive based compensation received during the twelve months following a financial disclosure that later requires an accounting restatement as a result of the issuer’s misconduct.¹¹⁹

Section 306 prohibits director or executive officer trades during pension fund blackout periods.¹²⁰

There was no effort in the Report to address the type of interpretative questions suggested by the text. *See id.* at 25-26, 53. Nor was there any effort to address the differences between § 302 and the earlier SEC order and rule proposal concerning certification. *See supra* note 53 for a discussion of both.

Section 906, a separate provision addressing criminal penalties for violation of the officer certification provision, was added later with somewhat different terms (e.g., “chief” executive officer rather than “principal” executive officer). Sarbanes-Oxley Act, *supra* note 67, at § 906.

118. *Id.* § 303.

119. *Id.* § 304.

120. Section 306(a)(4) defines a blackout period with respect to an issuer’s equity securities

(A) means any period of more than 3 consecutive business days during which the ability of not fewer than 50 percent of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase, sell, or otherwise acquire or transfer an interest in any equity of such issuer held in such an individual account plan is temporarily suspended by the issuer or by a fiduciary of the plan; and

(B) does not include, under regulations which shall be prescribed by the Commission—

(i) a regularly scheduled period in which the participants and beneficiaries may not purchase, sell, or otherwise acquire or transfer an interest in any equity of such issuer, if such period is—

(I) incorporated into the individual account plan; and

(II) timely disclosed to employees before becoming participants under the individual account plan or as a subsequent amendment to the plan; or

(ii) any suspension described in subparagraph (A) that is imposed solely in connection with persons becoming participants or beneficiaries, or ceasing to be participants or beneficiaries,

Senator Edwards successfully sponsored an amendment to the Sarbanes-Oxley Act to provide in § 307:

RULES OF PROFESSIONAL RESPONSIBILITY FOR ATTORNEYS.

Not later than 180 days after the date of enactment of this section, the Commission shall establish rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of public companies, including a rule—

(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company, or any agent thereof to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors comprised solely of directors not employed directly or indirectly by the company, or to the board of directors.¹²¹

This, as adopted, was not among the most felicitously drafted provisions of the new Act. It did limit the reporting attorney's burden to material violations of securities law or breach of fiduciary duty or similar violation and limited the reporting burden to a report within the corporation. On the other hand the reference to Commission power to establish rules "setting forth minimum standards of professional conduct for attorneys" sounded as if the SEC was empowered to supplant state authority over attorneys. As one who was consulted in the drafting of the

in an individual account plan by reason of a corporate merger, acquisition, divestiture, or similar transaction involving the plan or plan sponsor.

Id.

121. *Id.* § 307. On March 7, 2002, sixteen law professors, including the author, signed a letter drafted by the University of Illinois Law School's Richard Painter urging such an amendment to Rule 102(e). Letter to Harvey Pitt from Richard Painter et al. (Mar. 7, 2002) (on file with author). *See also Law Professors Urge SEC to Require Lawyers to Disclose Securities Violations to Directors*, 34 Sec. Reg. & L. Rep. (BNA) 431 (2002); *SEC Unlikely to Mandate that Lawyers Report Violations by Clients*. *Id.* at 555; *Senator Seeks Indication from Pitt of Intent to Force Lawyers to Report Clients*. *Id.* at 1009.

provision, it was clear to me that was not the intent. This was largely intended to codify the preexisting Commission power to adopt Rule 102(e) of its Rules of Practice, a power that has been periodically and unsuccessfully challenged.¹²² The reference in § 307 to “appearing and practicing before the Commission in any way” is directly derived from Rule 102(e). Since Congress codified the SEC authority to adopt Rule 102(e) in § 602, the reference to “minimum standards of professional conduct for attorneys” appears unnecessary.

In a different sense § 307 is too narrow. Surely an attorney should have an equal burden to report an antitrust, environmental, health, or safety law violation. The limitations to violations of “securities laws or breach of fiduciary duty or similar violation” was drafted on the floor when a question was posed as to whether earlier introduced language referring to “material violations of law” was germane to a securities act.¹²³

Section 308 provides that specified civil penalties shall be added to disgorgement funds for investors.¹²⁴

Section 401 amends § 13 of the 1934 Act to require the Commission to adopt rules providing for disclosure of material off-balance sheet transactions, arrangements, obligations and other relationships; and to address pro forma financial information.¹²⁵

Section 402 also amends § 13 to prohibit most loans to corporate directors or executive officers.¹²⁶

Section 403 amends § 16(a) of the 1934 Act to require insider reports to be filed within ten days after a person becomes a beneficial owner, director, or officer and within two days after a change of ownership.¹²⁷

Section 406 requires companies subject to §§ 13(a) or 15(d) to adopt codes of ethics for senior financial officers or explain why such a code was not adopted.¹²⁸

Section 407 would require an audit committee to have a financial expert or explain why one was not selected for the audit committee.¹²⁹

122. 10 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4870-84 (3d ed. 1996 & 2002 Supp.).

123. Sarbanes-Oxley Act, *supra* note 67, at § 308.

124. *Id.* § 308.

125. *Id.* § 401.

126. *Id.* § 402.

127. *Id.* § 403.

128. *Id.* § 406. Moreover § 406(b) requires prompt disclosure in Form 8-K by any issuer of any change in or waiver in the code of ethics for senior financial officers. This should be called the Andrew Fastow provision, but limiting it to senior *financial* officers makes it too narrow. Other officers can also violate a code of ethics.

129. *Id.* § 407.

Section 409 similarly requires “real time” “plain English” reporting under § 13(a) or 15(d) of material changes in the financial condition or operation of the issuer.¹³⁰

One step removed from Enron, but strongly suggested by its failure, are serious questions of the integrity of investment analysts. As former SEC Chairman Arthur Levitt, Jr., emphatically testified in February 2002:

For years, we’ve known that analysts’ compensation is tied to their ability to bring in or support investment banking deals. In early December, with Enron trading at 75 cents a share, 12 of the 17 analysts who covered Enron, rated the stock either a hold or buy.

Two years ago, I asked the New York Stock Exchange and the National Association of Securities Dealers to require investment banks and their analysts to disclose clearly all financial relationships with the companies they rate. Last week, we finally saw a response from the self-regulators. But it’s not enough. Wall Street’s major firms—not its trade group—need to take immediate steps to reform how analysts are compensated. As long as analysts are paid based on banking deals they generate or work on, there will always be a cloud over what they say.¹³¹

Congress should investigate whether investment banks have adequately maintained “Chinese walls” between retail brokerage and underwriting and whether, more fundamentally, securities firms that underwrite should be separated from retail brokerage.¹³² These are not new questions¹³³ but they have been revived by Enron.¹³⁴

In April 2002 New York Attorney General Elliot Spitzer reached a tentative settlement with Merrill Lynch, after earlier that month obtaining a court order requiring Merrill Lynch to make disclosures to investors regarding its relationships with investment banks. Spitzer had alleged that Merrill’s analysts were not independent and objective. The settlement, like

130. *Id.* § 409.

131. *Hearing, supra* note 57, at 2 (testimony of Arthur Levitt, Jr.).

132. Leslie Wayne, *Congress’s Scrutiny Shifts to Wall Street and Its Enron Role*, N.Y. TIMES, Feb. 19, 2002, at A1.

133. *See, e.g.*, 6 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2977-80 (3d ed. 1990) (proposed segregation of brokerage and underwriting in 1930s); 8 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3618-31 (3d ed. 1991) (Chinese wall).

134. *See, e.g.*, Rachel McTague & Kip Betz, *Broker-Dealers: Regulators, Lawmakers Unveil Proposals to Minimize Securities Analysts’ Conflicts*, 34 Sec. Reg. & L. Rep. (BNA) 225 (2002); Rosen, *Liability for Optimistic Analyst Reports*, 16 INSIGHTS NO. 4 at 9 (2002). *See* discussion in Senate Comm. Rep., *supra* note 90, at 32-39.

the order, will require disclosure of conflicts of interests and the amount of money received by Merrill Lynch as a result of the conflicts. Other issues, such as fines, penalties, or restitution, if any, were not resolved by the interim settlement.¹³⁵

In 2002 the Commission approved new NASD and NYSE rules relating to research analyst conflicts of interest:¹³⁶

The proposed rule changes address analyst conflicts of interest in connection with the preparation and publication of research reports for equity securities. . . .

First, the proposals limit the relationships and communications between a firm's investment banking department and its research department. Specifically, no research analyst may be supervised or controlled by a firm's investment banking department. In addition, the investment banking personnel may not discuss pending research reports with research analysts prior to distribution, unless the communication was intermediated by staff from the legal/compliance department. Similarly, the research report may not be reviewed by the company that is the subject of the report, except for checking factual sections for accuracy.

Second, the proposed changes to SRO rules place various restrictions on, and impose certain disclosure requirements with respect to, analyst and firm compensation arrangements. An analyst's compensation may not be tied to specific investment banking transactions. If an analyst received compensation that was based on the firm's general investment banking revenues, that fact must be disclosed in the firm's research reports. The firm also would have to disclose in a company's research report if it or its affiliates have managed or co-managed a public offering of equity securities for or received investment banking compensation from the subject company in the past 12 months, and if it expects to

135. Kip Betz, *Broker-Dealers: Merrill Lynch, Spitzer Reach Interim Deal; New Securities Research Disclosures Ordered*, 34 Sec. Reg. & L. Rep. (BNA) 647 (2002). See also Patrick McGeehan, *S.E.C. Begins Investigation into Analysts*, N.Y. TIMES, Apr. 26, 2002, at C1; Gretchen Morgenson, *Requiem for an Honorable Profession*, N.Y. TIMES, May 5, 2002, at C1; *SEC to Conduct Formal Inquiry into Possible Conflicts by Analysts*, 34 Sec. Reg. & L. Rep. (BNA) 669 (2002); Rachel McTague, *Broker-Dealers: Wall Street Firms Receive SEC Letters Seeking Information in Analyst Probe*, *Id.* at 705. See also Richard A. Oppel, Jr., *Merrill Replaced Research Analyst Who Upset Enron*, N.Y. TIMES, July 30, 2002, at A1.

136. Securities Act Release No. 45,526, 77 SEC Docket 196 (2002) (proposal); Securities Act Release No. 45,908, 77 SEC Docket 1737 (2002) (adoption).

receive or intends to seek compensation for investment banking services in the next three months. Finally, if an analyst recommends a security in a public appearance, and the issuer was a client of his or her firm, the analyst must disclose that fact.

Third, the proposed rule changes would take certain measures to prevent promises of favorable research. A firm may not offer a favorable research rating or specific price target to a company as consideration or inducement for the receipt of business or compensation. The proposal also would require "quiet periods" during which a firm acting as manager or co-manager of a securities offering could not issue a report on a company; within 40 days after an initial public offering ("IPO") or within 10 days after a secondary offering of an inactively traded security.

Fourth, the proposals place various restrictions on an analyst's personal trading. In general, no analyst (or household member) may purchase or receive an issuer's securities prior to its IPO, if the company engages in a type of business covered by the analyst. In addition, no analyst may trade securities issued by companies the analyst follows for the period beginning 30 days prior to the issuance of the research report and ending five days after the date of the report. The analyst also may not engage in trading contrary to the analyst's most recent recommendations.

Fifth, the proposed rule changes require certain disclosures about the ownership of securities by the firm and the analyst. An analyst must disclose in public appearances, and a firm must disclose in research reports, if the analyst or a member of his or her household has a financial interest in the securities of a recommended company. If, as of the previous month end, the firm owns one percent or more of any equity class of the company, that fact also must be disclosed during the analyst's public appearance or in the research report.

Finally, the proposal requires specific additional disclosures in research reports to provide investors with better information to make assessments of a firm's research. Firms must define in research reports the meaning of all ratings used in the ratings system and the definition of each rating must be consistent with its plain meaning (*e.g.*, "hold" must mean hold and not "sell"). In addition, regardless of the ratings system employed, firms must provide the percentage of all ratings assigned to buy/hold/sell categories. The proposal also requires a price chart that maps the historical price

movements of the recommended security and indicates those points at which ratings or price targets were assigned or changed.¹³⁷

Title V of the Sarbanes-Oxley Act adds a new § 15D to direct the Commission or a registered securities association to adopt rules regarding analyst conflicts of interest arising from equity security recommendations, including rules designed:

(1) to foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts, by—

(A) restricting the prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engaged in investment banking activities, or persons not directly responsible for investment research, other than legal or compliance staff;

(B) limiting the supervision and compensatory evaluation of securities analysts to officials employed by the broker or dealer who are not engaged in investment banking activities; and

(C) requiring that a broker or dealer and persons employed by a broker or dealer who are involved with investment banking activities may not, directly or indirectly, retaliate against or threaten to retaliate against any securities analyst employed by that broker or dealer or its affiliates as a result of an adverse, negative, or otherwise unfavorable research report that may adversely affect the present or prospective investment banking relationship of the broker or dealer with the issuer that is the subject of the research report, except that such rules may not limit the authority of a broker or dealer to discipline a securities analyst for causes other than such research report in accordance with the policies and procedures of the firm;

(2) to define periods during which brokers or dealers who have participated, or are to participate, in a public offering of securities as underwriters or dealers should not publish or otherwise distribute research reports relating to such securities or to the issuer of such securities;

(3) to establish structural and institutional safeguards within registered brokers or dealers to assure that securities analysts are

137. Securities Act Release No. 45,908, *supra* note 136, at 1738-39.

separated by appropriate informational partitions within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision; and

(4) to address such other issues as the Commission, or such association or exchange, determines appropriate.

(b) DISCLOSURE.—The Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange, shall have adopted, not later than 1 year after the date of enactment of this section, rules reasonably designed to require each securities analyst to disclose in public appearances, and each registered broker or dealer to disclose in each research report, as applicable, conflicts of interest that are known or should have been known by the securities analyst or the broker or dealer, to exist at the time of the appearance or the date of distribution of the report, including –

(1) the extent to which the securities analyst has debt or equity investments in the issuer that is the subject of the appearance or research report;

(2) whether any compensation has been received by the registered broker or dealer, or any affiliate thereof, including the securities analyst, from the issuer that is the subject of the appearance or research report, subject to such exemptions as the Commission may determine appropriate and necessary to prevent disclosure by virtue of this subparagraph of material non-public information regarding specific potential future investment banking transactions of such issuer, as is appropriate in the public interest and consistent with the protection of investors;

(3) whether an issuer, the securities of which are recommended in the appearance or research report, currently is, or during the 1-year period preceding the date of the appearance or date of distribution of the report has been, a client of the registered broker or dealer, and if so, stating the types of services provided to the issuer;

(4) whether the securities analyst received compensation with respect to a research report, based upon (among any other factors) the investment banking revenues (either generally or specifically earned from the issuer being analyzed) of the registered broker or dealer; and

(5) such other disclosures of conflicts of interest that are material to investors, research analysts, or the broker or dealer as the Commission, or such association or exchange, determines appropriate.¹³⁸

The balance of the original Sarbanes Bill retained within the Sarbanes-Oxley Act includes several provisions that directly address the Commission.

Most significantly § 601 of the new Act amends § 35 of the 1934 Act to increase the SEC budget to \$776,000,000 for fiscal year 2003 with new funds for pay parity, technology, and no fewer than 200 new professionals.¹³⁹

Section 408 requires the Commission to engage in enhanced review of periodic disclosure by issuers.¹⁴⁰

A new § 603 amends § 21(d) of the 1934 Act to authorize a court to prohibit persons from participating in a penny stock offerings.¹⁴¹

Section 604 amends § 15(b)(4) of the 1934 Act and § 203(e) of the Investment Advisers Act to establish Commission authority to bar or suspend the right of a person to be associated with a broker-dealer or investment adviser.¹⁴²

Several studies are required by the new Act:

(1) Section 108(d) requires a Commission study of principles-based, rather than rules-based, accounting reporting.¹⁴³

(2) Section 308(c) requires the SEC to review whether the past five years of civil penalties or disgorgements have fairly protected injured investors.¹⁴⁴

138. Sarbanes-Oxley Bill, *supra* note 67, at § 501.

139. *Id.* § 601. In late June 2002 the House voted 422 to 24 to increase the SEC authorization by 66% to \$766 million. *House Passes SEC Authorization Bill; Provides 66 Percent More Than Bush Budget*, 34 Sec. Reg. & L. Rep. (BNA) 1043 (2002). The Bush Administration, which earlier had made a budget request of \$466.9 million, *id.*, in early June proposed a \$100 million increase. *Transcript of President's Address Calling for New Era of Corporate Integrity*, N.Y. TIMES, July 10, 2002, at C4.

In July the Senate in § 601 of the Public Company Accounting Reform and Investor Protection Act unanimously voted to increase the SEC budget to \$776 million. Sarbanes-Oxley Act, *supra* note 67, at § 601.

140. *Id.* § 408.

141. *Id.* § 603.

142. *Id.* § 604.

143. *Id.* § 108(d).

144. *Id.* § 308(c).

(3) Section 401(c) requires an SEC report on off balance sheet transactions.¹⁴⁵

(4) Section 701 directs the Comptroller General to study the consolidation of public accounting firms since 1989.¹⁴⁶

(5) Section 702 directs the SEC to study the role and function of credit rating agencies on the operation of security markets.¹⁴⁷

(6) Section 703 requires the Commission to study the number of securities professionals who have been found to have aided and abetted a securities violation or to have been a primary violator.¹⁴⁸

(7) Section 704 requires the SEC to study all enforcement actions involving reporting requirements and earnings restatements during the five years preceding the new Act.¹⁴⁹

(8) Section 705 requires the Government Accounting Office (GAO) to study whether investment banks and financial advisers assisted public companies in manipulating earnings and obfuscating their true financial condition.¹⁵⁰

Titles VIII through XI were added to the initial Sarbanes bill after it was introduced in the Senate. Much in these relatively shorter titles was added in the Conference Committee.

Title VIII, which may be cited as the Corporate and Criminal Fraud Accountability Act of 2002, begins with § 802, which amends chapter 73 of title 18 of the United States Code to add a new § 1519, a criminal provision with up to a twenty-year term of imprisonment to address alteration or falsification of records in federal investigations and bankruptcy. Section 802, also adds § 1520 to create a criminal provision with up to ten-years imprisonment for destruction of corporate audit records.¹⁵¹

145. *Id.* § 401(c).

146. *Id.* § 701.

147. *Id.* § 702.

148. *Id.* § 703.

149. *Id.* § 704.

150. *Id.* § 705.

151. *Id.* § 802. These provisions were inspired by Arthur Andersen, which on March 7, 2002, was indicted, the first criminal indictment of a Big Five accounting firm. The indictment was bare bones in terms of describing those responsible at Arthur Andersen, but was nonetheless brutal in its allegations. The indictment read in part:

9. By Friday, October 19, 2001, Enron alerted the ANDERSEN audit team that the SBC had begun an inquiry regarding the Enron "special purpose entities" and the involvement of Enron's

Chief Financial Officer. The next morning, an emergency conference call among high-level ANDERSEN management was convened to address the SEC inquiry. During the call, it was decided that documentation that could assist Enron in responding to the SEC was to be assembled by the ANDERSEN auditors.

10. After spending Monday, October 22, 2001 [sic] at Enron, ANDERSEN partners assigned to the Enron engagement team launched on October 23, 2001, a wholesale destruction of documents at ANDERSEN's offices in Houston, Texas. ANDERSEN personnel were called to urgent and mandatory meetings. Instead of being advised to preserve documentation so as to assist Enron and the SEC, ANDERSEN employees on the Enron engagement team were instructed by ANDERSEN partners and others to destroy immediately documentation relating to Enron, and told to work overtime if necessary to accomplish the destruction. During the next few weeks, an unparalleled initiative was undertaken to shred physical documentation and delete computer files. Tons of paper relating to the Enron audit were promptly shredded as part of the orchestrated document destruction. The shredder at the ANDERSEN offices at the Enron building was used virtually constantly and, to handle the overload, dozens of large trunks filled with Enron documents were sent to ANDERSEN's main Houston office to be shredded. A systematic effort was also undertaken and carried out to purge the computer hard-drives and E-mail system of Enron-related files.

11. In addition to shredding and deleting documents in Houston, Texas, instructions were given to ANDERSEN personnel working on Enron audit matters in Portland, Oregon, Chicago, Illinois, and London, England, to make sure that Enron documents were destroyed there as well. Indeed, in London, a coordinated effort by ANDERSEN partners and others, similar to the initiative undertaken in Houston, was put into place to destroy Enron-related documents within days of notice of the SEC inquiry. Enron-related documents also were destroyed by ANDERSEN partners in Chicago.

12. On or about November 8, 2001, the SEC served ANDERSEN with the anticipated subpoena relating to its work for Enron. In response, members of the ANDERSEN team on the Enron audit were alerted finally that there could be "no more shredding" because the firm had been "officially served" for documents.

Indictment at 5, *United States v Arthur Anderson LLP* (S.D. Tex. 2002) (No. CRH-02-121) (on file with the Washington University Law Quarterly). *See also Andersen Charged with Obstruction over Shredding of Enron Documents*, 34 *Sec. Reg. & L. Rep.* (BNA) 443 (2002); *Andersen Partner Admits to Shredding Charge, Will Help Government*. *Id.* at 616.

On June 15, 2002, Arthur Andersen was convicted of obstruction of justice. Later that day the SEC was informed that Andersen would cease practicing before the Commission by August 31, 2002, unless the Commission determined that another date is appropriate. Kurt Eichenwald, *Andersen Guilty in Effort to Block Inquiry on Enron*, *N.Y. TIMES*, June 16, 2002, at A1.

In the aftermath of Arthur Andersen's indictment the Commission adopted a series of rules and temporary rules to minimize disruptions that could occur as a result of the indictment. Specifically, § 2-02 was added to Regulation S-X; Temporary Notes 1T, 2T, and 3T were added to the General Instructions to § 3-01 of Regulation S-X; Items 304T and 601T were added to Regulations S-B and S-K; Rule 401a, 427T, amendments to Rule 428 and Rule 437a were added to the Securities Act; Rule 12b-37 was amended under the Securities Exchange Act; General Instruction A-T1 was added to Form 20-F; and Rule 19a-1 was added to the Trust Indenture Act. Securities Act Release No. 8070, 77 SEC Docket 321 (2002) (adoption). The Commission also used its authority under § 36 of the 1934 Act to exempt any issuer who had used Arthur Andersen as an auditor from specific requirements in Forms 10-K, 10-KSB, 10-Q, 10-QSB, 20-F, as well as specific requirements of Rule 12b-25, Schedules 14A and 14C, Rule 14c-3, Schedule TO, Form 11-K, Rules 17a-5, and 17Ad-13. Securities Act Release No. 45,589, 77 SEC Docket 418 (2002). Under its exemptive authority in the Investment Company and Investment Advisers acts, the Commission adopted similar exemptions. Investment Co. Act Release No. 25,463, 77 SEC Docket 479 (2002).

Section 803 makes debts nondischargeable in bankruptcy proceedings if incurred in violation of securities fraud laws.¹⁵²

Section 804 may prove to be among the most consequential provisions of the new Act. This section amends 18 U.S.C. § 1658, which addresses all civil actions arising under an Act of Congress, to add a new § 1658(b), which provides:

(b) 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, may be brought not later than the earlier of—

(1) 2 years after the discovery of the facts constituting the violation; or

(2) 5 years after such violation.¹⁵³

This amounts to a legislative reversal of the United States Supreme Court's decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,¹⁵⁴ which had limited litigation under § 10(b) and Rule 10b-5 of the Securities Exchange Act to one year after discovery of the facts constituting a violation and three years after the violation.¹⁵⁵ The reversal of *Lampf* represents one of the most eagerly sought goals of the private plaintiff bar. Two other goals were not achieved. The Barnes-Oxley Act did not directly address the repeal of the Private Securities Litigation Reform Act of 1995¹⁵⁶ or permitting private aiding and abetting actions against attorneys and auditors and reverse through legislation the 1994 United States Supreme Court decision in *Central Bank*,¹⁵⁷ which held that such actions could not implied from the key federal securities law fraud remedy, Securities Exchange Act Rule 10b-5.¹⁵⁸

The reversal of *Lampf* nonetheless is quite significant. It represents a return to the general approach of Congress before the 1995 Act that private litigation performs an important role in deterring securities fraud. It is

152. Sarbanes-Oxley Act, *supra* note 67, at § 803.

153. *Id.* § 804(b).

154. 501 U.S. 350 (1991).

155. See generally 10 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4505-29 (3d ed. 1996).

156. *Id.* at 4636-69.

157. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

158. 9 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4479-88 (3d ed. 1992 & 2002 Ann. Supp.).

likely to lead to more private claims, particularly through its extension of the one-year-to-two-years-after-discovery standard. In 1995 Congress declined to adopt this type of approach because of a greater concern about frivolous litigation. The pendulum appears to have swung, at least temporarily, to a greater concern about malevolent corporate insiders and certified public accountants. In my own view demonization of either private litigation or malevolent corporate insiders is usually inappropriate. But the new statute of limitations may be wise as an ancillary device to deter securities fraud.

Section 805 directs the United States Sentencing Commission to review and amend specified provisions of the United States Sentencing Guidelines that, among other matters, address obstruction of justice.¹⁵⁹

Section 806 establishes whistle-blower protection for employees of companies registered under § 12 of the 1934 Act who provide information or assist an investigation which the employee reasonably believes constitutes a violation of §§ 1341, 1343, 1344, or 1348 of title 18 or of the federal securities laws.¹⁶⁰

Section 807 adds a provision that provides up to a twenty-five year term of imprisonment for securities fraud.¹⁶¹

Title IX, also known as the White Collar Crime Penalty Enforcement Act of 2002, also augments several criminal penalties.¹⁶² Notably § 906 creates criminal penalties for violation of the written certification required by the chief executive officer and chief financial officer.¹⁶³ A knowing violation can result in a fine up to \$1 million and imprisonment up to ten years.¹⁶⁴

Title X is one sentence long and conveys the sense of the Senate “that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation.”¹⁶⁵

Title XI, also known as the Corporate Fraud Accountability Act of 2002, has six substantive provisions.

Section 1102 amends 18 U.S.C. § 1512 to criminalize document mutilation.¹⁶⁶

159. Sarbanes-Oxley Act, *supra* note 67, § 805.

160. *Id.* § 806.

161. *Id.* § 807.

162. Note that § 903 increases the term of imprisonment under mail or wire fraud up to twenty years, rather than five years. *Id.* at 906.

163. *Id.* See also § 302, which is a better articulated certification provision. *Id.* § 302.

164. *Id.* § 906.

165. *Id.* § 1001.

166. *Id.* § 1102.

Section 1103 authorizes the SEC to seek from a Federal District Court a temporary freeze order whenever it appears that a corporation may make extraordinary payments to a corporate officer, director, partner, control person, agent or employee.¹⁶⁷

Section 1104 calls for prompt review by the United States Sentencing Commission of sentencing guidelines applicable to securities and accounting fraud and related offenses.¹⁶⁸

Section 1105 authorizes the SEC to issue its own order in a cease and desist proceeding prohibiting persons from acting as officers or directors of any company registered under § 12.¹⁶⁹

Section 1106 amends § 32(a) of the 1934 Act to increase specified criminal penalties up to \$5 million or \$25 million and imprisonment up to twenty years.¹⁷⁰

Section 1107 amends 18 U.S.C. § 1513(e) to add a generic prohibition against person who

knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.¹⁷¹

CONCLUSION

The Senate Report accompanying the Sarbanes Bill framed its purpose broadly:

The purpose of the bill is to address the systemic and structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility in recent months and years. . . .

167. *Id.* § 1103.

168. *Id.* § 1104.

169. *Id.* § 1105.

170. *Id.* § 1106.

171. *Id.* § 1107.

The bill also requires steps to enhance the direct responsibility of senior corporate management for financial reporting and for the quality of financial disclosures made by public companies.¹⁷²

I would amplify this articulation. At its core Enron and its sequelae were a triumph of aggressive corporate management and financial chicanery over time honored concepts such as “fair presentation” of financial information and “full disclosure” of material information.

No event in my adult lifetime has so powerfully driven home the need for public confidence in our securities markets as Enron and subsequent audit failures. If a substantial proportion of domestic and international investors cease to believe that published corporate records are honest, the loss to our stock markets can be measured in trillions of dollars, with related and substantial losses in tax revenues and employment. Confidence in our securities markets is not merely a reformer’s nostrum or a soft variable. It is a practical necessity.

The feeding frenzy pace of the final consideration and adoption of the Sarbanes-Oxley Act will inspire much critical analysis of the new law.

Did the Act go too far? There is some clumsiness in its drafting, particularly in Titles VIII to XI, which were added late in the process. Two Sections call for review by the United States Sentencing Commission of sentencing guidelines;¹⁷³ two sections address executive officer certification;¹⁷⁴ two sections address retaliation against informants.¹⁷⁵ The lawyer responsibility section is not felicitously drafted;¹⁷⁶ the basic officer certification provision may prove too draconian.¹⁷⁷

These are real defects, but the core of the Sarbanes-Oxley Act, particularly in Titles I to VII, is a thoughtful, well drafted effort to address a breakdown in corporate responsibility, that on occasion involved audit failure, auditor conflict of interest, porous generally accepted accounting principles, dysfunctional boards and audit committees, investment analysts conflict, and an overstretched SEC. At its core the Act is generally sound.

Will the Act make a difference in reviving investor confidence? I believe when this Act is combined with other changes involving more vigilant boards and audit committees, an expanded SEC with an activist enforcement program, greater private litigation, and much voluntary

172. Senate Comm. Rep., *supra* note 90, at 2.

173. §§ 805, 1104.

174. §§ 302, 906.

175. §§ 806, 1107.

176. § 307.

177. § 302.

restraint, for the foreseeable future there will be a material diminution of the type of accounting scandal that typified our recent past. This is all Congress could hope to achieve. If history is a guide, investors will gradually regain faith.

The most significant risk to the restoration of investor confidence is politics. The degree to which the SEC will subsume its traditional role as a nonpartisan independent regulatory agency and become instead a more politicized actor poses great risks. No incident in SEC history ever subjected the Commission to more criticism than the appointment of the Public Company Accounting Oversight Board on October 25, 2002.¹⁷⁸ Presumably, this criticism will be transitory and the Board, overtime, will perform an effective role. But the risk of any politization of the appointment process is clear. If the SEC becomes a political actor, its ability to enhance investor confidence is concomitantly reduced.

¹⁷⁸ Michael Schroeder, *Accounting-Board Rift Bodes Ill for SEC*, WALL ST. J., Oct. 28, 2002, at A4.

