The Sarbanes-Oxley Act: Investors Protection through Corporate Governance

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government were to establish a law school to train prosecutors in combating corporate crime, regulatory agencies would be better qualified to curb corruption. With larger budgets, regulatory agencies would have more muscle to find and convict corporate criminals. These measures could help restore the public's trust in U.S. companies.

The Sarbanes–Oxley Act: Investor Protection through Corporate Governance

Nicholas Beckstead*

The Sarbanes–Oxley Act effectively responded to calls for reform following the Enron fiasco and the dot-com collapse. Furthermore, the Sarbanes–Oxley Act includes significant preventative measures to ensure corporate responsibility.

Enron shocked the world when it unexpectedly declared the largest bankruptcy in American history. Mark Weisbrot, codirector of the Center for Economic and Policy Research, wrote this after the incident:

This master trader of everything from energy futures to advertising space . . . went from number seven on the Fortune 500 list of America's largest corporations to a bankrupt failure in a matter of months.

Enron reported a staggering $13.15 billion in debt, yet some bankers estimate that the unreported balance-sheet debt was near $27 billion. The result was an enormous group of disgruntled employees and irritated shareholders, as well as widespread distrust for the corporate system. Political leaders called for reactive legislation. In 2002, President Bush expressed this sentiment:

Through stricter accounting standards and tougher disclosure requirements, corporate America must be made more accountable to employees and shareholders and held to the highest standards of conduct.

* Nicholas Beckstead, from St. Paul, MN, is an applied physics major with a biomedical emphasis. He is also minor ing in math, chemistry, and philosophy. He plans to attend law school and practice patent law.


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SARBANES–OXLEY RESPONSE TO CORPORATE SCANDAL

The Sarbanes–Oxley Act effectively responded to calls for reform following the Enron fiasco, as well as other recent corporate scandals. To begin with, the Sarbanes–Oxley Act (SOA) made significant reforms to ensure the accuracy corporate financial statements. Moreover, the SOA responded to the need for warning periods before pension fund blackout periods in order to protect employees' retirement funds. Finally, the SOA addressed conflicts of interest for financial analysts to ensure ethical reporting and accounting practices.

In response to the demands of market analysts, the SOA made significant reforms to ensure the accuracy of corporate financial statements. Not only did Enron hide massive debt, it also published misleading financial reports. In order to protect investors, Bureau of National Affairs (BNA) analysts suggested tightening audit reports. The Sarbanes–Oxley Act contains provisions to encourage honest reporting. For example, when filing a periodic report with the Securities and Exchange Commission (SEC), §302(a) of the SOA requires the CFO and CEO of the company to sign an extensive document certifying the accuracy of the report. Furthermore, §404(b) of the SOA requires the auditing committee to certify that there are no material errors in the report. The SOA also mandates substantial increases of criminal penalties for various kinds of financial fraud. For example, Title IX of the SOA, entitled “White-Collar Crime Penalty Enhancements,” increases the penalty for most types of corporate fraud from five years in prison to twenty years in prison. Moreover, fiscal penalties are increased by as much as five times, bringing corporate fraud fines to $5 million for a natural person or $25 million otherwise. Heavy criminal penalties coupled with close supervision will dissuade executives from publishing inaccurate financial reports.

In addition to tightening financial reporting rules, the SOA responded to the need for warning periods before pension fund blackout periods in order to protect employees' retirement funds. During the Enron fallout, employees helplessly watched as the stock in their Section 401(k) plans plummeted in value during a lockout period while the plan changed administrators. Meanwhile, since they were on a different plan, executives freely sold their own stock. Analysts suggested a warning period before such a blackout in the future. Lawmakers responded by including in the SOA a mandatory thirty-day warning period before any blackouts and disallowed insiders from making any securities transactions during the blackout. This change will encourage investment and prevent unprincipled executives from taking advantage of their employees.

Lastly, in response to overspeculation caused by dishonest auditing during the dot-com collapse, the SOA addresses conflicts of interest for financial analysts to ensure ethical reporting and accounting practices. In its beginning, the dot-com craze saw unprecedented success. Internet Initial Public Offerings (IPO) went public and reached share values that were multiples of their offering prices on the first trading day. However, such dynamic growth was almost definitely caused by overspeculation of market potential. The overvaluation of these companies resulted in a heavy plunge, especially during the final quarters of 2000. Recent research indicates that much of the overvaluation of these shares resulted from analysts with

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3 Sarbanes–Oxley Act, Public Law 107-204 [H.R. 3763] Title IV, §404(b) (July 2002).
4 Sarbanes–Oxley Act, Public Law 107-204 [H.R. 3763] Title IX, §404(b) (July 2002).
5 Bureau of National Affairs Staff, "Enron Fallout," 19.
conflicted interests. Analysts gave positive reports in order to maintain business within the investment banking firm. Section 501(a) of the SOA gives analysts protections that will help produce reliable securities research. The SOA limits analysts' supervision and evaluation even when they are not involved with investment banking. More importantly, when "employed by a broker or dealer who [is] involved in investment banking activities," the employer may not retaliate against an analyst that produces a negative report. These changes promote analyst responsibility and discourage analysts from publishing inaccurate, but favorable reports. As a result, analysts will produce reports that are more trustworthy.

PREVENTATIVE MEASURES OF THE SARBANES–OXLEY ACT

Along with responsive reforms, the Sarbanes–Oxley Act includes significant preventative measures to ensure corporate responsibility. For instance, the SOA creates an accounting board to regulate accounting firms and their professional standards. The SOA also creates unity and independence in accounting standards and mandates the separation of auditing and financial services. Additionally, the SOA forces companies to disclose new information that helps investors to make prudent financial decisions. Furthermore, the SOA solidifies the role of the SEC, giving it serious power to intimidate offenders of securities laws. Finally, the SOA mandates some miscellaneous, but important, changes to securities laws that encourage corporate honesty. These preventative measures of the SOA provide significant protection for the American financier.

One of the major protective functions of the SOA is the conception of the Public Company Accounting Oversight Board (PCAOB). The PCAOB consists of five members that are appointed by the SEC in conjunction with the Federal Reserve Board and the Secretary of the Treasury. The SOA mandates that this board "will adopt auditing, quality, control, ethics, independence, and other standards for public accounting firms." The SOA empowers the Accounting Board to investigate public accounting firms and place disciplinary sanctions such as suspension or revocation of the firm's registration, disbarment of individual accountants, and harsh fines. The decisions of the Accounting Board will assure conformity and compliance among public accounting firms. Close inspection with a short leash will facilitate reasonable trust in the corporate system.

The SOA also creates unity and independence in accounting standards and mandates the separation of auditing and financial services. Under §108(b), the SOA empowers the SEC to recognize as Generally Accepted Accounting Principles (GAAP) any accounting principles that are set by a standard setting body that meets the specific requirements set out by the SOA. In order to maintain independence of the standard setting body, §109(b) mandates that the standard setting body must be funded by the federal government alone, so that the standard setting body does not seek contributions from any accounting firm. Furthermore, §201(g) of the SOA also reaffirms the professional standard of separation of audit services and financial services by designating that, in order to prevent conflicts of interest in auditing committees, one firm cannot perform both services. Uniform accounting standards and unbiased auditors will help ensure accurate financial statements.

In addition to creating unified accounting standards and maintaining unbiased auditors, the SOA also forces companies to disclose new information that helps investors make prudent financial decisions. Section 401 of the SOA also requires companies to publish the qualifications of the members of their audit committees in their periodic reports. If there is no financial expert on the audit committee, the report must explain why there is no

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12 Ibid.
13 Bloomenthal, 23.
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12 Ibid.
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expert. Moreover, the SOA mandates that companies must disclose a code of ethics or, in the absence of such a code, explain why one has not been adopted. These regulations allow investors to scrutinize the accuracy of the reports made by the companies in which they invest.

Along with requiring important new information in financial reports, the SOA solidifies the role of the SEC, giving it serious power to intimidate offenders of securities law(s). It allows the SEC to disqualify lawyers and accountants who knowingly or negligently violate securities laws. Under §305(a) of the SOA, the SEC may bar an officer or director from serving as the officer of a public company if that officer demonstrates "unfitness" rather than "substantial unfitness." In addition, the SEC may apply severe fiscal penalties to executives who break securities laws:

If an issuer is required to restate its financials as a result of misconduct, the CEO and the CFO of the issuer must reimburse the issuer for (1) all bonus or other incentive-based or equity-based compensation they received during the 12 months following the first public issuance or filing of the incorrect financial statements and (2) any profits they realized from the sale of the issuer's securities during that period.

Fiscal penalties become even more severe because any debt amassing as a result of violations of securities laws cannot be expunged in bankruptcy. The overwhelming disciplinary power of the SEC will encourage obedience to securities regulations and thereby facilitate investor trust in corporate organizations.

Finally, the SOA mandated some miscellaneous, but important, changes to securities laws that encourage corporate honesty. To prevent record destruction, the SOA requires auditing firms to keep records for five years, and it creates new penalties for destroying official documents. Also, rotation of the lead audit partner or the second review audit partner is required once every five years. This encourages auditor skepticism, independence, and honesty. Lastly, the SEC provides new protections for whistle-blowing employees in order to discourage retaliation from management. The sum of the preventative legislation in the Sarbanes–Oxley Act pressures corporations to follow the securities regulations laid out by the federal government.

Adequate Pressure

The corporate governance reforms made in the Sarbanes–Oxley Act effectively and efficiently protect investors. On the topic of corporate legislation, National Bureau of Economic Research researchers empirically conclude that "strong investor protection is associated with effective corporate governance." The substantive reforms of the Sarbanes–Oxley Act represent significant investor protection. Obviously, it is impossible to completely protect investors from unprincipled business practices; no law or regulation can ensure totally honest business practices. Moreover, if policymakers create more business regulations, then businesses will spend more time complying with legislative standards. At a certain level, more corporate governance means less productivity; it is impossible to quantify this level of pressure. Therefore, the best policy of corporate governance is to respond to observed flaws in the corporate system and prevent other foreseeable flaws. This way, corporate regulations can protect investors without interfering with daily business transactions. Some of the harm associated with corporate scandals could be eliminated without burdensome legislation. Bureau of National Affairs analysts remarked:

Whatever the cause of the Enron Corp.'s collapse, many employees lost their retirement nest eggs because their Section 401(k) plans were too heavily invested in company stock.
Mohr, the SOA mandates that companies must disclose a code of ethics or, in the absence of such a code, explain why one has not been adopted. These regulations allow investors to scrutinize the accuracy of the reports made by the companies in which they invest.

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19 Bloomenthal, 40-41.
21 Sarbanes-Oxley Act, Public Law 107-204 [H.R. 3763] Title III, §305(a) (July 2002).
22 Friedenberg, Haynes, and Nushbacher, 6.
23 Bloomenthal, 141.
24 Ibid., 139.
25 Friedenberg, Haynes, and Nushbacher, 8.

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26 Brancato and Plath, 74.
27 Ibid., 82.
29 BNA Staff, "Enron Fallout," 16.
When investors diversify their capital ventures, the consequence of one financial failure is substantially decreased. Therefore, smart investment practices combined with the protective reform of the Sarbanes-Oxley Act provides reasonable protection for investors. The recent combination of substantive, responsive, and preventative legislation indicates that there is effective corporate policy pressure in the United States. These responsive and preventative changes to securities regulations put adequate pressure on corporations to maintain ethical business practices, effectively and efficiently protecting the prudent investor.

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Trust in companies has been destroyed in recent years, and rightly so. Companies once hailed as headed by innovative geniuses and touted as "One of the Best Companies to Work For" have folded in incredible displays of mismanagement and fraud. Some optimists will no doubt argue that companies, by and large, remain trustworthy. After all, only a small percentage of companies have had the need to restate earnings and overhaul accounting methods. However, the presence of such a watershed of fraudulent activities has brought attention to some basic problems. William T. Allen said, "Enron is not just the hundred year flood of fraud, but is in fact a warning that there are fundamental weaknesses that require immediate attention." This essay will (1) suggest that a particular sector of business is more prone to fraudulent activities, (2) analyze the role of employee ethics in the downfall of a company, and (3) examine the viability of the proposed solutions for amending these fundamental weaknesses.

Charisa L. Player has won several awards for her writing, including placing in the Michael L. Rosten contest and the Disneyland Creativity Challenge. A mother of three boys, she plans to enter law school in 2005.
