

Background



After reading this chapter, you will be able to:

- Understand the historical environment from which the Sarbanes-Oxley Act (SOX) was born.
- Understand the key principles in the development of the Act.
- Understand the role of the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) in SOX-related regulation development and enforcement.

Introduction

The Sarbanes-Oxley Act (Publication License No. 107-204, 116 Stat. 745) is a U.S. federal law that is known by several names, including:

- Public Company Accounting Reform and Investor Protection Act of 2002
- SOA
- SOX
- SarbOx

This law was created, in part, as a reaction to the corporate corruption scandals that occurred during the late 1990s and early 2000s. One of the primary objectives of the Act was to establish clear accounting and reporting practices for both the boards of publicly traded U.S. companies and public accounting firms. This was done in the hope of reinstating the trust of investors and the general public.

Essentially, SOX requires that every publicly traded company's executive members evaluate and hold responsibility for the accuracy and completeness of all financial information that is released. This Act also requires that companies release information regarding those controls that are in place to ensure the accuracy of the financial information.

This chapter introduces the history of SOX and provides insight into the circumstances that resulted in its enactment.

Corporate Scandals

In the years surrounding the turn of the twenty-first century, several high-profile corporate scandals shook public trust. Insider trading,

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fraudulent financial records, and other deceitful incidents caused investors to question the integrity of the stock markets and their listed companies.

The poster children of this era include WorldCom, Enron, and Tyco International.¹ The exploits of some of their key executives resulted in document manipulation to facilitate insider trades, hide debts, and inflate assets, in an effort to purposely mislead investors.

- *WorldCom.* As chief executive officer (CEO) of WorldCom, Bernard Ebbers was able to amass a large fortune during the 1990s. Ebbers used his stock holdings to finance personal ventures and further increase his assets. In the year 2000 WorldCom's stock began its decline, and Ebbers was unable to cover his stock's margin calls. To raise the funds Ebbers turned to WorldCom's board of directors for loans and guarantees worth over \$400 million.

Ebbers resigned from his position in mid-2002 after a federal probe began in April of that year into both his loans and WorldCom's accounting practices. That June the SEC filed fraud charges against WorldCom, and on March 15, 2005, Ebbers was convicted on charges of fraud and conspiracy.

His legal conviction carried a sentence of 25 years in prison, which Ebbers is currently serving in a Louisiana federal prison. The former CEO has also agreed to civil lawsuit settlements that require the relinquishment of his assets.

Additionally, civil settlements also require Ebbers to issue financial restitution of \$6 billion to the investors that he defrauded.

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Although significant, this is relatively inconsequential when compared to the \$180 billion lost by investors as a direct result of the WorldCom fraud.

- *Enron scandal.* As the United States' seventh largest company, Enron once employed more than 21,000 people in over 40 countries. During its time on top, Enron was a major corporate competitor and held close ties with the White House.

In September 2006, Enron sold its last remaining business, Prisma International, thus completing its transition from industry leader to assetless corporation.

The company experienced its collapse as a direct result of corporate accounting fraud. In order to mislead investors and maintain its successful image, Enron manipulated its financial appearance by lying about profits and hiding debts.

Several Enron executives were convicted on charges related to fraud and conspiracy. For example, Andrew Fastow, chief financial officer (CFO), was sentenced to 10 years in prison and ordered to forfeit \$24 million. Kenneth Lay, CEO, was also convicted and faced 45 years in prison after his conviction, but died before the sentence was handed down.

- *Tyco International scandal.* Tyco International's CEO, Dennis Kozlowski, and CFO, Mark Swartz, were convicted on June 17, 2005, of stealing \$600 million from the corporation. Their actions not only defrauded investors, but also directly resulted in the loss of several thousand jobs.

Unlike Enron and WorldCom, Tyco International has been able to persevere through the scandal. Although suffering severe

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financial setbacks, the company has rearranged assets, sold smaller businesses, and worked to regain the trust of investors.

Unfortunately, these are not the only scandals that scar corporate America's past, although they are the ones that have received the most attention. These events created a collective sense of dishonesty and disregard for the rights of investors that has led to a breakdown of the trust that the public had for the U.S. markets and their company members.

Investor, Employee, and Public Trust

News of corporate corruption works to erode the trust of investors and employees whose resources are vital components of a company's success. When a specific act of fraud or corruption occurs, the company feels the direct impact. However, corruption also creates a trickle-down effect whereby all companies in the economy suffer.

Investor trust in publicly traded companies is integral to the success of the trading system. Profiles of incidences of corporate scandal and investor deception serve to create investors' suspicion in all companies in which they invest. The collective result is that reasonable traders start to question whether their investments are being respected and whether they are being treated fairly. Essentially, shareholders can be abused only so many times before they start to become wary.

With enough occurrences of fraud, investors begin to invest more conservatively in order to protect their finances. Without investor activity, the U.S. stock markets would collapse and publicly traded companies would suffer. The result would be severe economic recession as seen in the Great Depression following the stock market crash of 1929.



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Stock Exchange Crash in October 1929

We are all aware of the economic ramifications that the stock market crash of 1929 had on the United States and countries whose economy is directly linked to that of the United States.

After the reign of a bull market, the stocks of the New York Stock Exchange lost over 83% of their value between September 1929 and July 1932. This staggering collapse created unthinkable ramifications both nationally and abroad. Through this crash banks lost money, companies lost their fortunes, and the public lost not only their savings and jobs, but also their faith in the market. The result was the Great Depression, which plagued the economy for many years.

After the crash, members of the U.S. government agreed that part of their concerted effort to restore the health of the economy had to focus on reinstating people's trust in the capital markets. They knew that unless citizens felt comfortable investing in the future of their country's companies, industries, and markets would not recover.

This led to the creation of the Securities Act of 1933, which demanded that all publicly traded companies release their financial information to the public. Had such practices been established earlier, it is possible that the Great Depression would never have occurred.

The goal of the Securities Act was to make the investing process more transparent and eliminate the practice of insider trading. The overall objective was to provide investors with assurance that history would not repeat itself and that the stock market would be a safe place to invest.

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As a vehicle for enforcing the Securities Act, the U.S. government also passed the Securities Exchange Act of 1934. This Act created the SEC and outlined the commission's powers and goals.

The Securities Acts of the 1930s were effective in reassuring investors of the market's safety, and the SEC is still a viable power within the corporate world. Yet since the 1930s, the landscape of corporate America has undergone major changes. Although still applicable and relevant, these earlier acts have lost some of their previous control.

Over the course of 70 years, the nature of business, the global markets, and the sophistication of legal and accounting systems have created gaps in the controls of the securities laws. Even though the SEC sought to retain control through new regulations and amendments, the corporate scandals of the last decade demonstrated that new legislation was long past due.

In a sense, SOX seeks to reestablish the goals of the Securities Acts and make them applicable and relevant to the corporate world in the twenty-first century. This Act is designed to cover new circumstances that were not an issue during the 1930s, such as Internet, email, privacy regulations, and the ubiquitous global market.

Proponents of this Act hope that it also will reestablish investor trust in the market and enforce a corporate culture of ethical behavior and respect for shareholders. Although another depression may not be on the horizon, it is clear that fostering confidence in publicly traded companies will serve a greater economic good.

In addition to investor trust, it is also important to consider the implications that a lack of trust can have on employees. Although stock market and financial activity are not the only factors that contribute to

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an employee's impression of corporate management and executive boards, deceitful or fraudulent behaviors do have the potential for creating a contributing effect. There is a risk that employees working in the nonexecutive levels of corporations will assume that those running all companies are untrustworthy. Not only can this compromise the company's productivity, it also can create a culture of dishonesty in which lower-level frauds may also occur.

When a company suffers in the aftermath of a scandal, employees face the financial consequences of job loss and cutbacks. In times when scandals appear to abound, employees may experience fear of job insecurity, even if their executive members hold high ethical standards.

The aftermath of scandals such as Enron, WorldCom, and Tyco International has demonstrated these effects, but companies are making efforts to rectify the problem. The Watson Wyatt Work USA Survey (2004)² reported that just over 51% of respondents felt that their senior management was trustworthy.



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Securities Act of 1933 and Securities Exchange Act of 1934

Following the collapse of the New York Stock Exchange in 1929, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities Act of 1933 seeks to ensure that investors receive truthful and representative information about publicly traded companies; the Securities Exchange Act of 1934 created the SEC and provided it with powers over the securities industry to facilitate the fair treatment of investors.

Corporate Governance

At the heart of corporate governance is the ideal that a company's financial and business goals can be balanced with social and ethical considerations. In fact, many believe that a company's financial and business goals can actually be served by conscious policies toward ethical behavior.

Although corporate governance is not a new concept, it is an ever-evolving one. As different models demonstrate success, the world's opinion of the best standard changes and new corporate governance standards gain favor.

During the rampage of corporate scandal, the U.S. model fell temporarily out of favor. Nevertheless, as the economy and corporate culture regain their footing, U.S. corporate governance standards are reestablishing themselves in the eyes of the world.

History of the Sarbanes-Oxley Act

The history of SOX centers on two elected officials, Senator Paul Sarbanes (D-Md) and Congressman Michael Oxley (R-Oh). As the corporate scandals of the late 1990s reached their pinnacle, the U.S. Government recognized that they would have to make a concerted effort to prove to investors that their interests were important.

In April 2002 Congressman Oxley put forth the Corporate and Auditing Accountability, Responsibility, and Transparency Act (CAARTA).³ This bill sought to reinforce the ideals of the Securities Laws of the 1930s and eliminate the perception that corporations were blameless entities. CAARTA was passed on April 25, 2005, by the

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House of Representatives with a vote of 334 to 90. Congressman Oxley's bill then proceeded to the Senate Banking Committee for further approval.

Around the same time, Senator Sarbanes, head of the Senate Banking Committee, was preparing a similar proposal. His bill, Senate Bill 2673,⁴ also sought to bring the ideals of integrity and accountability back to the corporate world. Bill 2673 passed the Senate Banking Committee on June 18, 2002, by a vote of 17 to 4. The bill then moved to the U.S. Senate, where it received unanimous support of voting members with a vote of 97 to 0, on July 15, 2002.

In order to reconcile both Congressman Oxley's CAARTA and Senator Sarbanes' SB 2673, the House of Representatives and the Senate formed a Conference Committee. The resultant bill was the Public Company Accounting Reform and Investor Protection Act. This bill, which later became commonly known as the Sarbanes-Oxley Act, was approved by the House with a vote of 423 to 3 and by the Senate with a vote of 99 to 0.

Senator Paul Sarbanes

A Rhodes Scholar and lawyer by trade, Senator Paul Sarbanes introduced the first Article of Impeachment against President Richard Nixon while holding office in the House of Representatives.⁵

During his fourth term in the U.S. Senate, Senator Sarbanes served as the chairman of the Senate Banking, House, and Urban Affairs Committee. It was in this role that he held a series of hearings regarding the Enron scandal and established the bill that led to the Sarbanes-Oxley Act.



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Senate Banking, House, and Urban Affairs Committee

This U.S. Senate Committee oversees matters related to banks, price controls, export controls, federal monetary policy, currency and coinage, public and private housing, urban development, and mass transit. It is chaired by a senator of the majority party and is responsible for reviewing, editing, and passing all bills relevant to matters under their control.

Congressman Michael Oxley

Born February 11, 1944, Congressman Michael Oxley practiced law before being elected to the Congress. As a member of the House of Representatives, Congressman Oxley served 12 terms. This fiscal conservative has worked throughout his career to promote economic, technological, and telecommunications advancements.⁶

SEC and PCAOB

Publicly traded companies have always been very familiar with the Securities and Exchange Commission through both its requirements and a variety of quarterly and annual forms. Now these companies have a second organization with which to interact. SOX Section 101 created the Public Company Accounting Oversight Board and assigned its powers and jurisdictions.

Although both organizations are concerned with maintaining the integrity of the U.S. public market system, the SEC and PCAOB rule

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over different areas of the process. It is also important to understand that while the SEC is a government-appointed commission, the PCAOB is a private not-for-profit organization. This distinction does have an impact on how these two organizations are received by the corporate world.

SEC

After the New York Stock Exchange crash in 1929, the U.S. Congress determined that significant changes to the market's operations would have to be established in order to restore the public's faith in capital markets. Because of these efforts, the Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934. The first of these acts set forth the mandates for companies to follow, and the second established the SEC to govern over compliance.

The SEC's role is to enforce the Securities Act of 1933 and therefore protect investors. The primary objective of this Commission is to defend the concept that all investors, regardless of whether they are a large institution or a private individual, have a right to sound facts about their investments. To this end, the SEC requires public companies to disclose their financial and other relevant information to the public. Ideally, this should make for efficient information flow and a more transparent market.

In more recent years, the SEC's ability to govern publicly traded companies and their activities has fallen under criticism. It was because of the Commission's failure to effectively prevent the corporate scandals of the last decade that the U.S. government sought to increase investor security through SOX.



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SEC Investigations

The SEC has jurisdiction to investigate those companies it suspects are involved in unethical or illegal trade activities. The Commission maintains information on companies through mandatory submissions of quarterly and annual reports, and uses these reports as the basis of its investigations.

The SEC pursues an investigation if it suspects that members of a company are involved in any of these activities:

- Insider trading
- Information misrepresentation
- Stock price manipulation
- Fund or securities theft
- Unregistered securities sales

SEC Internal Organization

The SEC is a federal agency of over 3,000 staff organized into 18 offices and 4 divisions. Leading the operations are five presidentially appointed commissioners, one of whom is the chairperson. One of the four, the Division of Corporate Finance, oversees publicly traded companies and their disclosure of important information in compliance with the Securities Act of 1933. Additional activities of this division include serving as a liaison between companies and the Securities Act. In this capacity, the division is responsible for providing instructions and assistance to facilitate companies' efforts at complying with SEC rules and regulations.



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No-Action Letters

In one of its many roles, the SEC's Division of Corporation Finances serves as a liaison between publicly traded companies and the SEC. One of the most important functions that this division provides in this capacity is the issuance of no-action letters.

Companies will request a no-action letter when they are about to embark into uncharted activities that may or may not result in SEC investigation. To obtain guidance as to whether their actions will result in unpleasant consequences, companies submit an outline of their intended activities. After reviewing those activities, the Division of Corporation Finances releases a judgment as to whether it would or would not recommend SEC action against a company that acted in this manner.

Essentially these letters serve as a hypothetical "if I did this ... would you?" interaction between the SEC and the company.



TIPS AND TECHNIQUES

Documents Reviewed by the SEC Division of Corporation Finance

Depending on the nature of a public company and its financial organization, the SEC requires the submission of several reports and statements each year. The relevant division reviews these statements. The Division of Corporation Finance is responsible for:

- New securities registration statements
- Forms 10-K and 10-Q

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- Shareholder meeting material
- Documents of tender offers
- Merger and acquisition filings

PCAOB

The PCAOB was created by SOX to function as a private, nonprofit corporation reporting to the SEC. This organization oversees the auditors of public companies and their activities. In general, the purpose of the PCAOB is to protect investors and the public by ensuring informative and independent audit reports. It is through SOX Section 101 that the PCAOB has been ascribed its powers, which include:

- *Registering public accounting firms.* In an effort to uphold and regulate public accounting firms, the PCAOB has been instructed by SOX Section 101 to establish and maintain a registration of all those accounting firms that have publicly traded clients.
- *Setting standards for auditing, quality control, and ethics relating to issuer audit reports.* The scandals of the 1990s demonstrated that accountants can have a severe impact on corrupt practices either by direct and purposeful action or by failure to recognize the activities. By establishing the PCAOB as a regulatory board, SOX seeks to guide accounting firms in maintaining the highest level of standards and therefore preventing investor deception.

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- *Inspect registered public accounting firms.* In addition to providing regulations for public accounting firms, the PCAOB has also been charged with the responsibility of inspecting those firms to ensure that compliance is maintained.
- *Lead investigations and disciplinary proceedings.* SOX provides the PCAOB with the power to investigate and charge accounting firms and associated persons when they fail to comply with standards set. The PCAOB is also able to impose sanctions, which include fines of up to \$100,000 for individuals and \$2 million for audit firms.

PCAOB Internal Organization

The board of the PCAOB includes five full-time members, including one chairperson. These members are appointed by the SEC through consultation with the chairperson of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury. The rules stipulate that at least two of the five members must currently be, or have been in the past, certified public accountants (CPAs). The first appointed chairperson of the PCAOB was William J. McDonough, who served from May 21, 2003, until November 30, 2005, when he was succeeded by Mark W. Olson.

Unlike the SEC, board members of the PCAOB are not presidentially appointed. This fact has created a great deal of contention among those who disagree with SOX, especially because it does grant the PCAOB legal powers.



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Lawsuit Challenging the Constitutionality of the PCAOB

On February 7, 2003, the Free Enterprise Fund and the Competitive Enterprise Institute launched a lawsuit against the Public Company Accounting Oversight Board.^a Through this lawsuit, these organizations argue that the PCAOB violates Article II, Section 2 of the United States Constitution, referred to as the Appointments Clause.

The lawsuit asserts that in creating the PCAOB and assigning it regulatory powers, SOX has provided the organization with federal enforcement authority. The lawsuit further asserts that the PCAOB's powers violate the Appointments Clause because the members of the PCAOB are neither appointed by nor accountable to any political officers.

Although this lawsuit threatened to undo the PCAOB and therefore SOX, the PCAOB still exists and the lawsuit was ineffective.

^a More information regarding this lawsuit is available through www.feinstitute.org.

Relating the SEC to the PCAOB

Within SOX Sections 104 and 105, the SEC is given the jurisdiction to oversee the activities of the PCAOB. That jurisdiction is limited, however, and does not include the right to control the PCAOB's regular inspections nor its special investigations. As a result, the SEC is unable to pursue investigations against a company even if it believes that the PCAOB was wrong in neglecting to investigate it.

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This limitation of power can mean that the PCAOB is effectively not regulated in some important instances.

Additionally, while the SEC does have the ability to amend PCAOB rules and review its regulations and standards, doing so is a rare occurrence. The framework and process for such interactions are time consuming and costly, and are therefore rarely pursued. This further contributes to the PCAOB's sense of autonomy.

Conclusion

SOX was created to combat the declining trust that investors and the public had in American markets and their listed companies. In the past decade, this culture of distrust manifested itself with the uncovering of several corporate scandals in which shareholders were deceived as to the financial state of the companies in which they had invested.

The history of SOX centers on the work of Senator Paul Sarbanes and Congressman Michael Oxley. These men, and their respective houses, worked together to formulate an act that would hold publicly traded companies to a higher standard and require more transparent financial reporting methods to ensure the safety of shareholders' money.

After developing the framework of SOX, the U.S. Government handed the legislation, and the power to regulate its enforcement, over to the newly created PCAOB. Under the guidance of the SEC, the PCAOB is responsible for filling in the details for compliance and ensuring that the objectives of SOX are met.

The first step toward understanding SOX is understanding the history behind it. Armed with this knowledge, SOX, its current

state, and its possibilities for the future become much more transparent.

Summary

- The Sarbanes-Oxley Act is a federal law that is known by many names, most notably SOX.
- SOX was created as a reaction to corporate scandals of the 1990s, particularly those of Enron, Tyco International, and WorldCom.
- SOX resulted from the efforts of Congressman Michael Oxley and Senator Paul Sarbanes.
- Corporate corruption abuse of shareholders and their money can threaten the publicly traded market.

Notes

1. More information on the WorldCom, Tyco International, and Enron scandals can be found through the *Washington Post* archives at www.washingtonpost.com and through the SEC site at www.sec.gov.
2. The Watson Wyatt Work Survey, www.watsonwyatt.com/surveys.
3. Corporate and Auditing Accountability, Responsibility, and Transparency Act, www.biblioteca.jus.gov.ar/House-3763.pdf.
4. Bill 2673, <http://thomas.loc.gov/cgi-bin/query/R?r107:FLD001:S56684>.
5. www.sarbanes.senate.gov.
6. www.oxley.house.gov.

