

# Sarbanes-Oxley Act of 2002 (SOX): Implementation and Assessment

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## Points on a Continuum of Unethical Conduct

- **Rape?**
- **Burglary/Larceny?**
- **Armed Robbery?**
- **Large-scale Drug Trafficking?**
- **CFO's Manipulation of Corporate Balance Sheet? Why use the term "white collar" crime?**

# Sarbanes-Oxley Act: A Case Study in Crisis Management?

- Congress' compelling need to take symbolic action -- SOX.
- Due to globalization, the U.S. Congress cannot operate as if the country is an island.
- Look for corrective steps through future amendments and regulations.

# Analytical Assumptions

- Law tends to lag behind business practices.
- Complex business law issues must be examined in an interdisciplinary manner (business, law, macro-economics, political science, etc).

**The Sarbanes-Oxley Act of 2002 at  
[http://news.findlaw.com/hdocs/docs/gwbush/  
sarbanesoxley072302.pdf](http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf)**

- **Goal:** Restore confidence in the U.S. stock market.
- **Principal Approach:** Empower the Securities & Exchange Commission (SEC) & create the Public Company Accounting Oversight Board (PCAOB).
- **Key changes:** (i) increase legal exposure of CEOs and CFOs; (ii) regulate relationship between corporations and auditing firms (ensure auditor ‘independence’ ); and (iii) enhance corporate disclosures.
- **Some Undesirable Consequences:** (i) lawyers are reluctant to be “gatekeepers”; (ii) some accounting firms abandon auditing services, (iii) high compliance costs.

***“ [C]orporations, their officers and directors, as well as the professionals they retain have developed the ‘ethic of technical compliance’.”***

William H. Widen  
Associate Professor of Law at University of Miami

***“It is not an adequate ethical standard to aspire to get through the day without being indicted.”***

Richard Breeden  
Former SEC Chairman

***“The crime is not what is illegal, the crime is what is legal.”***

Michael Kinsley  
(then-Editor of the *New Republic*).

# SOX's Macro-Structure

- Title I – Public Company Accounting Oversight Board (partially self-financing).
- Title II – Auditor Independence (partner rotation was compromise; members of audit committee must be 'independent').
- Title III – Corporate Responsibility (includes: trading blackout periods; note that many features of SOX served to provide norms for privately-held companies).
- Title IV – Enhanced Financial Disclosures (Management & Board member: no loans).
- Title V – Analyst Conflicts of Interest (difficulty of definition & implementation).
- Title VI – Commission Resources and Authority (off-balance sheet transactions).
- Title VII – Studies and Reports (e.g. auditor concentration, credit ratings, violators and violations, investment banks, mandatory rotation of registered public accounting firms (last item Section 207 by Comptroller General)).
- Title VIII – Corporate and Criminal Fraud Accountability (enhanced protection for whistleblowers).
- Title IX – White Collar Crime Penalty Enhancement (given level of societal harm – is beheading appropriate?).
- Title X – Corporate Tax Returns.
- Title XI – Corporate Fraud and Accountability.

## SOX's Practical Impact

- Mandating that audit committees are hired and report to the Board and all members of the audit committee be “independent.”
- Strengthening auditor independence by reducing the potential for conflicts of interest.
- Enhancing the Commission's investigatory and enforcement powers.



## **Costs of Complying with SOX Section 404 – Management Assessment of Internal Controls: A Major Concern**

### **[Why not Section 302 - Corporate Responsibility for Financial Reports?]**

- Annual compliance cost for Fortune 1000 companies estimated to be \$5.1 million initially and \$3.7 million for on-going programs.
- A study by Financial Executives International put the cost at \$4.3 million per company on average. Regulators' original estimates were \$91,000 per publicly traded company.
- Estimates of large corporations that cannot meet existing deadlines fall in the 10-25% range.
- Do SOX requirements provide large corporations with a competitive advantage over smaller businesses (as is the case with the USA Patriot Act)?

# Federalism

Elliot Spitzer and his counterparts matter:

Each state has regulatory authority in this area, though jurisdictional issues arise. Lesson: pleasing the Feds is not always enough.

**New York & Delaware are the key states.**

# U.S. Extra-territoriality and its Potential Consequences

- Foreign companies threatened to de-list their securities.
- SEC Chairman Donaldson postpones (i) SOX implementation of Section 404 for foreign and small/medium companies and (ii) how to treat stock options as a corporate expense.
- Will SOX trigger comparable legislation by other countries, thus making U.S. companies subject to foreign regulators and courts? It has in Canada; others will follow.
- Will SOX encourage public corporations to reorganize as private entities, making it harder to conduct due diligence on counterparts?

# Is Declaratory Policy Consistent with Operational Policy ?

- Does the White House place a high priority on the enforcement of the law?
- Are the political appointees qualified and inclined to enforce the law?
- Do the regulators have a sufficient number of trained personnel to enforce the law?
- Do the regulators have the will to enforce the law without upper level support?
- Do the regulators have the financial and material resources to enforce the law?
- Is the U.S. Department of Justice (and other federal and state bodies) going to support SEC & PCAOB regulators' actions?

# Effective Corporate Governance Ultimately Depends On The Ethics of Corporate Personnel

- Do we expect too much from corporate Boards of Directors? If a country cannot rely on its regulators, can plaintiff lawyers fill the void (shareholder lawsuits & officer and director liability)?
- Is the U.S. corporate model viable given the 'agency' problem?
- Is the European continental model more effective since stakeholders play a role in corporate governance?
- If a country cannot rely on its regulators, can plaintiff lawyers fill the void (shareholder lawsuits & officer and director liability)?
- The separation of operational and oversight authority is critical to effective corporate governance.
- Corporate culture, not codes of conduct, is the key to corporate governance.

## **Unethical Behavior By Individuals: the Belief that . . . .**

- The conduct is not “really” illegal or immoral, which leads into gray areas.
- If one acts in his/her or the corporation’s best interests, there is a (reasonable) expectation that management will protect and benefit from such behavior.
- Transgression will never be discovered (“Master of the Universe” Phenomenon).

# Some Current Developments

- AIG President Maurice “Hank” Greenberg resigns after it is revealed that his personal charitable foundation (The Starr Foundation) gave charitable contribution of \$4 million to the Asia Society – an organization whose Board includes two AIG Independent Directors (Carla Hills & Richard Hollbrooke). Query: is one really “independent” if predisposed to certain courses of action or is serving on the board to gain networking opportunities? Greenberg like other AIG personnel to take the Fifth Amendment in connection with Elliot Spitzer’s investigations of AIG reinsurance transaction with Berkshire Hathaway’s subsidiary General Re.
- SEC’s Enforcement Director Steve Cutler resigns – during his 3+ year tenure he obtained \$6 billion in penalties. What is the policy significance? Some fear a “toothless watchdog.”
- BP-Amoco fires 252 employees for unethical behavior (i.e. bribery & corruption). How and why did this occur?
- According to Financial Times story, “[t]he trouble is that when share prices rise consistently, few pay much attention to corporate governance.” Classic warning signals include: over-dominant CEO, large number of related party transactions, and suspiciously high profits.

# Some Possible Improvements to Corporate Governance to Examine

- Licensing of individuals to serve on boards of directors, who all continuing education requirements.
- Limited number of Boards of Directors an individual may serve on and prohibit **independent directors** from holding stock in the company or its affiliates.
- Prohibition of CEOs and CFOs serving on a corporation's own Board of Directors.
- Assignment of auditors to corporation by PCAOB (2-3 year rotation).
- Elimination of fines as a civil (criminal?) penalty for corporations. Why should all shareholders suffer?
- *See also* Ira M. Millstein and Paul W. MacAvoy's Chapter "Proposals of Reform of Corporate Governance," in MacAvoy & Millstein, "The Recurrent Crisis in Corporate Governance," (Palgrave MacMillan 2003).