THE SARBANES OXLEY ACT: "BIG BROTHER IS WATCHING YOU" OR ADEQUATE MEASURES OF CORPORATE GOVERNANCE REGULATION?

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Corporate governance has become one of the hottest fields in international company law and economics. Whereas many European countries have chosen self-regulatory market-based approaches or favor "comply or explain" provisions, the U.S. government decided to take mandatory legislative actions in the aftermath of various accounting and corporate governance scandals, headed up by Enron and WorldCom. This article explains why most, if not all, of the relevant provisions regarding corporate governance are ill-conceived, and thus, should be withdrawn to prevent future economic harm. The author concludes with an evaluation and an outlook for alternatives.

I. INTRODUCTION

When U.S. President George Walker Bush put the Sarbanes-Oxley Act 2002[1] ("SOX") into force he declared: "[T]oday I sign the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[2] Whether the legal changes were as radical as politically proclaimed is debatable, yet SOX is unquestionably noteworthy as it stands for a significant drift in the U.S. corporate governance spirit. In order to understand its importance, it is indispensable to take into account the *raison d'être* by which the Act is driven. SOX is not just about specific modifications in accounting standards, disclosure provisions, or

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[1] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat.745. (2003).

[2] Press Release, Office of the Press Secretary, Remarks by President Bush at signing of H.R. 3763, the Sarbanes-Oxley Act of 2002, (July 30, 2002), *available at* http://www.whitehouse.gov/news/releases/2002/07/20020730-1.html.

criminal liability. The change for U.S. corporate governance is much more fundamental.[3] Whereas, before the enactment of SOX, corporate governance was mainly regulated by the market[4], the government now regulates corporate governance by adopting federal security laws. This shifting of power is significant. Before SOX, the general understanding was that the market was most efficient when it was able to make its own rules. Until now, the question of who governs a corporation was intrinsically tied to the question of why firms exist in general. Coase,[5] Alichian, and Demsetz[6] offered a solution to the question by coming up with the idea that directors are able to monitor firms more efficiently than the market does and therefore have a right to be in charge of the decision making. On the contrary, modern stakeholder approaches attempt to integrate the rights of employees into the decision making process, because notions of fairness are believed to incorporate such contribution when human capital is invested. While many of these approaches tackle the problem from different angles, they all have one thing in common. They all rely on the self regulatory efficiency of the market in order to explain corporate governance provisions.

[3] *See*, *e.g.,* John Friedland, *United States: The Sarbanes-Oxley Act: Corporate Governance, Financial Reporting and Economic Crime*, 23 COMP. L. 383, 384 (2002).

[4] The term "market" in this sense is not limited to the traditional market of trading goods and services, but rather represents every field where competition takes place to attract listed companies. Before the enactment of SOX there was a highly competitive "market" for U.S. states to attract corporation *inter alia via* (more relaxed) corporate governance rules in order to receive greater tax revenues and job opportunities. Moreover, there is a "market" of exchanges, such as the competition between NASDAQ and NYSE to enlist the most profitable corporations to be able to raise listing fees and boost reputation. *See* Larry Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 IOWA J. CORP. L. 1, 57 (2002). Before SOX, Corporate Governance in the U.S. mainly relied on self regulatory approaches by the states, listing standards by the NYSE and a division between federal and state jurisdiction.

[5] R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA, NEW SERIES 386, 404 (1937).

[6] Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

SOX's approach is essentially different. Determination guidelines which are directed towards the degree of influential rights and the general efficiency for the company only play a minor role. Instead, its major priority is the protection of small investors. Whoever is able to punish misconduct most effectively should be given the oversight of corporate governance, and SOX believes that the federal government is the best institution able to cope with the task.

However, it is a frequent literary argument that the SOX approach is anything but a good choice, since it fails to provide more trustworthiness, prevent future scandals, or improve corporate governance, and is thus ill-conceived.[7] In order to present a well founded analysis of this thesis, this article will place emphasis on the statutory provisions of SOX to provide answers. The requirement of independent audit committees, the restriction of corporations' purchases on nonaudit services from their auditors, the prohibition of corporate loans to officers and the requirement for CEOs and CFOs to certify financial statements and the consequences if they fail to comply, will be discussed. The author is aware of the fact, that due to the dimension of newly introduced provisions, it is only possible to discuss a small portion of the entire issue and therefore does not assert a claim to provide a comprehensive study of SOX. Instead emphasis will be placed upon special articles that are of great interest for the understanding of corporate governance.

II. INCIDENTS WHICH LED TO THE ENACTMENT OF SOX

SOX, with its radical changes in U.S. corporate governance, was not enacted out of the blue. It was enacted in the wake of a series of precedent accounting and bankruptcy scandals, which started with the collapse of Enron and was followed by the downfall of WorldCom, Adelphia Communications, Tyco, Sunbeam, Waste Management, Xerox, Global Crossing and others. The result was an almost

[7] Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance* (NYU Sch. of Law, NYU Law and Econ. Working Paper No. 3, 2004), *available at* http://lsr.nellco.org/nyu/lewp/papers/3.

unthinkable loss of stock value,[8] which was underlined by a variety of causes. In the bull market of the mid 1990's there was a high demand for stocks of fast growing companies which created the fantasy for huge future profit earnings. During that time the potential of growth was more significant for the determination of a high stock price than the analysis of current financial statements. Thus, "new breed executives,"[9] which lead companies like Enron and WorldCom were concerned with beating the analysts' growth expectations every quarter.[10]

This was mainly achieved by acquisition of other businesses and manipulation of financial statements.[11] The necessary money was raised by paying vendors with (constantly higher evaluated) stock packages of the vendee company and loans from investment banking firms which were willing to lend huge amounts of money for two

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[8] From March 2000 through September 30, 2002, the U.S. stock markets lost half of their market capitalizations, reducing investors' net worth by almost $8.5 trillion. *See* WALL ST. J., (Oct. 1, 2002). Stockholders lost almost $250 billion in market value because of the bankruptcy of Enron and WorldCom alone. Neil H. Aronson, *Enron: Lessons and Implications: Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J. L. BUS. & FIN. 127, 130 (2002); *see* Lisa M. Fairfax, *Form Over Substance? Offer Certification and the Promise of Enhanced Personal Accountability under the Sarbanes-Oxley Act,* 55 RUTGERS L. REV. 1, 1, 4 (2002).

[9] Ribstein, *supra* note 4, at 9.

[10] In order to enhance financial figures Enron made use of extensive derivated trading with Special Purpose Entities (SPEs) so that investors got the impression that Enron made highly profitable transactions. On the other hand, debts were led over to kamikaze subsidiary companies like Chewco, which was undetectable because of tricky accounting practices. Hence, two goals were achieved: firstly, a clean slate in the financial statements existed and secondly, there was no need to pay any taxes. When Enron's investments began to decline, Raptor entities were established to purportedly hedge against the fall of value. By October 2001, the Raptors were not able to cover up the losses so that the whole system collapsed. *See id.* at 4.

[11] Sunbeam i.e. manipulated financial statement by, among other things, excessive write downs in a "big bath" restructuring, booking phony sales and rebates, and not reporting for accounting and other advertising expenses; Richard C. Sauer, *Financial Statement Fraud: The Boundaries of Liability Under The Federal Securities Laws*, 57 BUS. LAW. 955, 991 (2002).

reasons. Firstly, they were afraid of not taking part in the bust. And secondly, investment banking firms had a strong incentive to produce favorable reports and let the companies appear to look good in order to win lucrative investment banking contracts.[12] As a consequence the company stock value grew rapidly, which had the effect that the CEO of such companies became a "hero" in American society who brought wealth to his or her employees by raising the value of company stock and expanding the use of stock option grants.[13] Under these circumstances concerns of excessive CEO remuneration packages and aggregation of decision making power were mostly forgotten.

Finally, the Securities and Exchange Commission ("SEC") was not without fault because it did not to effectively investigate and review financial statements and cover up fraudulent actions, which were caused by inadequate federal funding.

As the stock market bubble bursted and the presidential elections were just around the corner,[14] President Bush decided to take quick action to calm the troubled market, restore public and investor confidence,[15] and prevent future scandals.[16]

III. SOX CORPORATE GOVERNANCE PROVISIONS

Many corporate governance provisions of SOX are not "the invention of the wheel" but rather "recycled ideas advocated for quite

[12] In the 1990's market, the NASDAQ rocketed from 1400 to 5200 points within a few years.

[13] Aronson, *supra* note 8, at 130; Ribstein, *supra* note 4, at 3.

[14] *See* David E. Sanger, *Corporate Conduct: The Overview, Bush on Wall Street Offers Tough Stance*, N.Y. TIMES, July 10, 2002, at A1.

[15] Romano, *supra* note 7, at 3. As Romano indicates, public confidence in big businesses dropped from averaging 29.33% in the prior five years to 20% in 2002.

[16] Corporate Governance scandals were not a new occurrence in 2002. There have been famous U.S. insider trading scandals in the 1980's, which lead to the enactment of the Insider Trading and Securities Fraud Enforcement Act of 1988. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988). What was new though, was the extent of the damage caused.

some time by corporate governance entrepreneurs."[17] In order to heal the economic wounds which were caused by Enron et al., SOX mainly focused on "disclosure as the cure."[18] Better enforceability is grounded on two pillars: firstly, monitoring, which consists of a system where every party involved monitors the other and is obliged to report violations to SEC,[19] and secondly, punishment by SEC in case of non compliance.

A. "Inside" Disclosure and Monitoring Provisions

Inside control and monitoring mainly focuses on officers and directors and operates in a number of different but related ways.[20] The Board officers monitor employees,[21] the Audit Committee monitors the Board (as well as "outside" auditing firms), and the employees monitor the whole corporation through the help of whistle blowing protection.

[17] Romano, *supra* note 7, at 2.

[18] Larry Backer, *Corporate Surveillance after Sarbanes-Oxley*, 26. COMPANY. LAW. 1, at 4, (2005).

[19] *Id.* Backer characterizes this method as a system of surveillance, where, under the supervision of the government. *Id.*

[20] *Id.* at 5.

[21] *Id.* As Menard illustrates this can be achieved, i.e. by appointing a single person as a "disclosure controls monitor" who would be responsible for documenting compliance with the company's disclosure controls and procedures, preparing each SEC filing for the committee's review, and suggesting improvements in the disclosure controls. *Id.*

1. SOX § 301—Public Company Audit Committees

Section 301, an amendment of § 10A (m) of the Securities Exchange Act of 1934 ("SEA"),[22] requires all listed companies to have an audit committee. The committee is entirely composed of independent directors, [23] and is supposed to work as a watchdog for the actions taken by the Board. Furthermore, the audit committee is directly responsible for the appointment, compensation, and oversight of any outside auditor.

The *raison d'être* of this provision is to break open "club resistance"[24] between the board and the audit committee, and thus, by making it a requirement to put solely "outsiders" on the audit committee, to have it act more effectively. However, in dictating that only the audit committee has power to hire and fire outside auditors, shareholders are deprived of their right of decision making and the board might fail in realizing their oversight duty.[25] Furthermore, the SOX provision excludes entire categories of experts from the audit committee which leads to a lack of diversity and inflexibility when the business environment changes.[26]

Also, there is opinion in corporate governance literature that the proposed composition of an audit committee (exclusiveness of independent auditors) leads to worse results, because it is argued

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[22] *See* Securities and Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (1934) (amended by Sarbanes-Oxley Act of 2002, § 301).

[23] Sarbanes-Oxley Act of 2002, § 301 (amending 48 Stat. 881, § 10 (m)(3)) (defining independence).

> (A) IN GENERAL—Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent. (B) CRITERIA—In order to be considered to be independent for purposes of this paragraph, 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.

[24] Ismail Erturk et al., Corporate Governance and Disappointment, (Rev. Int'l. Pol. Econ., Working Paper No.1, 33, 2004).

[25] Romano, *supra* note 7, at 14.

[26] *See contra In re* Oracle Corp., 824 A.2d 917 (2003 Del. Ch.).

that too many outsiders might have a negative impact on performance.[27] Even though this view is not shared by all experts, there is a prevailing opinion that a composition of exclusively independent auditors has neither a positive nor a negative effect on better corporate governance.[28] Beasley concludes that, whereas the composition of the Audit Committee does not have a great impact on the prevention of fraud, a majority of independent directors on the Board does have an effect.[29] This is because even if the Audit

[27] Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921-63 (1999); Romano, *supra* note 7, at 5.

[28] Romano, *supra* note 7, at 19, 39. Points out there is mixed data on whether a committee with a majority of independent directors improves performance, however it is prevailing that with 100% independence this is not the case. *Id.* "The compelling thrust of the literature on the composition of audit committees, in sum, does not support the proposition that requiring audit committees to consist solely of independent directors will reduce the probability of financial statement wrongdoing." *See* April Klein, *Audit Committee, Board of Director Characteristics, and Earning Management*, 33 J. ACCT. & ECON. 375, 387 (2000); *see also* Sandra Marrakchi Chtourou et al., *Corporate Governance and Earnings Management*, 1-35 (April 2001), *available at* http://papers.ssrn.com/ sol3/papers.cfm?abstract_id=27 5053#PaperDownload; *see also* Biao Xie, et al., *Earnings Management and Corporate Governance: The Role of the Board and the Audit Committee*, 9 J. CORP. FIN. 295, 299-314 (2003); *see also* Lawrence J. Abbott et al., *Audit Committee Characteristics and Financial Misstatement: A Study of the Efficiency of Certain Blue Ribbon Committee Recommendations*, 1-47 (March 2002),*available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=319125#PaperDownload; *see also* Corporate Governance and Financial Reporting Centre, Organizing the Audit Committee to Maximize it's Effectiveness, Volume 1 Iss. (Jan. 2003); *see also* Hatice Uzun et al., *Board Composition and Corporate Fraud*, 60 FIN. ANALYSTS J. 33, 33-43 (2004). State that the number of affiliated ("grey") directors is linked to the degree of fraud. Yet as *Romano* points out, this is not *prima facie* evidence in support of the Sec. 301 SOX provision, because it equals affiliated directors with independent directors. Romano, *supra* note 7, at 35.

[29] Mark S. Beasley, *An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud*, 71 ACCT. REV. 443, 443-464 (1996); Romano, *supra* note 7, at 29 (citing Abbott, *supra* note 28); *see* Corporate Governance and Financial Reporting Centre, Organizing the Audit Committee to Maximize it's Effectiveness, *supra* note 28, at 6 (referencing Beasley, *supra* note 28).

Committee or outside auditors were willing to report fraudulent conduct, the Board must be willing to take action. With a majority of independent directors on the Board this is more likely to happen.

Finally, it is held that financial expertise[30] and frequent meetings might be valuable for investors.[31] Yet, SOX does not require such an expert to sit in the Audit Committee but only that his or her presence is disclosed.[32] Therefore it can be asked if the solution offered by SOX matches the problem involved, because the changed composition of the audit committee does not seem to help prevent future accounting.

2. SOX §§ 302 and 906 (a)—Corporate Responsibility For Financial Reports

[30] *See* Andrew J. Felo et al., *Audit Committee Characteristics and the Quality of Financial Reporting: An Empirical Analysis*, 1-39 (April 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=401240#PaperDownload.

[31] Xie, *supra* note 28, at 299. The positive effect of financial experts on the Audit Committee however is not undisputed. The argument of Abbott that an increase of financial experts is to be valued positively because it leads to fewer re-statements can be countered with the assertion, that a reduction of re-statements are connected with the intension of financial experts to aid fraud and misconduct. *Supra* note 28, at 3; Romano, *supra* note 7, at 26.

[32] Regarding the necessity to have at least one financial expert sitting on the audit committee the NYSE rules are rather flexible. *See* NYSE Listing Manual 303.01 (B)(2)(b) *et* (c) (stating that the Board has discretion to define expertise and literacy); *See also* § 407 SOX. The SEC is free to somewhat define the term "financial expert" although 407 (b) gave a mandatory guideline of considerations. Sec. 407 (b) SOX reads:

> CONSIDERATIONS—In defining the term `financial expert' for purposes of subsection (a), the Commission shall consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions—(1) an understanding of generally accepted accounting principles and financial statements; (2) experience in—(A) the preparation or auditing of financial statements of generally comparable issuers; and (B) the application of such principles in connection with the accounting for estimates, accruals, and reserves; (3) experience with internal accounting controls; and (4) an understanding of audit committee functions.

According to § 302[33] the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") are required to certify periodic reports which, to the best of their knowledge, do not contain material

[33] Sarbanes-Oxley Act of 2002, § 302; Securities and Exchange Act of 1934 §§ 13, 15.

> Corporate Responsibility for Financial Reports (a) REGULATIONS REQUIRED. The Commission shall, by rule, require, for each company filing periodic reports under section 13(a) or 15(d) of the SEA, that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act 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.

misstatements and fairly represent the firm's financial conditions and results of operations.[34] The provision, which was highly influenced by President Bush,[35] is a reaction of significant accounting inaccuracies and manipulations of dozens of public companies with the SEC in 2001,[36] which were often driven by fraudulent actions by senior managers, and which were exceptionally difficult to uncover.

As a countermeasure, § 302 requires that the Board actually concerns itself with the financial statements which the corporation issues and takes responsibility for them.[37] Consequently, many public companies have set up special disclosure committees to aid the officers in meeting their certification obligations. Furthermore, § 906(a) postulates the composition of an additional written statement (or equivalent) of the CEO and CFO. If they fail to comply with SOX § 302 (a) a civil wrong has been committed,[38] whereas a violation against SOX §§ 906(a), (c), which is a criminal provision, imposes penalties of fines up to $5 million and cumulatively twenty years imprisonment,[39] if the *mens rea* requirement is met.

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[34] Romano, *supra* note 7, at 92.

[35] President George W. Bush, Speech ("Bush's Speech") (July 9, 2002), *available at* http://www.pbs.org/news/bb/business/july-dec02/bush_7-9.html; *see also* President George W. Bush, President's Ten–Point Plan, *available at* http://www.whitehouse.gov/ infocus/corporateresponsibility/index2.html.

[36] Fairfax, *supra* note 8, at 1; Friedland, *supra* note 3, at 385.

[37] Bush's Speech, *supra* note 35. "Currently, a CEO signs a nominal certificate and does so merely on behalf of the company. In the future, the signature of the CEO should also be his or her personal certification of the veracity and fairness of the financial disclosures. When you sign a statement, you're pledging your word, and you should stand behind it." *Id.*

[38] Friedland, *supra* note 3, at 385 (noting that violations of SOX § 302 can consequently lead to civil legal actions for damages).

[39] Sarbanes-Oxley Act of 2002, § 906 (c).

> CRIMINAL PENALTIES: Whoever (1) certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $1,000,000 or imprisoned not more than 10 years, or both; or (2) willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all

Both sections are not without critique to say the least. Firstly, it can be argued that SOX's call for compliance, which is directed to all firms irrespective of their size and economic power, might lead to untimely or imprecise certifications especially from smaller companies because of the proportionally higher effort and costs that they have to make. Also, economic analysis points out that the SOX certification requirement does not have a significant positive impact on the stock value.[40] From this Romano draws the conclusion that the provision is "useless" since the market is able to predict beforehand what companies would certify and what companies would not. If scandals take place, which involve a lack of transparency of financial reports, the market adjusts voluntarily by increasing their disclosure because of the fear of being associated with similar practices. Thus, the certification requirement turns out to be a "non-event."[41] This conclusion seems to be somewhat misleading. It is certainly true that the market adjusts once it knows what is brewing, but the problem lies in its proper realization of misconduct on time. In the case of Enron, the stock price dropped from $80 to $40 when there was indication that the company had problems, although Enron already had penny stock value.[42]

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the requirements set forth in this section shall be fined not more than $5,000,000, or imprisoned not more than 20 years, or both.

[40] Utpal Bhattacharya et al., *Is CEO Certification of Earnings Numbers Value-Relevant?*, at 11(2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=332621#PaperDownload; Beverly Hirtle, *Stock Market Reaction to Financial Statement Certification by BankHolding Company CEOs*, Fed..Res.Bank N.Y. Staff Rep. No. 170 at 1 (2003), available at http://www.newyorkfed.org /research/staff_reports/sr170.pdf. "[...] not statistically significant [. . .]." *Id.*

[41] Bhattacharya, *supra* note 40, at 12. Furthermore it is difficult to draw a *conditio sine qua non* connection between the provisions of SOX and its direct effect on the stock value. Pankaj J. Jain & Zabihollah Rezaee, *The Sarbanes-Oxley Act of 2002 and Security Market Behavior. Early Evidence*, (May 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=498083#PaperDownload, (examining the influence of stock value on the direct enactment of Sox and finds such a positive connection, has been criticized as not being robust evidence;) *see* Romano, *supra* note 7, at 106 *et seq.*.

[42] Ribstein, *supra* note 4, at 8.

It could be argued that especially § 906 will lead to better and more trustworthy financial reports, since it prevents CEO's and CFO's from jumping through hoops, that is, the temptation to sign everything that is tabled due to lack of time, knowledge or will. However, it is questionable if the introduced provisions are able to reach the desired goal, because the
signature of a financial statement is not a substitute for bad judgment.[43] Also, it is not likely that the introduction of personal criminal liability will lead to a downswing of fraudulent actions, and thus, would have a deterrent effect because, as pointed out in literature, "crooked" managers mostly assume they will not get caught.[44] Further, Friedland illustrates that imposing criminal penalties leads to the "cook book" approach of accounting compliance[45] because the "principle based approach" is likely to conflict with the criminal law principle of *nullum crimen sine lege*. Despite the fact that the provision might have some effect if it punished negligent conduct also, the *mens rea* provisions of § 302 (a)(2) ("based on the officer's knowledge") and § 906 (c)(1) ("knowing") and (2) ("wilfully") do not offer a basis in this regard. Furthermore, the imposition of alternative sentences by the United States Sentencing Commission ("USSC"), which could lead to more flexibility, is almost impossible because the review of sentencing guidelines by SOX are mandatory, exclusive and *lex specialis*. Hence, as Li et al., point out, the relevant provisions of SOX are more "rhetoric than [. . .] reform."[46]

But, even if § 906 (a) penalties could be imposed more effectively, its extensive reach conflicts with the U.S. criminal law framework and is untuned with § 302 as well as GAAP. As Friedland

[43] Aulana Peters, Goodwin Seminar: Sarbanes-Oxley Act of 2002, *Congress' Response to Corporate Scandals: Will the New Rules Guarantee "Good" Governance and Avoid Future Scandals?*, 28 NOVA L. REV. 283, 287 (2004).

[44] Aronson, *supra* note 11, at 140.

[45] John Friedland, *Sarbanes-Oxley Makes Waves in the United Kingdom*, 25 COMPANY. LAW. 162 (2004).

[46] Haidan Li et al., *Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002 and Earnings Management*, at 2, (2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=475163#PaperDownload.

illustrates, a false statement which is in violation of § 302 cannot be prosecuted unless there is a "scheme to defraud under section 804 [SOX],"[47] which opens up two different scopes of applications regarding consequences resulting from the submission of false financial statements and thus leads to law fragmentation.

On the other hand, § 906 sets a lower threshold to ordinary elements of the criminal activity of wire fraud by neither requiring a pleading with particularity nor proof reliance. "Under section 906 (a) [SOX], it is not even necessary that a report be materially misleading. Thus a *de minimis* failure to comply might result in a jail term,"[48] which leads to the question of whether the intention of SOX, to punish economic crime, has been rightfully transformed into reality. Also, it is possible to penalize certain accounting practices, such as the installment of "cookie jar reserves" which are conformable with GAAP because this is not specifically counter mandated. However, a practice, which on the one hand complies with accounting standards and nevertheless produces a fraudulent action, seems to be inconsistent[49].

3. SOX § 402—Prohibition on Personal Loans to Executives

Section 402 (a) constitutes another amendment of SEA. According to subsection (k), corporations are prohibited from

[47] Friedland, *supra* note 3, at 385.

[48] *Id.*

[49] *See* U.S. v. Simon, 425 F. 2d 796 (2d Cir. 1969) (holding that auditors can be convicted for fraud even though their financial statements complied with GAAP). On the other hand, a statement which departs from GAAP might not automatically lead to the conclusion that the action must be considered fraudulent. *See* SEC Release No. 34-43570 (November 16, 2000). Generally the action taken by SEC to eliminate "cookie jar reserves" practices is driven by case by case analysis. *See* In the Matter of Microsoft, SEC Release No. 34-46017 (June 3, 2002); SEC Litigation Release No. 17001 (May 15, 2001). Even though SOX calls for full compliance with SEC requirements and "fair[] present[ation]" of the company's condition (Sec. 302 (a)(3) SOX) there is the problem that GAAP sometimes is highly ambiguous ("grey areas"). The decision of SEC to take action is important for Sec. 906(a) SOX because it is most likely to affect the decision of the U.S. attorney to indict. Friedman, *supra* note 4, at 387.

granting loans or extending already granted loans to executive officers or directors (unless § 402(k)(2) is relevant).[50] The provision was introduced as a defensive security measure

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[50] Sarbanes-Oxley Act of 2002, § 402.

> *Enhanced conflict of Interest Disclosures* (a) PROHIBITION ON PERSONAL LOANS TO EXECUTIVES. Section 13 of the Securities and Exchange Act of 1934 (15 U.S.C. 78m), as amended by this Act, is amended by adding at the end the following: (k) PROHIBITION ON PERSONAL LOANS TO EXECUTIVES.—(1) IN GENERAL.—It shall be unlawful for any issuer (as defined in section 2 of the Sarbanes-Oxley Act of 2002), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment. (2) LIMITATION.—Paragraph (1) does not preclude any home improvement and manufactured home loans (as that term is defined in section 5 of the Home Owners' Loan Act (12 U.S.C. 1464)), consumer credit (as defined in section 103 of the Truth in Lending Act (15 U.S.C. 1602)), or any extension of credit under an open end credit plan (as defined in section 103 of the Truth in Lending Act (15 U.S.C. 1602)), or a charge card (as defined in section 127(c)(4)(e) of the Truth in Lending Act (15 U.S.C. 1637(c)(4)(e)), or any extension of credit by a broker or dealer registered under section 15 of this title to an employee of that broker or dealer to buy, trade, or carry securities, that is permitted under rules or regulations of the Board of Governors of the Federal Reserve System pursuant to section 7 of this title (other than an extension of credit that would be used to purchase the stock of that issuer), that is—(A) made or provided in the ordinary course of the consumer credit business of such issuer; (B) of a type that is generally made available by such issuer to the public; and (C) made by such issuer on market terms, or terms that are no more favorable than those offered by the issuer to the general public for such extensions of credit. (3) RULE OF CONSTRUCTION FOR CERTAIN LOANS.—Paragraph (1) does not apply to any loan made or maintained by an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), if the loan is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act (12 U.S.C. 375b).

Id. (Emphasis in original); *see* Friedland, *supra* note 3, at 384.

against extensive loan grant practices to executives (in many cases millions of dollars)[51] at Enron, WorldCom, Tyco and Adelphia Communications, which lead to extensive "borderline looting"[52] by senior officials. However, SOX's blanket prohibition raised three problems. First, whereas there was a difference in scale, it was a unanimous *opinio iuris* and practice in the United States to permit such transactions before SOX.[53] The resulting situation created a conflict between federal law and state law. Second, it is questionable if the prohibition of grants has benefited the shareholders and improved corporate governance. Loans to directors were mainly granted for two reasons: either as "home buy" or relocation loans; or to assist in stock and stock option purchases, whereas many times the loan was granted when stock performance was under pressure.[54] "Home buy" and relocation loans were mostly granted interest free or on a low interest basis, yet the loan amounts given were far less, when compared to the loans for stock or stock option purchases[55] and were often secured by real estate.

Of course, loan grants come with risks. It might give managers incentives to pursue risky strategies when the stock price is falling and draining corporate cash reserves when they are needed most.[56] Furthermore, as seen at Tyco, the loan might be used for dubious purposes.[57] However, the positive effects outweigh the negative ones. By increasing executive ownership, directors are more closely aligned

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[51] Kathryn Kranhold & Michael Schroeder, *Enron's Directors Knew of Problems*, WALL ST. J., July 8, 2002, at A3 (reporting that Enron lent Kenneth Ley $81 million in 2001).

[52] Ribstein, *supra* note 4, at 15.

[53] *See* Romano, *supra* note 7, at 87. In 2003, 25 % of all major companies gave loans to executives, compared to 14 % in 1999 and 8.4 % in 1994. In Silicon valley half of the 150 largest companies granted loans to executives in 2002; *see* Kathleen M. Kahle & Kuldeep Shastri, *Executive Loans,* at 2, (2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=569765.

[54] Kahle, *supra* note 53, at 5.

[55] Romano, *supra* note 7, at 91.

[56] Kahle, *supra* note 53, at 2.

[57] Laurie P. Cohen & Mark Maremont, *Expanding Tyco Inquiry Targets Company Spending on Executives*, WALL ST. J., June 7, 2002, at A1. Tyco loans were granted to executives for the purpose of investing in expensive artwork.

with the interest of shareholders,[58] which can lead to less agency costs.[59] Also, it should be taken into account that a total prohibition of loan grants might cause executives to adopt "compensation packages" by increasing other components of the pay package, which would be less beneficial for shareholders. Thus, it would have been a better idea to require the disclosure of loan grants instead of articulating a total ban. Hence, as *Romano* rightfully points out, § 402 (a) of SOX represents a "public policy error."[60]

Third, it is unclear what is meant by the term "loan," or in other words, how the term "loan" is to be defined. Despite § 402 being rather
extensive in this regard, it does not give a direct answer to this question by introducing a legal definition, but instead places emphasis on the term "credit." Hence, the provision has lead to an extensive discussion of what grants may be considered a credit and what grants are not.[61] It will be up to the SEC to decide on the issue.

[58] Ribstein, *supra* note 4, at 7.

[59] Michael C. Jensen & William H. Meckling, *A Theory of the Firm: Governance, Residual Claims and Organizational Forms*, at 4, (1976), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=94043#PaperDownload.

[60] Romano, *supra* note 7, at 92.

[61] Friedland, *supra* note 3, at 384. Travel expenses are a loan, as well as certain kinds of insurance, whereas there is ambiguity about advances for litigation expenses (loan or contingent guaranties?).

4.. SOX § 806 (a)—Whistleblower Protection for Employees of Publicly Traded Companies

Finally, SOX assures that monitoring processes take place from "up to down" and vice versa. The provision introduces a new federal whistleblower protection[62] for employees who disclosed a breach of several federal laws and criminally penalizes any person who knowingly dismisses a whistleblower on the basis of retaliation. Thus, mainly influenced by the whistleblower story of Sherron Watkins,[63] who was the accountant at Enron, the intention of § 806 is to rely on corporate whistleblowers to cover up corporate fraud and collect disclosure evidence more easily.[64]

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[62] The concept of "whistleblowing" protection is not new, yet before SOX the scope of protection ranged from state to state. Currently, 42 states and the District of Columbia provide "whistleblower protection" to some extent. Leonard M Baynes, *Symposium Enron and Its Aftermath: Just Pucker and Blow? An Analysis of Corporate Whistleblowers, the Duty of Care, the Duty of Loyalty, and the Sarbanes-Oxley Act*, 76 ST. JOHN'S L. REV. 875, 888 (2002).

[63] Frank Pellegrini, *Person of the Week: "Enron Whistleblower" Sherron Watkins*, Time.com (Jan. 18, 2002), *available at* http://www.time.com/time/pow/printout/0,8816,194927,00.html.

[64] Sarbanes-Oxley Act of 2002, § 806(a).

> (a) WHISTLEBLOWER PROTECTION FOR EMPLOYEES OF PUBLICLY TRADED COMPANIES- No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee-- (1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by (A) a Federal regulatory or law enforcement agency;(B) any Member of Congress or any committee of Congress; or (C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to

However, the provision creates a big headache because despite providing some federal protection against retaliation on the one hand, it does not offer a solution for the actual problem of whistleblowing protection; the tension between the employee's duty of loyalty and the employee's duty of care. *Watkins*, who worked as an accountant for Enron's Vice President Andrew Fastow, had expertise knowledge about what was going on. Yet, in most cases, the situation is not that clear. Employees are required to take "reasonable effort" to disclose principal effort, which is determined by SEC *ex post*. Does that mean one must play the part of a detective? If that were so, it could result in a breach of loyalty. On the other hand, if the employee just looks away and does nothing it could result in a breach of care. Hence, the employee faces a dilemma of what to do, and § 806 is unable to provide any guidance. Furthermore, SOX only limits protection to fraudulent misconduct. Whistleblowing of other kinds (e.g. race discrimination) remains unprotected by this Act and additionally there is the problem that many illegal activities do not amount to an allegation of fraud. Additionally, playing the *Judas* might neither be good for the employee nor the company. The employee has to be aware of the fact that SOX protection is not comprehensive enough, and thus, his "betrayal" has a high chance to backfire.[65] Conversely, by not solving the problem internally, the

investigate, discover, or terminate misconduct); or (2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.

[65] *See* Baynes, *supra* note 62, at 895. The employer could: ". . . (1) attack[] the whistleblower's motives, credibility or professional competence, (2) build a damaging record, (3) threaten the employee with reprisals, (4) reassign the whistleblower to an isolated work location, (5) publically humiliate him, (6) set the whistleblower up for failure by putting him on impossible assignments, (7) prosecute the employee for unauthorized disclosures of information, (8) reorganize the company so that the whistleblower's job is eliminated or (9) blacklist the employee so that he or she will be unable to find work in the industry." *Id.* (naming a few countermeasures). Whereas some of these actions are covered by SOX, obviously not all of them are.

company risks damaging its reputation, even if the allegations turn out to be false, and thus, is vulnerable for extortion of employees because the principle of *in dubio pro reo* does not count much in public opinion. Hence, strangely enough, a fired employee is better off acting in an accusatory manner. Hence, the whistleblower protection provision might negatively affect corporate governance.

B. "Outside" Disclosure and Monitoring Provisions

Some of the most extensive changes mandated by SOX to the public market system affect public accounting firms[66] and lawyers as gatekeepers[67] of external control.

1. SOX § 201—Prohibited Activities

According to § 201, accounting firms are prohibited to provide audit services to an issuer if the lead audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit that is assigned to perform those audit services, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer. In order to prevent that, this provision becomes a toothless tiger as the Public Company Accounting Oversight Board ("PCAOB") was newly established with regulatory authority over private audit firms.[68] § 201's main features are not

[66] *See* Romano, *supra* note 7, at 41-42. (noting the influence of Arthur Levitt, Chairman of the SEC).

[67] *See* Backer, *supra* note 18, at 6.

[68] See Sarbanes-Oxley Act of 2002, §§ 101-09; *see also* Aronson, *supra* note 8, at 132; Friedland, *supra* note 3, at 384. According to § 101(a) of SOX the PCAOB has the power to "oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors". It is composed of 5 members, who are prominent individuals of integrity and reputation, who have demonstrated commitment to the interests of investors and the public. No more than two of the five members shall be or have been certified public accountants. Sarbanes-Oxley Act of 2002, at § 101(e).

new. In 2000, the SEC introduced a rule which forbade several types of nonaudit services and required firms to make proxy disclosures of their aggregate audit and no audit fees[69]. Yet § 201 is even more radical by not allowing any nonaudit activity.

The purpose of the provision seems to be clear. By banning outside auditors from offering special nonaudit services,[70] the auditor's independence was preserved, thus a second Arthur Anderson catastrophe would be unlikely to happen.[71] The question of whether offering auditing and nonauditing services influenced the independence of auditing firms was already well known before the enactment of SOX. Likely, the most famous analysis comes from Frankel, Johnson and Nelson,[72] which held that nonaudit services may impair auditor independence so that § 201 might be "on the right track."[73] However, there is strong evidence that their findings

In order to achieve independence, members serve a five year term (contrary to the four year term of the President) and the PCAOB is governmentally funded.

[69] Ribstein, *supra* note 4, at 14.

[70] Romano, *supra* note 7, at 41. These include services regarding financial information system design and implementation, appraisal or valuation services, internal auditing services, investment banking services, legal and expert services unrelated to audit, brokerage services, and actuarial services.

[71] Arthur Anderson as auditor of Enron was highly involved in the filing of false financial statements.

[72] Richard Frankel et al., The Relation between Auditors' Fees for Nonaudit Services and Earnings Management, 77 ACCT. REV. 71 (2002); *see also* Carol Dee et al., *Earnings Quality and the Auditor Independence: An Examination Using Nonaudit Fee Data*, (Jan. 28, 2002), *available at* http://papers.ssrn.com/sol3/papers .cfm?abstract_id=304185#PaperDownload; *see also* Michael Ferguson et al., *The Effect of Nonaudit Services on Earnings Management: Evidence from the U.K*, 21 CONTEMP. ACCT. RES. 4 (2004), *available at* http://papers.ssrn.com/sol3/papers. cfm?abstract_id=570034#PaperDownload.

[73] *See* Frankel, *supra* note 72. The Frankel article was the only one to be considered by Congress; however, five experts; Lynn Turner, James Copeland, James Glassman, Shaun F. O'Malley, and Lee J. Seidler, were heard on the subject, who declared that there was no empirical evidence of the assumed connection between independence and nonauditing services. Interestingly even Lynn Turner, as chief accountant of Arthur Levitt, pointed out that there was "no smoking gun that provides a basis for changes in regulation and laws." *See* Romano, *supra* note 7, at 48.

are misleading. Various analyses draw the conclusion that such a connection does not generally exist.[74] Rather, we must distinguish between the "Big 5" and "Non-Big 5" auditing companies.[75] There is evidence that a joint offer of auditing and nonauditing services might affect the independence of smaller businesses, due to economic pressure.[76] However, regarding the "Big 5" companies, it is concluded that this was not the case due to the fear of losing reputation.[77] Some

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[74] Hollis Ashbaugh-Skaife et al., *Do Nonaudit Services Compromise Auditor Independence? Further Evidence*, 79 ACCT. REV. 611 (2003); Hyeeso Chung & Sanjay Kallapur, *Client Importance, NonAudit Services, and Abnormal Accruals*, 78 ACCT. REV. 931 (2003); Kenneth Reynolds & Jere Francis, *Does Size Matter? The Influence of Large Clients on Office-Level Auditor Reporting Decisions*, 30 J. ACCT. & ECON. 375 (Dec. 2001); William Kinney et al., *Auditor Independence, NonAudit Services, and Restatements: Was the U.S. Government Right?*, 42 J. ACCT. RES. 3, 561 (June 2004).

[75]The "Big 5" consisted of: Arthur Anderson, Deloitte & Touche, Ernest & Young, KPMG, and PricewaterhouseCoopers. Due to the Enron scandal Arthur Anderson bowed out of the "Big 5" so that currently there is a remaining "Big 4" of auditing companies. The great majority of firms were audited by "Big 5" firms (4867 firm years, compared to 563 firm years by "Non- Big 5" auditing companies). *See* http://www.big4.com (Exclusively for Accenture, Andersen, BearingPoint, CapGemini, Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers Alumni).

[76] Pelham Gore et al., *Audit Services, Auditor Independence and Earnings Management* (Lancaster Univ. Mgmt. Sch. Working Paper, Paper No. 2001/014) (January 2001), *available at*, http://www.lums.lancs.ac.uk/publications/viewpdf/000126; Chung, *supra* note 74.

[77] Reynolds, supra note 74; *See* Catlin Ruddock et al., *Nonaudit Services and Earnings Conservatism: Is Auditor Independence Impaired?*, (April 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303343#PaperDownload; Kannan Raghunandan et al., *Are Nonaudit Fees Associated with Restated Financial Statements? Initial Empirical Evidence*, (April 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=394844#PaperDownload. Draw this conclusion from the fact that the "Big 5" rely on conservative financial reporting, issuance of ongoing concern and issuance of financial statements to a much greater extent than "Non–Big 5" companies.

authors even come to the conclusion that a joint offer of "Big 5" companies leads to better results and more efficiency.[78]

Although the latter argument seems to have some force, the former appears to be more than doubtful. If "Big 5" companies had really been concerned about the loss of reputation it is hard to explain why at least two of the five were heavily involved in dubious accounting practices,[79] and why Arthur Anderson, after being fined $7 million because of its shady accounting practices at Enron, was not concerned enough to switch to more conservative practices. However, this rebuttal does not conclude that the provision leads to more efficiency because it does not offer a solution to the problem. There is no doubt that auditing companies have become business actors and it is clear that this will be difficult to change. Yet, merely imposing penalties could have negative results. Because of the fact, that auditing firms make the big money with nonauditing services,[80] renowned auditing firms might loose interest in providing auditing services which would consequently lead to a brain drain of good auditors. The only chance to stop this is by having a joint reaction of all auditing firms to raise the price for auditing services. However, this is not very likely to happen, because the market is highly competitive.

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[78] Rick Antle et al., *The Joint Determination of Audit Fees, Nonaudit Fees, and Abnormal Accruals*,
(Yale University School of Management, Working Paper No. AC-15, 9) (2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=318943#
PaperDownload (arguing that the efficiency of outside auditing is not dependent upon the auditing firm itself, but rather on the effectiveness of the inside auditing committee of the firm, that is being audited); *see also* David Larcker & Scott Richardson, *Fees Paid to Audit Firms, Accrual Choices and Corporate Governance*, J. ACCT. RES. 625 (2004), *available at* http://knowledge.wharton.upenn.edu/papers/1259.pdf.

[79] Arthur Anderson was the major accounting firm for Enron, Waste Management, Sunbeam and Worldcom whereas Deloitte & Touche was responsible for the auditing of Adelphia Communications.

[80] Ribstein, *supra* note 4, at 9. In reality auditing firms often used their auditing services as "loss leaders" to sell nonauditing services, which were much more profitable.

Hence, I can agree with Romano that § 201 of SOX does not seem to have much positive, but rather some negative sides, so the policy "makes little sense."[81]

2. SOX § 307—Rules of Professional Responsibility For Attorneys

Section 307 gives attorneys a share of monitoring responsibility as well. According to (1) and (2):

> (1) . . . an attorney [is required to] 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 council or officer does not appropriately respond to the evidence [. . .] requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.[82]

Lawyers and auditors failing in their regulatory duties can by disciplined by the state, and may face liability to private parties under the security laws.[83]

The provision raises the problem of the scope of liability. Contrary to §§ 302 and 906(a), this clause appears to be a strict liability offense so that attorneys would be responsible for failing to report all violations of security laws regardless of whether they knew about them.[84] According to a press release by the SEC, it has been suggested that the regulation is violated when an attorney "reasonably believes that a material violation has occurred, is

[81] Romano, *supra* note 7, at 8.
[82] Sarbanes-Oxley Act of 2002, § 307.
[83] Backer, *supra* note 18, at 6.
[84] Aronson, *supra* note 8, at 144.

occurring, or is about to occur."[85] Accordingly, it is difficult to understand why the scale of liability is different for CEOs/CFOs as compared to attorneys.[86] Additionally, as Ribstein points out, it is unclear what is specifically meant by "fiduciary breaches and similar violations."[87] It will be up to the SEC to specify.

Furthermore, stricter liability and the extension of the scope of monitoring might have negative effects on efficient monitoring because it "makes it harder for firms to use boutique law firms for particular specialties or divide work among major law firms."[88] However, expertise is often needed in order to identify problems.

C. Governmental Co-operation and Regulation

Finally, SOX declares the state as being the overall watchdog of corporate governance. Section 107(a) provides the SEC with oversight and enforcement authority over the Board.[89] If a company chooses to introduce a new governance rule, it has to ask the SEC if the new rule is consistent with SOX before the new provision can be deemed effective.[90] The Board is required to "promptly file any notice with the Commission of any final sanction on any registered public accounting firm or on any associated person thereof,"[91] and has the final word regarding the gravity of disciplinary action against the outside auditor.[92] Under certain circumstances the SEC is also able

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[85] SEC Proposes Rules to Implement Sarbanes–Oxley Act Provisions Concerning Standards of Professional Conduct for Attorneys, Release No. 2002-158 (Nov. 6, 2002), *available at* http://www.sec.gov./news/ press.shtml.

[86] See Sarbanes-Oxley Act of 2002, §§ 302, 906(a).

[87] Ribstein, *supra* note 4, at 44.

[88] *Id.*

[89] Sarbanes-Oxley Act of 2002, § 107(b)(2),(3).

[90] *Id.*

[91] *Id.* at § 107(c)(1); *see also* SEC Release No. 34-49412, *available at* http://www.sec.gov/rules/final/34-49412.htm (amending § 107(c) of the Sarbanes-Oxley Act of 2002).

[92] Sarbanes-Oxley Act of 2002, § 107(c)(3).

> COMMISSION MODIFICATION AUTHORITY—The Commission may enhance, modify, cancel, reduce, or require the remission of a sanction imposed by the Board upon a registered public accounting firm or

to amend the rules of the Board.[93] Furthermore, SOX not only patronizes the decisions of the Board, but of shareholders as well. According to § 107(d) of SOX, the SEC has the authority to "relieve the Board of any responsibility to enforce compliance with any provision of this Act, the securities laws, the rules of the Board, or professional standards," and to censure and limit the activity of the Board if it has violated SOX without reasonable justification. If it is "in the public interest" or "for the protection of investors" the SEC even has the power to remove directors from office.[94]

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associated person thereof, if the Commission, having due regard for the public interest and the protection of investors, finds, after a proceeding in accordance with this subsection, that the sanction-- (A) is not necessary or appropriate in furtherance of this Act or the securities laws; or (B) is excessive, oppressive, inadequate, or otherwise not appropriate to the finding or the basis on which the sanction was imposed.

[93] *Id.* § 107(b)(5).

[94] *Id.* § 107(d).

CENSURE OF THE BOARD; OTHER SANCTIONS—(1) RESCISSION OF BOARD AUTHORITY—The Commission, by rule, consistent with the public interest, the protection of investors, and the other purposes of this Act and the securities laws, may relieve the Board of any responsibility to enforce compliance with any provision of this Act, the securities laws, the rules of the Board, or professional standards. (2) CENSURE OF THE BOARD; LIMITATIONS—The Commission may, by order, as it determines necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this Act or the securities laws, censure or impose limitations upon the activities, functions, and operations of the Board, if the Commission finds, on the record, after notice and opportunity for a hearing, that the Board—(A) has violated or is unable to comply with any provision of this Act, the rules of the Board, or the securities laws; or (B) without reasonable justification or excuse, has failed to enforce compliance with any such provision or rule, or any professional standard by a registered public accounting firm or an associated person thereof. (3) CENSURE OF BOARD MEMBERS; REMOVAL FROM OFFICE—The Commission may, as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this Act or the securities laws, remove from office or censure any member of the Board, if the Commission finds, on the record, after notice and opportunity for a hearing, that such member—(A) has willfully violated any provision of this Act, the rules of

This scope of authority is justified with the assertion that the shareholder is not able to effectively enforce his rights on his own. Since this is seen as a "failure of the market," there is a need for governmental regulation, which is achieved by a mix of paternalism[95] and the call for "shareholder empowerment." The latter is supposed to be realized by giving shareholders greater rights for the election to the Board of Directors.[96] Yet, it is questionable if the SOX and SEC strategies turn out to be effective. Managers would face discipline not only through the dynamics of the market for corporate control, but also internally through shareholder action.[97] And small investors, as Pettet illustrates, are very often not interested in participating in the decision making process because the amount of prospective profit compared to the required effort is disproportionate,[98] whereas institutional investors who have great influence in the decision making process will probably not like the enhanced decision making power of SEC because it undermines their own virtual rights. Hence, it is questionable if market self-regulatory processes are not more desirable. Small investors, in other words, can rely on "self help remedies" such as derivative suits. Also, the market is able to react via hostile takeover mechanisms.[99] Yet, the government chose to rely

the Board, or the securities laws;(B) has willfully abused the authority of that member; or (C) without reasonable justification or excuse, has failed to enforce compliance with any such provision or rule, or any professional standard by any registered public accounting firm or any associated person thereof.

[95] Austin v. Michigan Chamber of Commerce, 494 U.S. 652, 686 (1990). "His [author's note: the shareholder's] only protections against such assault upon his ideological commitments are (1) his ability to persuade a majority (or the requisite minority) of his fellow shareholders that the action should not be taken, and ultimately (2) his ability to sell his stock."

[96] Security Holder Director Nominations, SEC Release No. 34-48626, 68 Fed. Reg. 60784 (October 23, 2003), *available at* http://www.sec.gov/rules/proposed/34-48626.htm.

[97] Backer, *supra* note 18, at 7.

[98] BEN PETTET, COMPANY LAW 157 ¶ 2 (2d ed., Longman Law Series, Pearson Longman) (2005).

[99] Ribstein, *supra* note 4, at 5, 56 (noting that there is a problem of hostile takeover self regulating approaches due to the extensive federal regulation). In

on governmentally steered countermeasures, which destroys initial market regulation.

IV. CONCLUSION

The effect of the hastily and unbalanced adoption of SOX by Congress is noticeable. Many provisions seem to have, if any, only limited positive effect on corporate governance. SOX's big force of fighting fraud by strengthening independent monitoring is faulty, since the provisions do not seem to significantly improve corporate governance. When taking a look at the Enron scandal, this is not surprising. The company had prestigious outside directors on the board and an outside accounting firm, which enjoyed a high reputation at that time. Yet, both were unable, or unwilling, to stop fraudulent misconduct. Thus, an increase of independence does not automatically lead to better monitoring. As Ribstein illustrates, there are various arguments for this thesis.[100] Independent auditors might be beneficial in some, but certainly not in all tasks. This is because they are not as involved in the company as insiders, and thus, have much more difficulty detecting and realizing what is going on. Also, the cover up of misconduct always requires a level of trust that is hard to achieve if only outsiders are sitting on the committee. In addition, there is the problem that "independent" does not necessarily mean "independent at heart" because it is common practice for audit committee members to be nominated by insiders. Also, the whistleblower protection rule, which was passed to enhance disclosure, turns out to be ineffective.

Generally speaking, the system of federal monitoring for corporate governance is in itself doubtful. First of all, it is less

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1968 the Williams Act was put into force, which imposed disclosure requirements on bidders and required them to structure their bids to give incumbent directors time to defend. *Id.* The adoption of SEC Rule 14(e)-4 which covered disclosures of information about impending acquisition makes it even harder to go for hostile takeover approaches.

[100] *See generally* Ribstein, *supra* note 4.

flexible and less effective adapting to new economic scenarios[101] because the SEC cannot be everywhere. Especially when it comes to the supervision of accounting standards, there seems to be a great danger of inefficiency. The SEC will not be able to do forensic accounting tests due to its wide range of tasks. Also, the newly introduced PCAOB, which mainly consists of non-accounting experts in charge, is, according to § 201 of SOX, only concerned with overseeing. Yet, it is questionable who actually does the substantive accounting work.

Furthermore, punishment and surveillance measures always hurt the economic spirit of the market. By requiring CEOs and CFOs to certify for rightfulness and fair representation, they could be tempted to become overcautious and bureaucratic, if the provision turns out to have some effect. This, however, is not what shareholders want. Sometimes, taking a risk is important to gain good profit.

Finally, SOX is not flexible enough to reach compatibility with a progressive approach to corporate governance. The new provisions create great difficulties, especially for smaller listed companies, to reach compliance. Further, the new provisions create another financial and bureaucratic burden,[102] which is likely to lead to a

[101] This is because changes in federal statutes require a longer period of time until passed, as well as the sufficient political support by Congress, compared to a revision in exchange or agency rules. *See* Romano, *supra* note 7, at 205. The federal government as actor for mandatory regulations in this context is seen as less appropriate because it is assumed that innovations, which are tested by trial and error, become more effective than imposed from the top-down regulations. Frank Partnoy, *Lessons from Enron, How did Corporate and Securities Law Fail? A Revisionists View of Enron and the Sudden Death of "May"*, 48 VILL. L. REV. 1245 (2003); Romano, *supra* note 7, at 10.

[102] As if SOX was not lengthy enough, companies are also called to take the implementation provisions of the SEC into account. The SEC by being able to create Rule Adoptions, which become part of the official rules, SOX is like an amoeba, equipped with the capacity for its own reproduction. http://www.sec.gov/about/whatwedo.html; Backer, *supra* note 18, at 4. So far the SEC has generated four significant reports ([1] Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets" [January 24, 2003]; [2] Study and Report on Violations by Securities Professionals: Section 703 of the Sarbanes –

drain of profits for investors and an incentive for smaller listed companies to re-buy their stock, unlist, and to go private, which has negative effects on market capitalization. On the other hand, provisions that have turned out to be effective, such as the separation of CEO and chairman responsibilities, have been left out.

Of course, it is undeniable that self–regulatory approaches are not perfect either. Yet, they seem to offer better results and are more compatible with the spirit of corporate governance. As an alternative, the SEC, under its exemptive authority, could exclude small firms from SOX compliance in order to repair the gravest misleadings, even though this is not likely to happen.[103] More fundamental changes are also imaginable. The SEC could introduce either an opt-in or opt-out provision for mandatory compliance,[104] or replace mandatory provisions for more flexible "disclose and explain" provisions, even though it is likely that in this case agreement of Congress is required due to the fundamentality of the change. The U.S. government can hardly argue, despite its lack of sufficient research, to not have known about any of these alternatives before putting SOX into effect.[105] Rather, in the wake of public and economic pressure, it has chosen a different approach by passing federal regulations that are poorly conceived and are expected to
have only limited positive effects, if the literary analyses turn out to be right. Yet, as long as self – regulated market approaches are

Oxley Act of 2002 [January 24, 2003]; Report Pursuant to Section 308(c) of the Sarbanes – Oxley Act of 2002 [January 24, 2003]; Report Pursuant to Section 704 of the Sarbanes – Oxley Act of 2002 [January 24, 2003], *available at* http://www.sec.gov.html.

[103] *See* Romano, s*upra* note 7, at 206.

[104] *See* Romano, *supra* note 7, at 209 (discussing the advantages and disadvantages of either option).

[105] Special Study Group of the Committee on Federal Regulation of Securities of the Section of Business Law of the ABA made an interim proposal as early as on March 13, 2002 which recommended a set of appropriate nonbinding best practices designed to deal with current issues in corporate governance. Robert Todd Lang et al., *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1493 (2002).

unable to show that "they can do better," SOX is likely to be around for some time.