

2003

Congress Passes the Sarbanes-Oxley Act of 2002

Neil S. Lang

Sarah B. Estes

Follow this and additional works at: <https://scholar.smu.edu/lbra>

Recommended Citation

Neil S. Lang et al., *Congress Passes the Sarbanes-Oxley Act of 2002*, 9 LAW & BUS. REV. AM. 21 (2003)
<https://scholar.smu.edu/lbra/vol9/iss1/4>

This Symposium Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in Law and Business Review of the Americas by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

CONGRESS PASSES THE SARBANES–OXLEY ACT OF 2002

*Neil S. Lang and Sarah B. Estes**

[Note to Readers: This article was written shortly after the enactment of the Sarbanes-Oxley Act of 2002. Since such time, the Securities and Exchange Commission has proposed rules to implement certain provisions of the Sarbanes-Oxley Act of 2002. Some of these proposed rules are open and are subject to comment.¹ Others have become effective.² Others have yet to be proposed.³

In many cases, the proposed and final rules promulgated by the Securities and Exchange Commission go well beyond the statutory mandate in the Sarbanes-Oxley Act of 2002. For example, the Securities and Exchange Commission created the new term “disclosure controls and procedures” in connection with the certification requirements of section 302 of the Sarbanes-Oxley Act of 2002, and the concept of a “noisy-withdrawal” in connection with the professional conduct for attorneys requirement of section 307 of the Sarbanes-Oxley Act of 2002.

In addition, the New York Stock Exchange, the American Stock Exchange, and NASDAQ have proposed listing-rules to comply with the requirements of section 301 of the Sarbanes-Oxley Act of 2002. Such proposed listing-rules are subject to comment and approval by the Securities and Exchange Commission. As a result, you should review such proposed and final rules to get the full flavor of the Sarbanes-Oxley Act of 2002 in its current form.]

I. INTRODUCTION

ON July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002 (the Act).⁴ The Act was passed in response to nationwide concerns regarding corporate misconduct and the role that accountants may have played (in some instances) in

-
- * Partners, Sutherland Asbill & Brennan LLP, Washington, DC and Atlanta, GA.
1. The Securities and Exchange Commission has proposed rules to implement sections 301, 303(a), 403(a)(4) and 404.
 2. The Securities and Exchange Commission has adopted final rules to implement sections 201, 202, 203, 204, 206, 302, 306(a), 307, 401(a), 401(b), 403(a)(1) through (3), 406, 407, 409 and 802.
 3. The Securities and Exchange Commission has yet to propose rules to implement sections 409 (although the Securities and Commission has adopted rules pursuant to this section, it is likely that it will adopt other rules relating to real-time disclosure by public companies) and 501.
 4. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 15 U.S.C.A. § 7201.

facilitating such misconduct. The new law significantly alters corporate and accounting requirements in six important areas: (1) auditor oversight, (2) auditor independence, (3) corporate responsibility, (4) financial disclosures, (5) analyst conflicts of interest, and (6) civil and criminal penalties for fraud. The most significant provisions in each area are summarized below.

A. AUDITOR OVERSIGHT

The Act provides for federal regulation of the public accounting profession through the newly created Public Company Accounting Oversight Board (the Board). The Securities and Exchange Commission (the Commission) has "oversight and enforcement authority over the Board," similar to the authority of the Commission over other securities self-regulatory organizations.⁵ Significant provisions include:

Establishment of the Board: The Board, which must be fully operational within 270 days after enactment of the Act, will have five members appointed by the Commission.⁶ Only two of the five members can be accountants.⁷

Mandatory registration: All public accounting firms that prepare audit reports for publicly traded companies are required to register with the Board within 180 days after the Commission determines that the Board is fully operational.⁸

Board sets accounting standards: The Act requires the Board to establish the standards to be used in audits of public companies.⁹ Specifically, the Board is charged with adopting "auditing and related attestation standards, [] quality control standards, and [] ethics standards . . ." ¹⁰ The Board may adopt standards proposed by the accounting industry and is directed to cooperate with industry representatives in setting standards.¹¹

Inspections of accounting firms: The Board will conduct inspections of each registered public accounting firm to assess compliance with the Act.¹² Firms that perform audits for more than 100 public companies per year will be inspected annually;¹³ other firms will be inspected at least every three years.¹⁴ The Board's inspection reports will be provided to the Commission and to state regulators;¹⁵ furthermore, at least parts of the reports will be made public.¹⁶

5. § 107(a).

6. § 101(d), (e)(1).

7. § 101(e)(2).

8. § 102(a).

9. § 103(a)(1).

10. § 103(a)(2).

11. § 103(a)(3)(A)(i).

12. § 104(a).

13. § 104(b)(1)(A).

14. § 104(b)(1)(B).

15. § 104(g)(1).

16. § 104(g)(2).

Investigations: The Board will conduct investigations of accounting firms and their associated persons as to potential violations of: the Act; the rules of the Board; the federal securities laws dealing with accounting; the rules of the Commission; and professional standards.¹⁷ The Board will have the power to compel accountants, their clients, or “any other person” to give testimony and produce audit workpapers and other documents.¹⁸ Accounting firms or their associated persons who refuse to cooperate in investigations will be subject to sanctions by the Board,¹⁹ including having their registration with the Board suspended or revoked.²⁰ If needed, the Board can apply to the Commission for issuance of subpoenas, which may be directed to “any person.”²¹ “The Board [is directed to] notify the Commission of [] investigation[s] . . . [of] potential violation[s] of the [federal] securities laws, and thereafter coordinate its [activities] with [those of] the ‘Commission’s Division of Enforcement’.”²²

Disciplinary proceedings and sanctions: The Board will conduct disciplinary proceedings “to determine whether a registered public accounting firm,” or an individual associated with the firm,²³ has violated the “Act, the securities laws, the rules of the Board, or professional standards.”²⁴ The Board is authorized to sanction violators, including:

Suspend or revoke an accounting firm’s or individual’s registration with the Board (effectively preventing them from auditing public companies);²⁵ Limit the activities, functions or operations of the registered firm or individual;²⁶ Impose civil monetary penalties of up to \$100,000 for an individual, and \$2,000,000 for a firm, but with provisions for higher penalties (\$750,000 for an individual, and \$15,000,000 for a firm) if the violation is intentional, knowing, reckless, or a repeated instance of negligence;²⁷ Censure a registered accounting firm or individual;²⁸ Require additional training;²⁹ and Impose other sanctions as deemed appropriate.³⁰

Suspensions, revocations, limitations of activities, and imposition of the higher levels of monetary penalties require a finding that there was “intentional or knowing conduct,” “reckless conduct”³¹ or “repeated in-

17. § 105(b)(1).

18. § 105(b)(2)(A-C).

19. § 105(b)(3).

20. § 105(b)(3)(i),(ii).

21. § 105(b)(2)(D).

22. § 105(b)(4)(A).

23. § 105(c)(1).

24. § 105(c)(3)(B).

25. § 105(c)(4)(A),(B).

26. § 105(c)(4)(C).

27. § 105(c)(4)(D)(i),(ii).

28. § 105(c)(4)(E).

29. § 105(c)(4)(F).

30. § 105(c)(4)(G).

31. § 105(c)(5)(A).

stances of negligent conduct.”³² The Board may also impose sanctions for a public accounting firm’s failure to supervise those associated with it.³³ Final disciplinary sanctions can be appealed to the Commission for review.³⁴

Act applies to foreign public accounting firms: The Act provides that “[a]ny foreign public accounting firm that prepares [,] furnishes” . . . ,³⁵ [or] “plays such a substantial role”³⁶ with respect to an audit report for a public company shall be subject to the Act, the rules of the Board, and the rules of the Commission, to the same extent as a domestic accounting firm (unless the Commission or the Board exempts the foreign firm.)³⁷ Foreign accounting firms must produce audit workpapers in connection with any investigation by the Board or the Commission,³⁸ and the U.S. Federal courts have jurisdiction to enforce requests for production of those documents.³⁹

Study of principles-based accounting: In addition to the Board’s authority to set accounting standards, the Act also provides that “the Commission may recognize, as ‘generally accepted’ for purposes of the securities laws, any accounting principles established by a standard-setting body.”⁴⁰ The Commission is further charged with conducting a study, to be completed within one year of enactment of the Act, on the adoption of a “principles-based [as opposed to a rules-based] accounting system” in the United States.⁴¹

Funding of the Board: The Board’s budget will be funded by the registration fees paid by accounting firms and also by “accounting support fees” which will be assessed against publicly traded companies in an allocation based on their equity market capitalization.⁴² “[M]onetary penalties [collected by the Board will] fund a merit scholarship program” for students seeking accounting degrees, which program the Board is to administer.⁴³

B. AUDITOR INDEPENDENCE

The Act attempts to ensure auditor independence by prohibiting accounting firms from providing non-audit services to the public companies they audit.⁴⁴ Significant provisions include:

32. § 105(c)(5)(B).

33. § 105(c)(6).

34. *See* §§ 105(e), 107(c)(2).

35. § 106(a)(1).

36. § 106(a)(2).

37. § 106.

38. § 106(b), (b)(1)(A).

39. § 106(b)(1)(B).

40. § 108(b)(1).

41. § 108(d)(1)(A), (d)(2).

42. § 109(c)(1).

43. § 109(c)(2).

44. § 201(g).

Non-audit services prohibited: Registered public accounting firms (those auditing public companies) are prohibited from performing a variety of specified “non-audit services” including: “bookkeeping;”⁴⁵ “financial information systems design and implementation;”⁴⁶ “appraisal or valuation services; fairness opinions or contribution-in-kind reports;”⁴⁷ “actuarial services;”⁴⁸ “internal audit outsourcing services;”⁴⁹ “management functions or human resources;”⁵⁰ “broker or dealer, investment adviser, or investment banking services;”⁵¹ and “legal services and expert services unrelated to the audit.”⁵² An “accounting firm may engage in any non-audit service, including tax services, [that are not specifically banned, but] only if [such services are] approved in advance” by the public company’s audit committee.⁵³

Rotation of audit partners: Accounting firms must rotate the lead audit partner and the audit partner responsible for reviewing the audit for each public company client at least every five years.⁵⁴

Cooling-off period if auditors join management: An accounting firm is prohibited from auditing a public company if a current member of senior management of the company (CEO, CFO, controller, chief accounting officer, or person holding an equivalent position) was previously employed by the accounting firm and participated in the public company’s audit during the previous year.⁵⁵

Study on rotation of accounting firms: The Act mandates a study by the Comptroller General to determine whether there should also be a five-year limit on the period of time an accounting firm may serve as the auditor for a particular public company.⁵⁶

C. CORPORATE RESPONSIBILITY

The Act attempts to impose greater responsibility on corporations by holding their officers and directors personally accountable and by toughening disclosure requirements. Significant provisions include:

Audit committee independence and oversight: The audit committee of a public company must be comprised solely of independent directors.⁵⁷ The audit committee is directly responsible for hiring, compensating and overseeing the work of the outside public accounting firm that audits the company, and the audit committee must resolve any disagreements be-

45. § 201(g)(1).

46. § 201(g)(2).

47. § 201(g)(3).

48. § 201(g)(4).

49. § 201(g)(5).

50. § 201(g)(6).

51. § 201(g)(7).

52. § 201(g)(8).

53. § 201(h).

54. § 201(j).

55. § 206.

56. § 207.

57. § 301(m).

tween the auditors and company management.⁵⁸ The company must adequately fund the audit committee to pay the auditing firm and any independent legal counsel or other advisors the committee hires.⁵⁹ Any publicly traded company that fails to comply with these requirements will have its stock de-listed from a national stock exchange or national securities association (such as the NYSE, AMEX and NASDAQ).⁶⁰

Management must certify 10-K and 10-Q reports: Section 302(a) of the Act states that CEOs and CFOs of public companies are required to certify each annual and quarterly report filed with the Commission, certifying the following:

The “officer has reviewed the report;”⁶¹ “[B]ased on the officer’s knowledge the report does not contain” any material misstatements or omissions;⁶² “[B]ased on such officer’s knowledge the financial statements . . . “fairly present . . . the financial condition and results of operations” of the company in all material respects;⁶³ The officer is responsible for establishing internal controls designed to ensure that the officer receives all material information, and the officer has evaluated such controls within the last ninety days;⁶⁴ The officer has disclosed to the outside auditors and the audit committee significant deficiencies in the internal controls,⁶⁵ and any fraud that involves management or employees having a role in the internal controls;⁶⁶ and The report indicates whether there have been “significant changes in [the] internal controls or [] other factors that could” affect them, since management’s last evaluation of the controls.⁶⁷

The Commission must adopt rules within thirty days to implement the certification provision.⁶⁸ The Act expressly provides that a company cannot escape this provision by reincorporating or changing its domicile to a foreign country.⁶⁹

Executive interference with audits outlawed: The Act makes it unlawful for any officer, director or person acting at their direction “to fraudulently influence, coerce, manipulate, or mislead” an accountant conducting an audit of the company’s financial statements.⁷⁰ The Commission, which is given exclusive authority to enforce this provision, is charged with proposing rules within ninety days for this purpose.⁷¹

Bonuses forfeited upon restatements: If a public company is required

58. § 301(m)(2).

59. § 301(m)(6)(A),(B).

60. § 301(m)(1)(A).

61. § 302(a)(1).

62. § 302(a)(2).

63. § 302(a)(3).

64. § 302(a)(4)(A-C).

65. § 302(a)(5)(A).

66. § 302(a)(5)(B).

67. § 302(a)(5)(B), (a)(6).

68. § 302(c).

69. § 302(b).

70. § 303(a).

71. § 303(b),(d)(1).

to restate its financial statements “as a result of misconduct”,⁷² then the CEO and CFO must reimburse the company for “any bonus or other incentive-based . . . compensation” paid to them during the twelve-month period following the improper reporting.⁷³ The CEO and CFO must also forfeit to the company any profits they have realized from the sale of the company’s stock or other securities during that twelve-month period.⁷⁴

Standard for bars of officers and directors lowered to unfitness: The Act lowers the standard for barring an individual from serving as an officer or director of a public company from “substantial unfitness” (the old standard) to the presumably lower standard of mere “unfitness.”⁷⁵ (The Commission in federal District Court still must bring such actions; the Act did not give the Commission the power to bring these as administrative proceedings.)⁷⁶

Executives may not trade during pension fund “blackouts”: Officers and directors of a public company are prohibited from trading in the company’s stock during a pension fund “blackout” period when the plan participants’ ability to trade is suspended.⁷⁷ If they do, any profits they realize are recoverable by the company. The pension plan administrator must give plan participants at least thirty days advance notice of a blackout period.⁷⁸

Lawyers as whistleblowers: The Act requires an attorney representing a public company “to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation[s] by [or within] the company to the chief legal counsel or chief executive officer of the company.”⁷⁹ If those officers do not “appropriately respond,” the attorney must “report the evidence to the audit committee” or other committee comprised solely of outside directors.⁸⁰ However, the Act does not specify what happens if the committee does not appropriately respond. The Commission is directed to issue rules within 180 days to implement this provision of the Act.⁸¹ The rules will apply to any attorney who practices before the Commission in any way.

Victim relief fund for investors: In any action where the Commission obtains both disgorgement of ill-gotten gains and civil monetary penalties, the penalties will be added to a “disgorgement fund for the benefit of victims” of the securities law violations.⁸² The Commission is also authorized to accept gifts, bequests and other donations to the disgorge-

72. § 304(a).

73. § 304(a)(1).

74. § 304(a)(2).

75. § 305(a)(1).

76. § 305(b).

77. § 306(a)(1).

78. §. 306(b)(1)(i)(2)(B).

79. §. 307(1).

80. §. 307(2).

81. § 307.

82. § 308(a).

ment fund.⁸³

D. ENHANCED FINANCIAL DISCLOSURES BY PUBLIC COMPANIES

The Act requires enhanced financial disclosures designed to increase the transparency of public companies' financial statements. Significant provisions include:

Off-balance sheet transactions and "pro forma" statements: The Act mandates the Commission to issue rules, within 180 days, to require the public financial filings of public companies to reflect "off-balance sheet transactions, arrangements, [and] obligations . . . that may have a material . . . effect" on the company's financial condition, either currently or in the future.⁸⁴ In addition, such financial filings must immediately reflect any "material correcting adjustments" identified by the company's auditor.⁸⁵ Finally, any "pro forma" figures included in a public filing or "any public disclosure" (such as a press release) are required to be presented in a manner that is not misleading, and which "reconciles" the pro forma figures with the company's financial statements according to generally accepted accounting principles.⁸⁶

Study of special purpose entities and off-balance sheet arrangements: The Commission is directed to conduct a study on the extent to which public companies use off-balance sheet transactions and "special purpose entities" (SPEs), to consider whether generally accepted accounting rules are adequate to account for such transactions in a "transparent fashion," and to make recommendations to improve the financial reporting of such transactions.⁸⁷

Personal loans to executives banned: Public companies are prohibited from extending personal loans to their officers and directors.⁸⁸

Disclosure period shortened for insider transactions: The Act shortens the deadline for principal stockholders, directors and senior executives to disclose changes in ownership of their company's securities or security-based swap agreements to two business days after the change occurs (reduced from the previous requirement of ten days after the close of the calendar month).⁸⁹

Annual reports must assess "internal controls": The Commission is directed to issue rules requiring public companies to include, as part of their annual report, an assessment of the company's "internal control structure and procedures for financial reporting."⁹⁰ The company's public auditor must "attest to, and report on," management's assessment as

83. § 308(b).

84. § 401(a)(j).

85. § 401(a)(k).

86. § 401(b).

87. § 401(c)(1),(2).

88. § 402(k)(1).

89. § 403(a)(2)(C).

90. § 404(a)(2).

part of the audit engagement.⁹¹

Corporate code of ethics required: The Act requires each public company to have a code of ethics for its senior financial officers or to explain why it does not have one.⁹² Any changes in the code of ethics must be disclosed promptly on Form 8-K.⁹³ The Commission is required to issue rules within ninety days concerning this provision.⁹⁴

Audit committee financial expert: The Act requires a public company to disclose whether “at least 1 member . . . [of its audit committee] is a financial expert” (and if not, the reasons why its audit committee does not have at least one member who is a financial expert).⁹⁵ The Commission is required to issue rules within ninety days concerning this provision.⁹⁶

Enhanced review of public companies: The Act mandates that the Commission review the 10-K and other periodic filings of all public companies at least once every three years.⁹⁷ In scheduling the reviews, the Commission is expressly directed to consider certain factors, including:

Companies that have restated their financial results;⁹⁸ Companies whose stock has experienced significant volatility;⁹⁹ Companies “with the largest market capitalization;”¹⁰⁰ “[E]merging companies with disparities in [their] price-to-earnings ratios;”¹⁰¹ and Companies “whose operations significantly affect a material sector of the economy.”¹⁰²

Real time financial disclosure required: The Act requires public companies to “disclose . . . on a rapid and current basis . . . material changes [in the company’s] financial condition or operations in plain English . . .” according to rules that the Commission will issue.¹⁰³

E. SECURITIES ANALYST CONFLICTS OF INTEREST

Within one year, the Commission must promulgate rules designed to address conflicts of interest between securities analysts and investment bankers working at the same firm.¹⁰⁴ Some of the rule provisions required by the Act include:

91. § 404(b).

92. § 406(a).

93. § 406(b).

94. § 406(d)(1).

95. § 407(a).

96. § 407(c)(1).

97. § 408.

98. § 408(b)(1).

99. § 408(b)(2).

100. § 408(b)(3).

101. § 408(b)(4).

102. § 408(b)(5).

103. § 409(1).

104. § 501. The Act makes no mention of the analyst conflict of interest rules recently enacted by the securities self-regulatory organizations (the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE)) and approved by the Commission.

Preapproval of research reports banned: “Prepublication clearance or approval of [analyst] research reports” by the investment banking arm of a broker/dealer is prohibited.¹⁰⁵

Supervision of analysts: Analysts cannot be supervised, nor can their compensation be evaluated, by those engaged in the investment banking activities of the firm.¹⁰⁶

Analysts protected from retaliation: Analysts who publish negative research reports must be protected from retaliation by their employers, or by individuals employed in the investment-banking arm of the firm.¹⁰⁷

Disclosure of conflicts of interest mandated: Analysts must make disclosures of conflicts of interest during public appearances and in all research reports, including such matters as whether the analyst or his broker/dealer has an investment in the securities of, or has received compensation from, any public company whose securities are being reviewed.¹⁰⁸

F. CIVIL AND CRIMINAL PENALTIES FOR FRAUD AND DOCUMENT DESTRUCTION

The Act includes several provisions designed to apply the tough-on-crime principle to various securities and white-collar crime violations. Significant provisions include:

Stiff sentences for document destruction: The Act provides for fines and prison sentences of up to twenty years for the “[d]estruction, alteration or falsification of records in [order to impede] Federal investigations and bankruptcies.”¹⁰⁹ Ten-year prison sentences and fines are authorized for accountants who fail to maintain audit workpapers for the prescribed time period (five years).¹¹⁰

Non-dischargeability in bankruptcy: Debts, which are the result of claims based on violations of the federal securities laws or common law fraud, are not dischargeable in bankruptcy.¹¹¹

Statute of limitations extended for civil claims: The statute of limitations for private (civil) fraud claims under the federal securities laws is extended to the earlier of two years after the discovery of the violation (previously it was one year), or five years after such violation occurred (previously it was three years).¹¹²

Protection for whistleblowers: The Act includes provisions to protect whistleblowers (employees of public companies who report information concerning possible instances of securities fraud) from retaliation by the

105. § 501(a)(1)(A).

106. § 501(a)(1)(B).

107. § 501(a)(1)(C).

108. § 501(b)(1-5).

109. § 802(a).

110. § 802(a-c).

111. § 803.

112. § 804(b)(1),(2).

company.¹¹³

New crime of “securities fraud” created: The Act creates the new crime of securities fraud, making it illegal to “knowingly . . . defraud any person in connection with any security [of a publicly traded company]; or obtain by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale . . .” of such securities.¹¹⁴ The penalty for the crime of securities fraud is imprisonment of up to twenty-five years, a fine, or both.¹¹⁵

Stiffer sentences for white-collar crimes: The Act also establishes and/or increases penalties for various white-collar crimes, including:

Mail and wire fraud (prison terms increased from five years to twenty years);¹¹⁶ ERISA violations (fines increased to a range of \$100,000 to \$500,000, and prison terms increased from one year to ten years);¹¹⁷ Tampering with, destroying or concealing a record or otherwise impeding or obstructing “any official proceeding” (fines, prison terms of twenty years, or both).¹¹⁸

Criminal penalties for management’s certification: The Act imposes criminal penalties for anyone who certifies a periodic report filed with the Commission by a public company knowing that the report does not comply with the certification requirements (imposing fines up to \$1,000,000 and prison terms up to ten years for “knowing” violations),¹¹⁹ or who willfully certifies a report that does not comply (imposing fines up to \$5,000,000 and prison terms up to twenty years for “willful” violations).¹²⁰ Unlike the certification required by section 302, which is effective only after the SEC adopts rules, this certification is effective immediately and will be required for all periodic reports containing financial statements filed after enactment.¹²¹

II. CONCLUSION

In summary, much of the impact of the Act will depend on the many rules and regulations that the Securities and Exchange Commission is charged with issuing over the course of the next year, and how effectively the Commission can enforce those rules in the future. It will also depend on the Public Company Accounting Oversight Board’s ability to design and create the infrastructure needed to implement the Act’s provisions concerning the accounting profession, and the many rules and regulations that must be issued to carry out the Board’s mandate.

113. § 806.

114. § 807(a).

115. § 807.

116. § 903(a),(b).

117. § 904(1-3).

118. § 1102(c)(1),(2).

119. 906(c)(1).

120. 906(c)(2).

121. § 906(a).

