CORPORATE GOVERNANCE

SARBANES-OXLEY LAW: CREATING A CHALLENGING OPERATING ENVIRONMENT FOR CORPORATE FINANCE PROFESSIONALS

Hank Boerner

The somber mood of federal policymakers was summed up by Senator Paul Sarbanes of Maryland, who told his colleagues: "For nearly seventy years, our framework of [U.S.] securities laws proved remarkably effective at protecting investors. Recent events [in 2002] show how urgently this framework needs reform. We must ensure that investors can once again trust corporate executives and their financial reports, and have confidence in the independence of accountants and analysts. We must assure that the SEC has adequate funds to carry out its mandate."

Responding to the bold challenge of the Chair of the Senate Banking Committee, the U.S. Senate and House of Representatives eventually passed the wide-ranging Public Company Reform and Investor Protection Act of 2002, and President Bush quickly put his signature on the package of new laws on July 31, 2002. Immediately, the U.S. Securities & Exchange Commission (SEC) began the rule-making process, which will continue well into 2003. In a highly unusual move, Congress made certain portions of the law effective literally upon the signature of the President.

The net effect of the Sarbanes-Oxley (S-O) legislation will be the embodiment in U.S. laws of very high standards of corporate governance, accountability, and responsibility—including the personal responsibility (and vulnerability) of senior corporate executives, board members, auditors, accountants, and lawyers—intended to restore confidence and trust among all stakeholders in the American capitalistic democracy.

Senator Sarbanes' reference to 70 years of SEC policy reminded his colleagues and the nation of the determination of predecessor policymakers in 1933 and 1934, when federal laws were created to protect investors, ensure that investors could trust executives and corporate financial reports, regulate the capital markets, and create the SEC. The National Investor Relations Institute President Lou Thompson has been reminding audiences that "portfolio loss is personal, and not easily forgotten by the voter . . . ." Similar fears about the capital markets and corporate executives triggered the 1930s law-making.

HIGHLIGHTS OF THE LONG-TERM EFFECTS OF SARBANES-OXLEY

Critical provisions of the 2003 reform legislation package for financial executives include:

- Sets new standards for investigating and disciplining accountants (auditing firms will now have to register with the new board to obtain permission to audit public companies; oversight of auditors will ratchet up

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geometrically in future months)
- Provides major criminal fraud amendments to punish corporate wrongdoers (the Senate Judiciary Committee played a key role in shaping certain portions of the law)
- Restricts auditor services that can be provided to audit clients—some of these services are clearly spelled out, with possibly more restrictions to come
- Addresses critical questions of corporate responsibility through law—new and amended federal statutes—rather than by persuasion or other means, by specifying personal responsibilities for CEOs and CFOs
- Establishes the board of directors as clear owners of the corporate audit process; outside auditors will report to the board, not to corporate management, and will be hired and fired, and their performance will be monitored by independent board members
- Creates higher standards of corporate governance—in effect, in a revolutionary step for American government, bringing to the private sector the expected standards of conduct, accountability, and certain responsibilities that parallel some public sector standards and practices; it will not be long before non-profit and social sector institutions experience similar reforms
- Establishes a process to define and enforce independence clearly for auditors and accountants, securities analysts, and especially corporate board members

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- Directly addresses analyst conflicts and independence, and specifies approved behaviors of analysts, investment bankers, and brokers
- Strengthens SEC oversight, especially through budget increases for monitoring and enforcement

Washington-based securities lawyer Dixie Johnson points out that the S-O tests for investor treatment will be broader than traditional generally accepted accounting principles (GAAP). The ultimate test of S-O legislation as applied to various situations will be: Is this information fairly presented?

RESTORING CONFIDENCE IN TROUBLED TIMES

The underlying theme of the legislation as it moved through the Congress was the urgent perceived need to improve the quality, transparency, and reliability of corporate financial reports. The words trust, confidence, and protect were being universally used by elected officials as they watched the stock market's continued malaise and reacted to examples of corporate wrongdoing as these were excitingly revealed by print and electronic media.

As the S-O legislation was introduced in January 2002, major financial fiascoes continued to haunt the corporate community and American investors. Legislation-drafting began within days of Enron's filing for bankruptcy protection. The bill's proposals were hotly debated in the Senate and House; a less comprehensive companion bill passed earlier in the House of Representatives, sponsored by Michael Oxley of Ohio. The revelations of financial shenanigans at WorldCom provided the final impetus for the bill's bipartisan support for passage.

Troubled by the lingering effects of the recession, the collapse of the "new economy" stock market—many investor hopes were dashed by the Tech Wreck that began in March 2000—plummeting share prices; and then revelations of outrageous behavior by corporate executives, financial analysts, and others, investors continued to lose confidence in the equities and debt markets throughout 2002.

But even with adoption of the strict investor protection laws in mid-year, the major U.S. equities markets ended year 2002 on a sour note; the major indices registered their worst declines since the Great Crash of October 1929. (The period from March 2000 to December 2002 closely resembled the period from November 1929 to December 1931. The Dow Jones Index fell 79 percent in the period from 1929 to 1931; the Nasdaq was down 73 percent from March 2000 through autumn 2002.)

Institutional investors were understandably upset about the condition of the markets (and their portfolios). Public employee pension funds in 21 states lost a collective $2 billion invested in WorldCom alone. Total investor losses were projected to be as high as $7 trillion since spring 2000. Some portion of that loss actually was transferred to departing CEOs at collapsing companies, another source of outrage for investors, who are, after all, voters to members of Congress.

Jobs also disappeared at alarming rates: the summer 2002 announcements included 17,000 cuts at WorldCom; 7,000 at Enron; and 9,300 at Global Crossing. At times it appeared that the very foundations of American capitalism were at risk. Dramatic action was needed.

ADDRESSING THE RESTATEMENT EPIDEMIC

Very troubling to investors were continuing announcements of financial restatements, which threatened to become epidemic. Between 1988 and 1997, according to the CFO trade group Financial Executives International, 464 public companies restated financial results (averaging 46 per year). In 1998, 100 firms restated prior results; this doubled to 207 restatements in 1999 and 157 in 2000, the last year of the bull market. Not only were significant quantities of previously filed statements being corrected, but massive amounts of money were disappearing or being moved around in some restatements, raising the serious question of what numbers could be trusted.

Among the well-known examples, Adelphia Communications revealed that $3 billion in previously undisclosed loans had been granted to founding family members; drug chain Rite Aid posted a $1.6 billion restatement; Tyco International disclosed that more than $4 billion in short-term costs should have been classified as long-term investments; and Xerox reclassified more than $6 billion in revenue for multi-year period. And so the revelations continued.

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Moving aggressively to address this perceived avalanche of corporate restatements, the SEC ordered more than 900 companies to file signed CEO and CFO attestations that current period and prior (one year for most companies) results were accurate as filed. As the August 14 deadline for filing neared, investors watched cautiously, but only a handful of companies restated results on the filing deadline, as the media trumpeted the news of each day's filings and the SEC Web site postings increased by the hour.

S-O legislation has now made such attestations a matter of federal law, required by statute, with severe penalties for violations, and set in motion a process to expand the requirements and nature of future CEO-CFO certifications substantially. Executives will have to affirm their knowledge of material information contained in SEC filings.

THE DAILY EFFECTS OF S-O BEGIN

Just as the 1933 and 1934 securities legislation—with numerous amendments over the years—shaped the environment in which issuers and securities markets conduct their daily business, the amendments and new statutes embodied in the comprehensive S-O legislation will dramatically change the day-to-day work and behavior of the U.S. capital markets and corporate community, affecting:

- Senior corporate executives
- Boards of directors
- Audit committees of boards
- External auditors (accounting firms)
- Corporate general counsel and internal lawyers
- Financial analysts
- Investment bankers
- Institutional investors

The comprehensive package of laws is not legislative arcana; S-O features plain English components that address specific aspects of issuer and capital market governance and behavior. Following are titles and highlights that you'll be hearing more about in the weeks and months ahead, with notes of new statutory authority.

Title I—Creates the Public Company Accounting Oversight Board

Its highlights are: It establishes Board authority (reports to SEC); it is to be a non-profit entity, not a government agency; public company auditors must register with new Board; it establishes authority to establish auditing, quality control, and auditor independence standards and rules; it investigates wrongdoing and issues disciplinary actions; it addresses accounting standards. Title I generally sets out rules of the road for the new five-member Board and provides standard-setter funding (through fees and assessments) for the Board and the Financial Accounting Standards Board (FASB). This title also orders the SEC to study the adoption of principles-based accounting system by issuers, with a deadline of July 2003.

Title II—Addresses Auditor Independence

It amends the Securities Exchange Act of 1934. Its highlights are: Specific services outside the scope of audit practice are clearly identified (e.g., no bookkeeping services, no design of financial information systems design and implementation). There are eight in all with more to come as determined by the Board. It mandates audit partner rotation (five-year limit), conflicts of interest, and that the outside auditor reports to the board audit committee. If no designated board audit committee exists, statute requires the entire issuer board of directors to be responsible. The Comptroller General of the United States will now study the requirement of mandatory rotation of registered accounting firms.

Title III—Establishes Framework for Corporate Responsibility

It amends the Securities Exchange Act of 1934. Its highlights are: Mandates the specifics of public company audit committee operation; responsibility for attesting financial reports (executives must have knowledge of material facts, have established internal controls, discussed report contents with auditors, etc.); improper influence on conduct of audits; forfeiture of certain bonuses and profits; officer and director bars; insider trades prohibited during pension fund blackout periods; and rules of professional responsibility for lawyers. This title provides authority to self-regulating organizations (SROs) to prohibit listing of issuer's securities if they are not in compliance, a critical issue being the independence of directors and the audit committee. It also empowers issuer audit committees to engage advisors and obtain corporate funding, amends the Employee Retirement Income Security Act (ERISA), and establishes a disgorgement fund for victims of violations.

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Title IV—Enhanced Financial Disclosures

It amends the Securities Exchange Act of 1934. Its highlights are: Mandates disclosure in periodic reports; enhanced conflict of interest provisions; management to assess internal controls; requirement of a code of ethics for senior financial officers; disclosure of audit committee financial experts; enhanced review of periodic disclosures by issuer (formal process); real-time issuer disclosures; and no personal loans to executives. Requires disclosure of off-balance sheet transactions with material effect on financial condition; special purpose entities (SPEs) are to be studied by the SEC and a report to be issued by July 2003. New rules to come in February 2003 for pro-forma financial information.

Of critical importance to those involved in corporate disclosure: This title authorizes the SEC to require issues to move to rapid and current disclosure of material changes; in effect, this further fuels SEC's moves toward real-time disclosure (rules to follow).

Title V—Addresses Analyst Conflicts of Interest

It amends the Securities Exchange Act of 1934. Its highlights are: Mandates treatment of registered securities analysts by associations and exchanges, like the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE); creates firewalls with investment bankers; and significantly expands disclosure requirements for analysts. The legislative intent is to foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts.

Title VI—Strengthens SEC Resources and Authority

It amends the Securities Exchange Act of 1934. Its highlights are: Mandates appropriations for the SEC and SEC practice issues. The SEC will receive $776 million for FY 2003, including $98 million to hire 200 professionals to oversee auditors.

Title VII—Additional Studies and Reports

This title provides guidelines for the General Accounting Office (GAO), the investigative arm of Congress, to study the effects of consolidation of public accounting firms; and study and report on investment banks and whether they assisted public companies in manipulating earnings and concealing companies' true financial conditions. The SEC is to study and report on credit rating agencies and the past five years' enforcement actions.

Title VIII—Corporate and Criminal Fraud Accountability

This title is known as "Corporate and Criminal Fraud Accountability Act." Its highlights are: Mandates criminal penalties for altering or destroying corporate documents; discharge of debts if not incurred in violation of securities fraud laws; statute of limitations; review of Federal Sentencing Guidelines for obstruction of justice and extensive criminal fraud; enhanced protection of whistleblowers; and criminal penalties for defrauding shareholders.

Title IX—Enhances White-Collar Crime Penalties

This title is known as "White-Collar Crime Penalty Enhancement Act." It addresses criminal fraud conspiracies; mail and wire fraud; ERISA violations; and establishes corporate responsibility for accuracy of financial reports. It includes directives to the U.S. Sentencing Commission to consider the serious nature of offenses and extends emergency authority for rapid adoption of more stringent sentencing guidelines for federal courts. This title includes additional penalties for senior corporate officers' certification of financial reports.

Title X—Corporate Tax Returns

This title provides guidelines for having CEOs sign all corporate tax returns. The Treasury or Internal Revenue Service (IRS) would need to proceed with regulations.

Title XI—Corporate Fraud and Accountability

This title is known as "Corporate Fraud Accountability Act." It addresses record-tampering; authorizes freezing of assets for the SEC and important Federal Sentencing Guidelines amendments; addresses the SEC's prohibition of persons from serving as officers or directors; increases criminal penalties for violations of the Securities Exchange Act of 1934 (certain fines increased to $25 million and up to 20 years in jail); and establishes a policy of no retaliation against informants.

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ON A PRACTICAL BASIS, THE NEXT STEP

The specifics of the legislation are forming the basis of lengthy and detailed rule-making by a variety of public agencies, including the new Public Company Accounting Oversight Board, SEC, cabinet departments (Labor, Justice, Treasury), independent accounting standards-setters (FASB), private sector standard-setters (American Institute of Certified Public Accountants, American Bar Association), private securities firms, the broad-based issuer community in the United States and abroad, and others.

On a practical basis, what intended or unintended effects should finance professionals be prepared to deal with in the short-term? Consider these issues:

- Companies will be managing a more complex and highly-visible auditor selection and board oversight process (for outside auditors).
- Relationship management challenges will emerge, affecting the relationships among senior management, the boards, and the external auditors they hire, fire, and supervise. (Note that the board is empowered by federal law now to hire its own staff and advisors.)
- Rotation of senior audit partner of the external audit firm is required after five years.
- The changing role of in-house legal counsel: These rules of the road are still evolving. S-O legislation, it has been observed, can be viewed as federalizing legal counsel; their traditional roles have been as state-authorized professionals. Also, the shareholder can be viewed as the ultimate client rather than the senior managers or board to whom the counsel now reports. Lawyers must report suspicions to the general counsel or CEO; if they don't take action, the board's audit committee or committee of independent directors will be responsible.
- Development and adoption of codes of ethics and corporate governance standards for senior officers; these codes will evolve to apply to all officers and, perhaps, rank and file workers.
- The necessity to develop open-door policies for employees and afford real protection for whistleblowers (*Time* magazine named three whistleblowers as Persons of the Year in December—insiders at WorldCom, Enron, and the Federal Bureau of Investigation).
- Issuer stock trading policies, employee benefit programs, and blackout periods are all affected by the new package of laws.
- The mandated CEO/CFO formal certification process (including filing 10B-5 certificates with the SEC) have more depth and heft than previous filings, including the SEC-ordered attestations of August 2002. There is real potential for incurring serious personal liability for signers.

- The need for real-time disclosure processes for material changes in financial condition and other aspects of corporate operations now recognized in federal law. Watch for SEC proposals on a continuing basis, this could complicate issuer disclosure policies. S-O legislation requires issuers to adopt formal disclosure policies if none exist. Materiality will be vetted by a formal disclosure committee (to be created by issuer boards).
- All issuers' filed reports and adopted disclosure policies will be examined by the SEC over a three-year cycle and all companies will be examined on a rolling basis.
- In 2003, at least nine separate studies will be conducted by the SEC, GAO, and other agencies and the announced findings will continue to shape the corporate and securities industry communities' behavior.
- The corporation's relationships with financial analysts and investment bankers is already changing; many more changes are in store, including broad securities analyst disclosure and clear separation of analysis/research and investment banking services.
- Off-balance sheet transactions will be much more visible; SPE accounting treatment will probably change in the months ahead.

THE HARVEY PITT LEGACY

Former SEC Chairman Harvey Pitt's lasting legacy may be the emergence of real-time disclosure. The much-criticized chairman was an early champion of faster and more complete corporate disclosure, including shortening of filing deadlines for mandated reports. He envisioned immediate disclosure of material changes in financial condition and more transparency in corporate financial reporting. Chairman Pitt's April 2002 proposals became S-O statutory requirements and now evolving SEC rules will address many details of such real time disclosure. This will bring greater SEC scrutiny of corporate news releases, Web-site postings (mandated now), investor conference calls, and other methods of communication with shareholders.

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WALL STREET EXPERIENCING REVOLUTION

Even before S-O passage, a dramatic revolution was taking place on Wall Street. S-O legislation directly addressed financial analyst and investment banker behavior. Equity research reports must contain such information as:

- Full disclosure of conflicts (some brokerage house reports now contain pages of small print disclosures)
- Information on analyst compensation for the research report
- Disclosure of client relationships, if any exist
- Whether the analyst's firm was compensated by the subject company during the year (e.g., for investment banking or management of public offerings)

The Congress suggested that the SEC and the SROs consider additional rules for analysts, including the potential of personal liability for research reports. Also suggested is more work on analyst stock ratings systems (a number of investment houses adopted new standards on a voluntary basis in 2002). Congress suggested that firms that issue ratings on issuers might periodically update or confirm analysis. If coverage is dropped, issue a final report and explain why coverage is ending, instead of quietly exiting the scene without notice to investors who previously relied on the research. (It didn't help that 16 of 17 financial analysts maintained "buy," "strong buy," and other favorable ratings on Enron even as the lawyers entered the bankruptcy court.)

FOREIGN ISSUERS—GRAY AREA

One gray area that needs to be clarified is the application of new laws and rules to foreign issuers. S-O legislation provisions generally apply to all non-U.S. companies that register securities with the SEC. Executives at a number of German companies joined with their government in protesting S-O adoption to U.S. government officials and the CEO of Porsche postponed the company's NYSE listing.

THE IMPORTANCE OF S-O LEGISLATION

The closing comment goes to former SEC Chairman Richard Breeden: "Federal law requires a publicly traded company to hire an independent accounting firm to perform an annual audit.

More than 100 million investors in the United States depend on audited financial statements to make decisions. That imbues accounting firms with a high level of public trust and also explains why there is a strong federal interest in how well the accounting system functions."

And that sums up at least one fundamental reason why the Sarbanes-Oxley comprehensive package of legislative remedies is so important.

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