TOWARD UNDERSTANDING SARBANES-OXLEY:

BUSINESS AND FINANCIAL ETHICS REQUIREMENTS

IN A POST-ENRON WORLD

Patrick W. Fitzgerald*
Stephanie Arnoldin**
Courtney R. Fitzgerald***
Max Sytch****
Zephanie Zimpleton**

I. Introduction

Numerous major regulatory and ethical issues have been revealed in the aftermath of the Enron collapse. In the following pages, contributing factors to the far-reaching Enron debacle are presented along with a range of solutions to these issues. Sarbanes-Oxley is one of the intended solutions and is presented as possibly the most significant single piece of business regulation in the United States since 1933. This new Act is discussed generally and the business ethics and financial experts portions of the Act are discussed in some detail. There is a need to understand the likely impact of these requirements, both good and bad. There is also a need to find the right balance between external regulatory interference and market participant and institution adjustment if we are to accomplish an efficient and effective environment for business and business investment.

II. Enron Background Summary

Formed in 1985 from a merger of Houston Natural Gas and Internorth, Enron was the first nationwide natural gas pipeline network. Prior to filing Chapter 11 bankruptcy on December 2, 2001, Enron, by then a conglomerate pursuing unrelated diversification with purely financial incentives, had expanded beyond the energy field to include newsprint, broadband, and cable.[1] Revenues of $101 billion made Enron the seventh largest

*Professor of Finance and Economics, Meinders School of Business, Oklahoma City University
**Business executives and MBA candidates, Executive MBA program, Oklahoma City University
***Business consultant and graduate student at the University of Texas at Austin
**** Financial consultant and MBA graduate, Oklahoma City University

company of 2000's Fortune 500. At the time Enron and its subsidiaries filed bankruptcy, Enron's acting CEO, Stephen F. Cooper, estimated the company faced liability claims of $60 to $100 billion.[2] Enron's dramatic collapse resulted from a series of illegal business practices, which has invited a national reexamination of not only Enron's particular actions but also business ethics in general.

In addition to illegal practices, basic deception played a large role in Enron's worldview. The underlying Enron motive was to be less than forthright with those who needed to know the truth most--the employees, investors, and government. The company's policy on retirement accounts misled employees about the security of their futures. When employees received Enron stock, the company prevented them from selling it. Top executives, however, could sell off their shares as they chose. While this policy was legal, its ethics proved less certain when thousands of employees found their retirement funds empty. Also, deceptive in their desire to keep investors, Enron executives went to great lengths to hide funds from the books. Likewise, Enron attempted to manipulate the government. It was not uncommon for Enron to boast of its large donations and hosting of charitable events in and beyond Houston. Enron executives tried extremely hard to be someone they were not, and, in the end, this became evident to all.

Blame for Enron's disgrace was not limited to just one person. While CEO Lay was largely responsible, the company's board was also culpable. In 1999, for example, the Enron board waived the firm's code of ethics in order to permit the kind of off-balance-sheet deals that hid massive debt from public view. In the year before financial collapse, the board had inflated profits by almost $1 billion through transactions with a group of partnerships that served little to no economic purpose other than manipulating reported profits. University of Texas Law School Dean, William Powers, Jr., and other members of a committee established to investigate Enron's collapse summarize the downfall's culprits as "a flawed idea, self-enrichment by employees, inadequately designed controls, poor implementation, inattentive oversight, simple (and not so simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits."[3]

While its failure may be especially public, Enron is not the first U.S. corporation to have acted so flagrantly. "Enron has been in the unfortunate position of being…the flash point for much of what has gone wrong with Corporate America," says current Enron CEO Cooper.[2] Earnings restatements and consequent reductions in equity position by other corporations have in fact been surprisingly common. Since 1997, 723 companies have been forced to restate their earnings.[4] According to the research of Lynn E. Turner at Colorado State University, in the past six years investors have lost close to $200 billion in earnings restatements and market capitalization following audit failures.[5] Taking a

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[1] Mark Jickling, *The Enron Collapse: An Overview of Financial Issues*, 2002 (February 4) CRS REPORT FOR CONGRESS.

[2] Mitchell Pacelle, *Man With a Plan: Acting CEO Sees Future for Enron*, 2002 (April 12) THE WALL STREET JOURNAL A2.

[3] Kurt Eichenwald, *Enron's Management, Ethics Blasted in Report*, 2002 (February 3) REAL CITIES, available at http://krd.realcities.com/ads/media/dfw/news/popup2.htm.

[4] Bruce N Nussbaum, *Can You Trust Anybody Anymore?* 2002 (January 28) BUSINESS WEEK 31.

[5] Nanette Byrnes, et al, *Special Report: Accounting in Crisis*, 2002 (January 28) BUSINESS WEEK 44.

closer look then at the Enron scandal's most valuable players may thus provide priceless tools toward understanding larger ambiguities in America's current corporate milieu.

III. Major Contributing Factors to the Enron Collapse

A. Tangible vs. Intangible Assets

Enron represents the perfect example of a corporate entity driven by intangible cash generating assets. One of the most valuable lessons learned from the collapse of Enron is the fact that a firm is inherently fragile if its value-added emanates more from conceptual as distinct from physical assets..

Corporate reliance on intangible assets, such as patents and copyrights, has increased steadily. Polaroid had 3,000 patents when it filed for bankruptcy protection. Broadband pioneer Global Crossing Ltd. carried the same fragility Fifty years ago, tangible assets represented 78% of the assets of U.S. non-financial corporations. Today, the proportion is 53%, according to Federal Reserve data.[6] Leonard Nakamura, a researcher at the Federal Reserve Bank of Philadelphia, estimates that annual investment in intangible assets, which he classifies as research and development, software purchasing and advertising, rose from 4% of GDP in 1978 to almost 10% in 2000.[7] Because miscalculation of intangible asset value consistently yields market value loss, it is critical that corporations seek a more harmonious balance between intangible and tangible assets. Ultimately, regulatory measures taken to define proper valuation of intangible assets could be constructive.

B. Wall Street

Suspicious Wall Street behavior is another player in the haze surrounding Enron. As late as November 8, 2001, for example, 11 out of 16 analysts classified Enron with "buy" or "strong buy" ratings, despite the SEC probe and reduction of shareholder equity by $1.2 billion.[8] As the Congressional Research Service reported on November 29, 2001, even after Enron's stock had fallen 99% and rating agencies had downgraded it to "junk bond" status, only 2 of 11 major firm analysts rated the stock a "sell."[9]

Several Wall Street companies[10] currently find themselves under intense scrutiny by the SEC, which opened official investigations into the truthfulness of their analytical coverage.[11] The way in which brokerage firms generate profit facilitates banker complicity. That is, an analyst's individual compensation corresponds to overall

[6] Greg Ip, *Why High-Fliers, Built on Big Ideas, Are Such Fast Fallers*, 2002 (April 4) WALL STREET JOURNAL A1.
[7] *Infra*, Ip.
[8] Marcia T. Vickers, et al, *Betrayed Investor*, 2002 (February 25) BUSINESS WEEK 112.
[9] *Supra*, Jickling.
[10] See *infra* Appendix A.
[11] Patrick McGeehan, *S.E.C. Begins Investigation Into Analysts*, 2002 (April 26) NEW YORK TIMES C1.

revenues of the company. Favorable ratings are, therefore, inseparable from future earnings. Exemplifying the closeness of the analyst-corporation relationship, are the actions of Merrill Lynch during its raising of $400 million from individual and institutional clients for LJM2, one of Enron's partnerships. As a display of its faith, Merrill Lynch added an additional $5 million of its own cash, and about 100 of its executives plowed in another 16 million of personal money.[12]

Solid steps toward solving the problems associated with the analyst-corporation relationship have already been taken. The NYSE and NASDAQ initiated proposals to limit the amount of compensation analysts can receive from investment banking activity. Analysts would also be banned from trading the stocks they cover. And, the New York Attorney General has been pursuing Merrill Lynch and other firms in an attempt to set right the patterns of misconduct.[13]

Fortunately, Wall Street, itself, has taken certain self-regulatory steps as well.[14] As Emily Thornton reports, one major firm, for competitive reasons, stopped investing in private partnerships of companies it advises to avoid conflicts of interest.[15]

The most radical way to sever the troublesome connection between corporation and analyst would consist of a regulation requiring Wall Street to spin off its research divisions into separate institutions. In that case, however, the process of generating revenues by those divisions becomes a crucial question.

Currently, investors and corporations share the cost of operating the research divisions. Ideally, though, the cost should be the sole onus of a party without conflict of interest. A new fee can be introduced to investors alone. It should be levied for each type of traded security and depend on the quantity. It may also be limited to a certain dollar figure per one type of security. The budget may be formed for a specific governmental organization controlled by the SEC. Depending on the trading volume; each stock would have one or several analysts who would avoid any conflict of interest. Significant drawbacks to this theory are possible, however. First, analysts' compensation would be lower compared to current levels in the corporate world, which would make it difficult to attract and retain talent. Second, coverage could be less efficient due to lack of competition.

In order to complete necessary restructuring, we need to evaluate whether the existing conflicts of interests within the internal flaws of the current system outweigh the market efficiency derived from its competitive nature. If there is a positive answer, and the situation cannot be rectified with the proposed minor measures, a viable substitute should be found. A separate government agency may need to be established to go along with the

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[12] Emily Thornton, *Too Close For Comfort,* 2002 (March 18) BUSINESS WEEK 78.
[13] Heidi Moore, *Merrill Signs Disclosure Accord With New York Attorney General,* 2002 (April 22), THE DEAL.
[14] Ari Weinberg, Self Regulation Hits the NYSE, 2003 (June 6) FORBES.COM. In this article, the author reports that "Almost a year after recommending corporate governance changes for listed companies, the New York Stock Exchange revealed ten changes to get its own governance in line with the companies it regulates." For example, senior NYSE officers will not be allowed to serve on boards of listed companies. But see Ari Weinberg, "Rewriting Wall Street's Rulemakers,"2002 (October 16) where Weinberg reports on the attack on self regulatory efforts by the New York Stock Exchange and NASD and other Wall Street and regional financial institutions for failure to do their proper part at regulating member firms, individuals and companies. He quotes New York Attorney General Eliot Spitzer as calling Wall Street's sellf-regulatory organizations a "complete failure."
[15] *Supra*, Thornton.

new SEC powers brought on by Sarbanes-Oxley, discussed in detail later, and self-regulatory organizations such as the National Association of Securities Dealers may need to be put in charge of some oversight. Certainly, much more needs to be done in the area of self-regulation.

C. The White House

Recent polls reflect public awareness of close business ties between corporate America and elected government officials. Forty-four percent of 1,034 adults involved in a NYT/CBS News Poll on the Enron topic said they believed the Bush Administration was hiding something the public needed to know. A further 67% of respondents believed that administration dealings with Enron prior to bankruptcy also included hiding untruths.[16]

> Should even one of the many concerns raised by Congressman Waxman prove correct, the Bush Administration is in trouble….
> I have little doubt that Enron is going to become a full-fledged political scandal. The odor of political influence being bought, sold, and traded is too strong for me-and apparently others-not to strongly suspect that there is something putrid in the midst of Enron's political activities.[17]

In a provocative article, Omar J Pahati says

> $5,951,570. That is the amount that Enron and its executive paid for political influence between 1990 and 2002, according to the Federal Election Commission. Those millions were contributed to the campaigns of dozens of candidates, propelling them into office. Three quarters of the money went to Republicans. ..
> Republicans in Enron's home state of Texas have especially benefited from the company's support over the years. Even George W.'s rise to the Oval Office was brought to you in part by Enron. One has to ask, does Enron own the GOP?
>
> One group of Texas Democrats believes so. Their Web site address says it all-EnronOwnsTheGOP.com…[18]

Former White House counsel for President Richard Nixon argues that Enron's extraordinary rise appears to have been "accomplished largely by the company's buying political influence."[19] He refers to a letter from California Congressman Henry Waxman, the ranking member of the House Committee on Government Reform, sent to Chairman Dan Burton concerning Enron and the need for an investigation of how Enron received its influence.[20] Dean goes on to say

Frankly, I have no doubt that the Bush White House is covering up relationships with Enron, which is why they failed to respond to Congressman Waxman's inquiries…

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[16] The New York Times/CBS News Poll 01/21-24/02

[17] *Supra*, Dean.

[18] Omar J. Pahati, *How Much for That GOP in the Window?* 2002 (February 28) , ALTERNET.ORG., 1. Also See Sam Parry, *Bush Did Try to Save Enron*, 2002 (January 3), THE CONSORTIUM.

[19] John Dean, Political Scandals Past and Present: Watergate, Iran-Contra and Now Enron, 2002 (February 22) TOMPAINE.COMMONSENSE.COM., 1.

[20] *Supra*, Dean.

Congress has recently adopted a bill that aims to not only weaken the power of these corporate-government ties, but also to make the most wide-ranging change in campaign law since the Watergate era. The proposed legislation would ban unlimited contributions to political parties (known as soft money).[21] However, the proposed changes are not likely to repair public trust. When it is status quo for government officials to hold equity portfolios, conflicts of interest remain embedded risks. The general public cannot help questioning the effectiveness of the regulatory system's foundation when it supports such a gamble. Hopefully, we can rely on more self-regulation by the market. BP in an exemplary effort, has taken an official stance of not making political contributions in any form.[22] Perhaps others will follow suit.

D. The Accounting Profession

One of the major controversies in the aftermath of the Enron scandal concerns the accounting and auditing industry.[23] Scholars and businesspersons have debated the ethics and legality of auditors' combining external and internal audits under the same roof.[24] Recent scandals have brought about renewed concerns about auditor independence. This is especially true concerning the ability to remain independent when employed by very powerful businesses.[25] Sarbanes-Oxley, as described later, addresses much of this concern. A quick review of recent history illustrates just how much the legal changes were needed in this area in particular.

Over recent decades, the value of non-audit services in the audit business has grown steadily. According to an analysis by the Wall Street Journal, audit firms collect non-audit fees nearly three times what they collect from audits. The study looked at 21 of 30 companies in the Dow Jones Industrial Average filing proxy statements by early April 2002. They had paid total fees of $725.7 million to their audit firms. 27% went for audit services and the rest for non-audit services.[26].

Business Week reports much the same findings. "That accountants have become increasingly dependent on consulting is clear. In 1993, 31% of the industry's fees came from consulting. By 1999, that had jumped to 51%."[27]

Conflicts of interest necessarily arise when single companies perform both auditing and consulting duties.[28] Enron's relationship with Arthur Andersen reveals that heavy

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[21] Representatives Martin T. Meehan (Massachusetts Democrat) and Christopher Shays (Connecticut Republican) proposed the legislation.

[22] John Brown, *Leading Toward A Better World?* Burden Auditorium, Harvard University, April 3, 2002.

[23] See G. Bennett Stewart, III, *Accounting is Broken: Here's How to Fix It-A Radical Manifesto,* Volume 5, Issue 1, 2002 (September), EVALUATION 1-29.

[24] See *supra* Stewart at note 19, Pearlstein and Behr and Kay and Crenshaw *Infra* at note 21. Also See Hilzenrath, *Infra* at note 24.

[25] See S. Pearlstein and P. Behr, *At Enron, The Fall Came Quickly*, 2001 (December 2) WASHINGTON POST.A01. See also, K. Day and A.B. Crenshaw, SEC, *Accounting Firms Redrafting Audit Rules*, 2002 (January 16) WASHINGTON POST E01

[26] *Auditors Still Perform Nonaudit Services*, WALL STREET JOURNAL, 2002 (April 3).

[27] *Supra*, Byrnes..

[28] See David S. Hilzenrath, *After Enron, New Doubts About Auditors*, 2001 (December 5) WASHINGTON POST A01. Also, See David S. Hilzenrath, *Two SEC Views of Industry; Ex-Head Levitt Attacked; New*

involvement in consulting practices may challenge an auditor to compromise independent judgment of an external auditor.[29]

The ineffectiveness of accounting industry regulation became apparent after Enron's collapse. Andersen's announcement, for example, that it had successfully passed review by Deloitte & Touche prior to Enron's fall underscores the inefficiency of a peer review system. Public interest institutions such as the Public Oversight Board and the Quality Control Inquiry Committee remain futile by relying on CPA firms for funding, and lacking authority to investigate, punish violators, or serve subpoenas.[30]

An especially effective approach would be to require mandatory rotation of audit firms every few years.[31] Such rotation would provide a number of important benefits. First, a new audit firm would bring a fresh perspective that a long-term auditor may lack. Second, auditors tend to rely excessively on prior years' working papers, including prior tests of the client's internal control structure, particularly if fees are a concern. Consequently, longtime auditors may come to believe they know the totality of the client's issues and may look for those issues in the next audit rather than staying open to other possibilities. Finally, auditors may place less emphasis on retaining a client relationship, even at the cost of a compromised audit, if they know the engagement will end after several years.

E. Corporate Disclosure

With Sarbanes-Oxley, the Securities and Exchange Commission has moved to rectify the pre-Enron disclosure system. Now, companies must produce quarterly reports within 30 days, rather than 45, and they must generate annual reports in 60 days, rather than 90.[32] Revelation of significant trading in company stock by officers and directors must be immediate, and report of any important changes in business must occur within days, including waivers of corporate ethics rules or off-balance sheet financing.[33]

Enron's fall is rooted in the specific corporate disclosure concept of "securitization." Securitization can be defined by examining what Enron did. By establishing a complicated network of 3,000 subsidiaries and partnerships, Enron could keep debt level low enough to support a high credit rating and continued investor interest. That is, via securitization, a company transfers assets (e.g., a pool of loans) to an SPE (Special

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Chief Pitt Vows Respect, 2001 (December 5), WASHINGTON POST A25 and David S. Hilzenrath, *Auditors Face Scant Discipline; Review Process Lacks Resources, Coordination, Will,* 2001 (December 6) WASHINGTON POST A01.

[29] *Supra* at 19, 20, 22 and 24.

[30] *Special Report: Accounting In Crisis,* 2002 (January 28) BUSINESSES 45.

[31] The Monetary Authority of Singapore has issued a directive requiring local banks, every five years, to change external auditors. In an undated Website article, *Mandatory Rotation of Audit Firms-Will it Improve Audit Quality?* PriceWaterhouse Coopers argues against this and any mandatory rotation requirement. The paper contends that experience and research show that such requirements would reduce audit quality and increase costs in the long term. Also, See *Testimony of Consumers Union Before the Texas Sunset Commission On Sunset Review of Texas State Board of Public Accountancy,* 2002 (November) www.consumersunion.org

[32] *SEC Approves Accelerated Filing of Annual and Quarterly Reports, Requires Disclosure of Web Site Access to SEC Reports,* 2002 (September 10), PUBLIC COMPANY ADVISORY

[33] *Infra* at 70.

Purpose Entity) and actually accounts for the transfer as a sale. The bond issues of SPEs can be sold at a premium compared to those of the parent company. This is possible because the debt is backed by assets legally separated from the parent company. On January 27, 2003, the SEC published final rules that specifically require public companies to describe off-balance sheet arrangements in separately-captioned section in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)section of the required SEC periodic reports. Also included must be a table which summarizes specified type of contractual obligations.[34]

Some additional progress toward an adequate solution to disclosure issues associated with SPEs has recently surfaced. The Financial Accounting Standards Board set forth new rules which became effective July 1 of 2003. Known as FIN 46, now outside investors must provide "at least 10% of the SPE's capital for companies to keep it off its books."[35]

Rachael Beck states:

> In addition, the company that bears a majority of the risk or reaps the majority of rewards from an SPE now must account for it. The tricky part is figuring out who carries the burden.
>
> For entities that do remain off the balance sheet, companies now have to detail the nature, purpose and risks in their annual reports. That falls under rules issued by the Securities and Exchange Commission, effective for fiscal years that ended on or after June 15.
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> Although accounting rules established in 1959 state that once a company owns 50% or more of another company, financial reporting must be consolidated, a controversial exception to the rule has maintained that if 3% of an SPE's capital is purchased by outsiders, it may be kept off the balance sheet. The practice of doing so is not unique to Enron.[36]

Studies by David Henry, et al, for example, indicate that the carrying of significant liabilities off balance sheets by several major companies makes a repeal of the 3% rule essential. [37] Tax dodging is another way in which Enron did not meet full disclosure. The corporation managed to erase most of its tax liability despite reporting nearly $2 billion in profits from 1996 to 2000.[38] Harvard economist Mihir A. Desai estimates, just among companies with assets in excess of $250 million, book earnings in 1998 exceeded taxable income by $287 billion.[39]

F. Unrealistic Valuation of Stock

Enron's valuations of energy contracts can hardly be described as reasonable. As Peter Coy reported, if Enron contracted to buy natural gas through 2010 for $3 per 1,000 cubic

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[34] See www.sec.gov/rules/final/33-8182.htm.

[35] Rachel Beck, *Risky Deals Difficult to Hide From Investors*, 2003 (July 23) Associated Press.

[36] *Who Else is Hiding Debt.(weak accounting standards and practice that allow special purpose entities not addressed when they should have been)*, 2002 (January 28) BUSINESS WEEK, 36.

[37] *Special Report: Who Else Is Hiding Debt?* 2002 (January 28) BUSINESS WEEK 36.

[38] Howard Gleckman, et al, *Tax Dodging: Enron Isn't Alone*, 2002 (March 4) BUSINESS WEEK 40.

[39] Gleckman, *supra* note 21, at 40-41.

feet, an energy-trading desk could aggressively assume it would be able to supply gas in each year at a cost of just $2, for a $1 profit margin.[40] Furthermore, according to Frank Partnoy from the University of San Diego, Enron deliberately reduced its trading portfolio risk exposure on the day when the value at risk was measured.[41]

Under current guidelines, companies must either expense the fair value of the stock options to their bottom line or disclose their theoretical value in footnotes, and all but a few companies usually choose the latter.[42] A survey conducted by PricewaterhouseCoopers of 100 publicly traded, high-tech and emerging companies estimates that the median impact of mandated options expense would be a 13.9% reduction in earnings per share from reported results in 1999 and a 16.5% earnings reduction in 2000.[43] Companies such as Yahoo and Novell would see their profits turn into huge losses, according to analysts at Bear Stearns.[44]

In recent years, the corporate world has seen a dramatic increase in the use of stock options for executive and labor compensation. Investors, unfortunately, tend to overlook dilution, the predictable mathematical relationship occurring when shares proliferate due to options grants.

Critics disagree about the importance of expensing stock options. Alan Greenspan deems expensing a mere bookkeeping transaction with no real changes in the operations or cash flows of a corporation.[45] National Venture Capital Association President Mark Heesen highlights a risk associated with expensing stock options by noting that, if companies are forced to expense employee stock options, they will stop issuing them to rank-and-file employees.[46] This, in turn, would significantly affect the prospects of growth for precarious start-ups by eliminating both ability to draw employees without attractive salaries and the golden handcuff linking employees' fortunes to the success of the company. Proponents of expensing stock options, conversely, attest that if investors are dissuaded by lower earnings as a result of expensing, it means only that they were less informed than they should have been. From the economic theory prospective, capital allocated on the basis of camouflaged information is capital allocated inefficiently anyway.[47]

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[40] Peter Coy, et al, *Enron: How Good Of an Energy Trader?* 2002 (February 11) BUSINESS WEEK 42.

[41] The value at risk measure was used for calculations. Potential losses Enron could incur during one day of trading with a probability of at least 5%.

[42] Janet Whitman, *Stock Options Face Scrutiny in Wake of Enron*, 2002 (April 3) WALL STREET JOURNAL B7B.

[43] *Supra*, Whitman, at B7B.

[44] Allan Murray, *Greenspan Stays Firm On Idea That Options Should Be Expensed*, 2002 (April 9) WALL STREET Journal A4.

[45] Holman Jenkins, Jr., *Much Ado About Stock Options*, 2002 (April 3) WALL STREET JOURNAL A23.

[46] *Supra*, Whitman, at B7B.

[47] See Zvi Bodie, Robert S. Kaplan and Robert C. Merton, *For the Last Time: Stock Options Are an Expense*, 2003 (March) Harvard Business Review. The authors argue that it is time to end the debate on expensing of stock options and require it. They trace the history of the debate citing 1972 as the year when the Accounting Principles Board, which preceded the Financial Accounting Standards Board (FASB), issued APB 25. "The rule specified that the cost of options at the grant date should be measured by their intrinsic value—the difference between the current fair market value of the stock and the exercise price of the option. Under this method, no cost was assigned to options when their exercise price was set at the current market price." They argue that APB 25 was obsolete within a year due to the publication, in 1973, of the Black-Scholes formula leading to a boom in publicly traded options and, in that year, the opening of

G. Company Stock Pension Plans

Enron employees suffered tremendous losses because their 401(k) plans were heavily invested in Enron stock.[48] "Some 20,000 employees at Enron lost billions of dollars in their pension plans, after they were barred by the company from selling Enron shares."[49]

Unfortunately, Enron's pension situation was not unusual. As Kathy Chen reports in *The Wall Street Journal*, several major companies hold a significant part of their defined-contribution plans in corporate stock. When these companies match employee contributions with company stock, they often impose restrictions on selling that stock.[50]

Obviously, contributing stock instead of cash is much more attractive for employers because it is typically cheaper and keeps stock in amicable hands. Also, there are typically tax advantages associated with such plans which are beyond the scope of this paper. Because of the advantages, it is unlikely that companies would voluntarily give up this way of funding this employee benefit.

However, President Bush, in early 2002, ordered a review of US Pension regulations following the Enron collapse.[51] Among the recent proposals addressed during congressional hearings are the cap-limits on the fraction of 401(k) funds invested in a single equity.[52] According to William Poole of the Federal Reserve Bank of St. Louis, "Perhaps a 50 percent cap on company stock would still retain a significant diversification protecting pension benefits. Particularly in the context of a new pension system, it would probably make sense to maintain a relatively low cap on company stock until the system becomes established and people become confident in its soundness."[53]

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the Chicago Board Options Exchange. Then, "FASB initiated a review of stock option accounting in 1984 and, after more than a decade of heated controversy, finally issued SFAS 123 in October 1995. It recommended –but did not require—companies to report the cost of options granted and to determine their fair market value using option-pricing models…Inevitably, most companies chose to ignore the recommendation that they opposed so vehemently and continued to record only the intrinsic value at the grant date, typically zero, of their stock option grants…

"We believe that the case for expensing options is overwhelming…stock option grants have real cash flow implications that need to be reported, that the way to quantify those implications is available, that footnote disclosure is not an acceptable substitute for reporting the transaction in the income statement and balance sheet, and that full recognition of option costs need not emasculate the incentives of entrepreneurial ventures."

[48] Frances B. Smith, *Your 401 (k) Plan—Lessons from Enron*, 2002 (February).

[49] *Supra* at 51.

[50] Kathy Chen, *Pension Plans Are Adjusted After Enron*, 2002 (January 29) WALL STREET JOURNAL A2.

[51] *Enron Losses Prompt Pension Review*, 2002 (January 10), BUSINESS.

[52] Clifton Linton, 401 (k) Reform Proposals Urge CompanyStock Limits, Encourage Advice, 2002 (March 21) MPOWERCAFE.COM. Numerous legislative proposals have been submitted to reform 401 (k) plans n response to Enron. In December 2001, Sens. Barbara Boxer, D-Calif., and Jon Corzine, D-N.J., proposed a bill calling for a 20% cap on company stock and the ability to sell company stock within 90 days of acquisition. They also tried to reduce the tax break given to businesses offering company stock as an employer contribution.

[53] William Poole, *The Role of Self-Regulation and Voluntary Compliance Incentives in the Design of Pension Systems*, 2993 (September 25) THE FEDERAL RESERVE BANK OF ST. LOUIS., 16.

The measures undertaken in this field seem to be long overdue. Employees should be given an opportunity to hire outside advisors for their retirement funds and elect trustees for additional control. Furthermore, if employees are prohibited from disposing of certain holdings for certain periods of time, similar rules should apply to executives' option holdings.

H. Corrupt Corporate Governance

Enron's most obvious violation of expected ethical conduct lies in executive gain at the expense of ordinary workers. According to the Congressional Research Service report, 600 top Enron executives received $100 million in bonuses as the company was collapsing in November 2001. Despite the company's weakening financial condition, 29 leaders of Enron cashed $1 billion in stock sales in 2000 and 2001.[54] Employees terminated before December 2, 2001, the day when Enron filed for bankruptcy, are not entitled to severance payments under the automatic stay provision of bankruptcy regulations.[55]

The market has fortunately already begun to address executive fraud. Institutional Shareholder Services, for example, recommended clients holding shares of Lockheed Martin Corporation vote against Frank Salvage as director due to his position on Enron's board.[56] It is the first time an influential advisory firm has taken a position on whether Enron board members should continue to serve at other companies.[57]

IV. A Legislative Answer to Enron: The Sarbanes-Oxley Act of 2002

Federal government's solution to corrupt corporate governance comes in part via the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, enacted by Congress and signed into law by President Bush on July 30, 2002. Affecting financial services, accounting, auditing, financial reporting and professional services firms, the Act is perhaps the most extensive securities act since the U.S. securities and exchange laws of 1934.[58]

Officially described as "an Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes," [59]the Sarbanes-Oxley Act should cover a lot of ground. The Act increases

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54 S*upra*, Jickling, note 1.

55 See ENRON.COM where there is a long list of questions and answers for current and former Enron employees. One of the questions asks "What happens to my severance payments if I was terminated before Enron filed for bankruptcy on Sunday, December 2? The answer is "Bankruptcy prohibits Enron from continuing to make those payments. Those claims will have to be pursued through the bankruptcy process by filing a claim with the bankruptcy court."

56 Joshua Green, *Savage Business: What Has Become of Enron's Former Directors?*, 2002 (June 17), THE AMERICAN PROSPECT Volume 13, Issue 11.

57 Dow Jones Newswires, *Lockheed Director On Enron's Board Is Opposed by ISS*, 2002 (April 11) WALL STREET JOURNAL A6.

58 American Institute of Certified Public Accountants. *Summary of the Sarbanes-Oxley Act of 2002*, available at http://www.aicpa.org/info/sarbanes_oxley_summary.htm.

59 Introductory phrase of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

responsibility and independence of auditors, orders whistle blowing on corporate fraud, enhances and accelerates the disclosure obligations of public companies and corporate insiders, forbids loans to officers and directors, raises criminal penalties for securities fraud, extends the statute of limitations for private securities fraud lawsuits, and mandates SEC rules on securities analysts' conflicts of interest.[60] Named for its primary draftsmen, Senator Paul Sarbanes (D) and Representative Michael Oxley (R), the Act applies only to public companies. Private companies consequently fall under state jurisdiction.

V. Effectiveness of the Sarbanes-Oxley Act

A. Business Ethics, Sarbanes-Oxley, and the SEC

Enron was known for its much-cited code of ethics. ideals. Even if this apparent commitment to business ethics had been more widespread or more than "window-dressing" at companies like Enron and had aggressively pushed executives and boards of directors into active roles in ethics and compliance programs, an Enron disaster may have been unavoidable, since many ethics and compliance programs appear to be largely for purposes of risk reduction, e.g. to avoid punitive damages in the event of litigation.

If ethics and policy are ever to be in sync, ethics officers and adherents must demand that the ethical foundations of the country itself be respected.[61] The SEC and Congress are making that more likely for the future.

The SEC defines a "code of ethics" as the "codification of standards that are reasonably designed to deter wrongdoing and to promote honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships."[62] In the proposed rule for a business code of ethics, the SEC listed the following six standards: [63]

(1) honest and ethical conduct, including the ethical handling of actual and apparent conflicts of interest between personal and professional relationships;
(2) full, fair, accurate, timely and understandable disclosure in the periodic reports required to be filed by the issuer;
(3) compliance with applicable rules and regulations;
(4) avoidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict.
(5) prompt internal reporting to an appropriate person or persons identified in the code of violations of the code of ethics;
(6) accountability for adherence to the code.

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[60] William Baue, *The Strengths and Inadequacies of the Sarbanes-Oxley Act*, 2002 (September 27) SOCIAL FUNDS, available at http://www.socialfunds.com/news/article.cgi/936.html.
[61] ENRON TO WORLDCOM AND BEYOND: WHERE WAS THE ETHICS INDUSTRY?, 2002 (July 27) ETHICAL EDGE, available at http://www, ethicaledge.com/enron.html.
[62] *Supra*, American Institute of Certified Public Accountants, note 37.
[63] *Proposed Rule*, SEC RELEASE 33-8138.

On January 24, 2003, The SEC published the final rules implementing the almost all of the proposed provisions for "codes of ethics" as written standards reasonably designed to deter wrongdoing and to promote all of the above, with the exception that the final rules do not include the proposed requirement that the code of ethics promote avoidance of conflict of interest. Note that the rules do not specify everything that might be addressed in the code, language, procedures or sanctions.[64]

The final rules require the code of ethics apply to the principal executive officer, principal financial officer, principal accounting officer or controller, or persons who perform like services.[65] It has to cover the ethical issues set forth in the new rules. The new rules allow different codes of ethics for different types of officers and the SEC permits and encourages companies to adopt codes for additional persons and to cover additional ethical issues.[66] The final rules do not require that a company have a code of ethics, but if the company has not adopted a code of ethics, it must explain why it has not done so.[67]

The new rules allow the code of ethics to be made known to the public in any of three ways:

- filing the code as an exhibit to its annual report filed with the SEC;
- posting the code on the part of its Web site normally used for investor relations, if the company has previously disclosed its intent to do so (and the Web Site address) in its annual report filed with the SEC; or

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[64] See SECURITIES AND EXCHANGE COMMISSION RELEASE NOS. 33-8177; 34-47235; File No. S7-40-02, 17 CFR PARTS 228, 229 and 249, 2003 (January 24). Also see *SEC Adopts Disclosure Rules On Audit Committee Financial Experts and Codes of Ethics*, Public Company Advisory, Goodwin-Procter, 2003 (January 29), 5.

[65] Commenters reacting to the proposed SEC rules on business ethics had very mixed reactions. The SEC made the following statement when releasing its final rules:

> Some of the commentators thought that the required disclosure should be limited to a statement indicating whether the company has a code of ethics that applies to its senior financial officers, and if not, why not. Others stated that it was appropriate to expand the requirements of the Sarbanes-Oxley Act to also require a company to disclose whether it has a code of ethics that applies to its principal executive officer. A few commentators thought that we should extend the requirement even further to require a company to state whether it has a code of ethics that applies to other individuals, such as directors, all executive officers, and the company's employees generally.
>
> After considering the comments, we continue to think that it is appropriate and consistent with the purposes of the Sarbanes-Oxley Act to extend the scope of our rules under Section 406 to include a company's principal executive officer, as proposed. It seems reasonable to expect that a company would hold its chief executive officer, an official superior to the company's senior financial officers, to at least the same standards of ethical conduct to which it holds its senior financial officers. Some commentators who are investors confirmed that they not only have an interest in knowing whether a company holds its senior financial officers to certain ethical standards, but whether the company holds its principal executive officer to ethical standards as well.

[66] *Supra* note 43.

[67] See new Items 406(a) of Regulation S-K, and S-B, Item 16B(a) of Form 20-F and paragraph (9)(a) of General Instruction B to Form 40-F.

- o providing an undertaking in its SEC annual report to provide copies of the code on request to any person at no cost.[68]

Under the new rules, a company must disclose any amendment or waiver of the code of ethics. This includes any implicit waiver of the requirements of the code where a covered officer is involved. This disclosure can be achieved in one of two ways:

- o in a Form *-K report filed within five business days (or, for foreign private issuers, in their next SEC annual report); or
- o on the company's investor relations Web site, if the company has previously disclosed in its most recently filed SEC annual report its intent to post this disclosure there and the internet address."[69]

If posted on the Web site, it must remain for twelve months. Even after the twelve months, the information must be retained for five years.[70]

B. Whistle Blowing

Recent corporate scandals indicate that systems designed to protect whistle-blowers and encourage ethical behavior among employees are by and large ineffective. James Fisher, director of the Emerson Center for Business Ethics at Saint Louis University agrees, saying whistleblowers "often regret it. They lose their jobs…have their family problems, or they are shunned off to the side."[71]

The Sarbanes-Oxley Act has a few provisions to enhance informant protection. It creates both a private right of action and a source of criminal liability.[72]

Section 806(codified at 18 U.S.C. Section 1514A) creates a right of civil action, in federal court, protecting whistleblowers against retaliation. This applies to securities fraud cases. [73]

Section 1107 (codified at 18 U.S.C. Section 1513(e)) provides for severe penalties for those who retaliate against informants, including employees. It broadens the scope of criminal liability for individuals who take actions against whistle-blowers, making them subject to fines or imprisonment for up to ten years.[74]

Increased litigation spurred by Sarbanes-Oxley should bring about more proactive risk management approaches by corporations. For example, human resource practices will require updating to assist with compliance with the new provisions. Some items corporations could consider are:

(1) ensuring that a neutral third party scrutinizes all unfavorable employment actions (i.e., termination, demotion, etc.);

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[68] *Supra* note 43.
[69] *Supra* note 43.
[70] *Supra* note 43.
[71] Joseph McCafferty, *Whistle Blowing*, 2002 (October 11) CFO MAGAZINE.
[72] See Sections 806 and 1107 of the Sarbanes-Oxley Act.
[73] Charles H. Kaplan, *The Sarbanes-Oxley Act of 2002—Employment Law Aspects—Whistleblower and Securities Analyst Protections*, 2002-2003 (Winter) THELEN REID 7 PRIEST, LLP.
[74] Id.

(2) revision of employment policies to explicitly prohibit whistleblower discrimination;
(3) effective procedures for soliciting complaints, including those made anonymously;
(4) educating and training employees, contractors, and subcontractors about their rights to bring forward complaints;
(5) when an employee makes a complaint of discrimination or retaliation, that complaint should be investigated and remedied promptly.[75]

While the government set up Sarbanes-Oxley for public corporations, privately held companies should also consider incorporating these rules.

- C. Conflicts of Interest

The Act further amends Section 13A of the Securities Exchange Act of 1934 by generally prohibiting "any form of personal loan arrangement between the issuer and its director or executive officer. Section 402 of the Act makes it unlawful for any public company, directly or indirectly, to extend credit, maintain credit or arrange for the extension of credit in the form of a personal loan to or for the benefit of any director or executive officer."[76]

On January 26, 2003, following the requirements of Section 208(a) of the Sarbanes-Oxley Act of 2002, the SEC adopted amendments to its existing requirements regarding auditor independence to enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the Commission. Because of the most important role played by audit committees in the financial reporting process and due to the unique position of audit committees in assuring auditor independence. Revised are the Commission's regulations related to the non-audit services that, if provided to an audit client, would impair an accounting firm's independence.[77] According to the rules:

> The new rules require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor of an issuer's financial statements; prohibit certain partners on the audit engagement team from providing audit services to the issuer for more than five or seven consecutive years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempted from this requirement; prohibit an accounting firm from auditing an issuer's financial statements if certain members of management of that issuer had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures; require that the auditor of an issuer's financial statements report certain matters to the issuer's audit committee, including "critical" accounting

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[75] *Infra*, Kaplan
[76] The Sarbanes-Oxley Act of 2002: *Prohibition on Personal Loans to Executives*, 2002 (September), COOLEY GODWARD, LLP.
[77] Securities and Exchange Commission RELEASE NO. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103, FR-68, 17 CFR 210, 240, 249 and 274 2003.

> policies used by the issuer; and require disclosures to investors of information related to audit and non-audit services provided by, and fees paid to, the auditor of the issuer's financial statements. [78]

Also, an accountant is not independent from an audit client if an audit partner received compensation based on selling engagements to that client for services other than audit, review and attest services.[79]

Very important in addressing the conflicts of interest discussed *supra*, Title II of the Sarbanes-Oxley Act adds new subsections (g) through (l) to Section 10A of the Securities Exchange Act of 1934 as follows:

> * Section 201 adds sub-section (g), which specifies that a number of non-audit services are prohibited. Many of these services were previously prohibited by the Commission's independence standards adopted in November 2000 (with some exceptions and qualifications).10 The rules we are adopting amend the Commission's existing rules on auditor independence and clarify the meaning and scope of the prohibited services under the Sarbanes-Oxley Act.
>
> * Section 201 also adds sub-section (h), which requires that non-audit services that are not prohibited under the Sarbanes-Oxley Act and the Commission's rules be subject to pre-approval by the registrant's audit committee. These rules specify the requirements for obtaining such pre-approval from the registrant's audit committee.
>
> * Section 202 adds sub-section (i), which requires an audit committee to pre-approve allowable non-audit services and specifies certain exceptions to the requirement to obtain pre-approval. These rules specify the requirements of the registrant's audit committee for pre-approving non-audit services by the auditor of the registrant's financial statements.
>
> * Section 203 adds sub-section (j), which establishes mandatory rotation of the lead partner and the concurring partner every five years. These rules expand the number of engagement personnel covered by the rotation requirement and clarify the "time out" period.
>
> * Section 204 adds sub-section (k), which requires that the auditor report on a timely basis certain information to the audit committee. In particular, the Sarbanes-Oxley Act requires that the auditor report to the audit committee on a timely basis (a) all critical accounting policies used by the registrant, (b) alternative accounting treatments that have been discussed with management along with the potential ramifications of using those alternatives, and (c) other written communications provided by the auditor to management, including a schedule of unadjusted audit differences. These rules strengthen the relationship between the audit committee and the auditor.

[78] Supra note 33.
[79] Supra note 33.

> *   Section 206 adds sub-section (l) addressing certain conflict of interest provisions. The Sarbanes-Oxley Act prohibits an accounting firm from performing audit services for a registrant if certain key members of management have recently been employed in an audit capacity by the audit firm. These rules clarify which members of management are covered by these conflict of interest rules.[80]
>
> Furthermore, "under the final rules, an accountant would not be independent of an audit client if an audit partner received compensation based on selling engagements to that client for services other than audit, review and attest services."[81]

- D. Financial Expert Requirements

In an attempt to address concerns about the need for independent financial expertise, even before Sarbanes-Oxley, the SEC has been attempting to establish and enforce adequate oversight from corporate auditing committees since 1972.[82] Starting in 1999, the SEC began to require companies to disclose whether their audit committee members were independent.[83] In 1999 the NYSE and NASD sponsored the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. In its 1999 findings and recommendations, the Blue Ribbon Committee pointed out a significant need for corporate audit committee members to have accounting and/or related financial expertise.[84] Following these recommendations the NYSE, NASD, AMEX, and PCX adopted rules for listed companies regarding the composition of audit committees. The NYSE and PCX started to require that at least one member of a company's audit committee have accounting or related financial management expertise, leaving the interpretation of the adequacy of such expertise to the discretion of the company's management.[85] The NASD and PCX introduced similar regulations. It is interesting to note that the NASD and AMEX defined required financial expertise as "the ability to read and understand fundamental financial statements."[86]

The Sarbanes-Oxley Act of 2002 attempts to tighten internal corporate control systems even further. First, disclosure of rules regarding financial expertise of audit committee members become mandatory for all companies filing reports under Sections 13(a) and 15(d) of the Securities Exchange Act. Previous requirements were applicable only to companies listed on respective exchanges. Second, Section 407 of the Act requires that corporate rules specifying the term "financial expert" be adopted.

In the final rules regarding financial experts, also adopted on January 24, 2003,the SEC states:

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[80] *Supra* note 33.
[81] *Supra* note 33.
[82] ,*ASR*, ACCOUNTING SERIES RELEASE *123*, (March 23, 1972).
[83] SECURITIES AND EXCHANGE COMMISSION RELEASE NO. 34-42266, 64 FR 73389 (December 22, 1999).
[84] REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES, 1999.
[85] NYSE Rule 303.01, PCX Rule 5.3(b).
[86] NASD Rule 4350(d)(2) and AMEX Company Guide §121.

> We proposed to define the term "financial expert" to mean a person who has, through education and experience as a public accountant, auditor, principal financial officer, controller or principal accounting officer, of a company that, at the time the person held such position, was required to file reports pursuant to Section 13(a) or 15(d) of the Exchange Act, or experience in one or more positions that involve the performance of similar functions (or that results, in the judgment of the company's board of directors, in the person's having similar expertise and experience),23 the following attributes:
> (1) An understanding of generally accepted accounting principles and financial statements;
> (2) Experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the registrant's financial statements;
> (3) Experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the registrant's financial statements;
> (4) Experience with internal controls and procedures for financial reporting; and
> (5) An understanding of audit committee functions.[87]

Looking back at the SEC proposed rule of October 31,2002, qualifying for this role has never been easy. It is possible, that a person who previously qualified as a financial expert under the rules of the self-regulatory organizations may not have sufficient expertise and experience to be considered a financial expert under the proposed rules.[88] The proposed rule was widely commented on and the SEC chose to make some changes in the final rule issued on.

Neither the Sarbanes-Oxley Act nor the SEC proposed rules precisely define the persons who would be in charge of making the assessment of a potential expert's knowledge and qualifications.

Professional reaction to the mandated role of financial expert suggests that some future regulatory developments may include answering the following questions:

(1) Should the SEC modify the list of requirements for a financial expert, and what should be the minimum acceptable standard? Should there be other standards or methodologies for assessing financial expert's qualifications?
(2) Should qualitative assessment of a potential financial expert's knowledge or expertise be left to the discretion of the board of directors, or should there be a "Bright-Line Test" that would eliminate all elements of subjectivity?
(3) Should the regulatory authorities address the issue of the degree of individual responsibility, obligation or liability under state or federal law of a financial Expert? Is it possible that such discussions along with presently required disclosure of names may in fact discourage people from serving as financial

[88] Security and Exchange Commission 17 CFR Part 210, 228, et al. Proposed Rule, (October 30, 2002).

experts?

(4) Given that disclosure of "independency" of financial experts is required, should Section 10A(m)(3) of the Exchange Act definition of independency be retained? According to the present definition, audit committee members cannot accept any consulting, advisory or compensatory fee from the issuer or be an affiliated person of the issuer or any of its subsidiaries.[89]

After the proposed SEC rules for financial experts were issued, there were substantial changes, based, in large part, on the challenges received from the legal, accounting and financial community. These rules are effective March 3, 2003.
Under the new rules, "financial expert" has been replaced with "audit committee expert."

> The final rules state:
> We agree that the term "financial" may not completely capture the attributes referenced in Section 407, given the provision's focus on accounting and auditing expertise and the fact that traditional "financial" matters extend to capital structure, valuation, cash flows, risk analysis and capital-raising techniques. Furthermore, several recent articles on the proposals have noted that many experienced investors and business leaders with considerable financial expertise would not necessarily qualify as financial experts under the proposed definition.14 We have decided to use the term "audit[1] committee financial expert" in our rules implementing Section 407 instead of the term "financial expert."15 This term suggests more pointedly that the designated person has characteristics that are particularly relevant to the functions of the audit committee, such as: a thorough understanding of the audit committee's oversight role, expertise in accounting matters as well as understanding of financial statements, and the ability to ask the right questions to determine whether the company's financial statements are complete and accurate. The new rules include a definition of the term "audit committee financial expert.

The SEC has also decided to change its proposed rules regarding the disclosure and names of audit committee financial experts.[90]

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[89] SECURITIES EXCHANGE ACT OF 1934, § 10(m)(3).

[90] The Sarbanes-Oxley Act expressly states that companies must include the financial expert disclosure in their periodic reports required pursuant to Section 13(a) or 15(d) of the Exchange Act. The final rules that were adopted require companies to include the new disclosure in their annual reports on Forms 10-K, 10-KSB, 20-F or 40-F. The requirement to provide the new audit committee disclosure item is included in Part III of Forms 10-K and 10-KSB, enabling a domestic company that voluntarily chooses to include this disclosure in its proxy or information statement to incorporate this information by reference into its Form 10-K or 10-KSB if it files the proxy or information statement with the Commission no later than 120 days after the end of the fiscal year covered by the Form 10-K or 10-KSB. Also see General Instruction E(3) to Form 10-KSB [17 CFR 249.310b] and General Instruction G(3) to Form 10-K [17 CFR 249.310].

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> "We have modified the proposals that would have required disclosure of the number and names of audit committee financial experts serving on a company's audit committee to more closely track the language used in Section 407 of the Sarbanes-Oxley Act. Under the rules that we are adopting, a company must disclose that its board of directors has determined that the company either:
>
> * has at least one audit committee financial expert serving on its audit committee; or
>
> * does not have an audit committee financial expert serving on its audit committee.
>
> A company disclosing that it does not have an audit committee financial expert must explain why it does not have such an expert. We continue to believe that disclosure of the name of the audit committee financial expert is necessary to benefit investors and to carry out the purpose of Section 407. Therefore, under the final rules, if a company discloses that it has an audit committee financial expert, it also must disclose the expert's name. We believe that, in general, omission of the expert's name ultimately would not result in the expert's identity remaining non-public. To the extent that there are liability concerns, we believe that they are best addressed by our inclusion of a safe harbor in our rules, as discussed below.
>
> The final rules permit, but do not require, a company to disclose that it has more than one audit committee financial expert on its audit committee. Therefore, once a company's board determines that a particular audit committee member qualifies as an audit committee financial expert, it may, but is not required to, determine whether additional audit committee members also qualify as experts. Every company subject to the audit committee disclosure requirements would, however, have to determine whether or not it has at least one audit committee financial expert; a company will not satisfy the new disclosure requirements by stating that it has decided not to make a determination or by simply disclosing the qualifications of all of its audit committee members. Furthermore, if the company's board determines that at least one of the audit committee members qualifies as an expert, the company must accurately disclose this fact. It will not be appropriate for a company to disclose that it does not have an audit committee financial expert if its board has determined that such an expert serves on the audit committee.

In the final rules, the SEC responded to concerns about their proposed rules regarding independence of the audit committee financial expert.[91]

> We proposed to require a company to disclose whether its audit committee financial expert is independent of management. A number of commenters opposed this disclosure requirement as unnecessary, noting that Section 301 of the

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[91] Supra note 61.

> Sarbanes-Oxley Act mandates the Commission to direct the self-regulatory organizations to prohibit the listing of any company that does not require all of its audit committee members to be independent. However, not all Exchange Act reporting companies are listed on a national securities exchange or association. We believe that investors in these companies would be interested in knowing whether the audit committee financial expert is independent of management. Therefore, the final rules require a company to disclose whether the person or persons identified as the audit committee financial expert is independent of management.

D. Limitations of Sarbanes-Oxley

Without a doubt, the Sarbanes-Oxley Act has limited the egregious conflict of interest thriving in the accounting industry by separating auditing and consulting services. However, a number of additional needed changes to the pre-Enron climate could not be made, due to the Act's omission of several issues.

The Act does not speak to the relationship between auditor and board of directors. The auditor should be able to feel secure in his or her regular reporting to and contact with the board of directors. In the words of Thomas Lys, regulation should exist, which yields a "good board," that can "take an auditor aside and say, 'be tough. If management fires you, we will fire them [sic].'"[92]

Social Investors have also highlighted a few areas of weakness within the Act. These areas in need of strengthening include: board independence, staggered boards, treating stock options as expenses, and increased disclosure on social and environmental issues. The first three of these are missing altogether from the Act. Recommended solutions for fortifying board independence include replacing staggered board elections for boards of directors.[93] Finding a solution to the issue of expensing stock options seems more challenging and represents an example of the multiple loopholes in GAAP that could not be fixed by the Sarbanes-Oxley Act. The overwhelming emphasis on stock options in executive compensation packages leads to a tough choice for executives between maximizing short term revenues, pumping stock price, and exercising more strategic managerial approach with possible immediate detrimental effects on their remuneration.[94] Last, while the Act does cover financial disclosure, it does not address the disclosure of corporate environmental and social liabilities. If practical solutions to the aforementioned neglected issues were implemented into the Act, the resultant reforms would perhaps help bridge the gap between social and mainstream investors who hold mutual interest in secure, fair markets.

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[92] OPEN DISCUSSION OF POST-ENRON IMPLICATIONS BY ACCOUNTING FACULTY OF NORTHWESTERN UNIVERSITY, available at http://www.kellogg.nwu.edu/kwo/win02/indepth/cover.htm.
[93] Baue, *supra* note 31.
[94] See the discussion of stock options and the cited articles *Supra* at notes 43-48 .

Conclusion

Today, Enron is in the midst of restructuring its business with the hopes of emerging from bankruptcy as a strong, viable, and somewhat smaller company. The bankruptcy court has approved the sale of Enron Center South to Intell Management and Investment Company. Recently, Stephen F. Cooper, CEO, and Raymond M. Bowen, Jr., CFO, signed a statement under oath regarding facts and circumstances relating to Exchange Act Filing. They stated the current management of the company was lacking the required information and knowledge to make any certification with respect to the Pre-Petition Filings. Key members of Enron's prior management would be needed to facilitate an appropriate review of the Pre-Petition Filings, but they are no longer employed with Enron. Between August 2001 and June 2002, Enron lost experienced staff, including the former CEO, Chairman, Chief Operating Officer, CFO, Treasurer, Chief Accounting Officer, Chief Risk Officer, and General Counsel. As stated in the company's Form 8-K filed with the SEC on April 22, 2002, they believe the existing equity of the company has and will have no value and that any Chapter 11 plan confirmed by the Court will not provide the company's existing equity holders with any recovery.

Additional accounting scandals exacerbate the crisis of confidence. These include the now famous World-Com and Tyco exposures. Consequently, people have moved money to the sidelines due to the high degree of concern about the quality of corporate earnings and how much accounting engineering is involved in producing those earnings. With the recent resignation of Harvey Pitt and other changes, not nearly enough is being done to resolve the image problems and the reality of insufficient budgets and leadership at the national level. This must be addressed for Sarbanes-Oxley to have any practical power and for investor confidence to be restored in a timely fashion.

How the system reacts to unexpected external impulses is the best indication of its viability. In the case of Enron, there are two extremes in responding to the impulse: either to over regulate the economy or do absolutely nothing and allow the "invisible hand of the market" to restore the balance. On the one hand, the latter is unlikely to happen. Due to multiple factors, with direct government involvement in the debacle not being the least of them, the regulatory system is under tremendous pressure to act and act quickly. On the other hand, overregulation, which may be viewed as a significant possibility, would inevitably reduce opportunities for economic growth and result in reduced consumer surplus. Sarbanes-Oxley, unfortunately, may go too far as it federalizes many areas of traditional state law practice. Not only are federalization and criminalization important matters to ponder, but also the increased costs of compliance, including significantly increased auditing costs and the added costs and time commitments of directors, if they will serve, must be more fully evaluated. Perhaps we will move to a class of professional directors that choose that role as their profession.

It is essential to realize that, even before this new legislation, the market had already started to respond by enforcing higher ethical standards of business behavior. Increased scrutiny by better-educated stakeholders was happening and needs to happen more. Both stock-price valuations and corporations' borrowing costs were already beginning to reflect investors' degree of confidence in companies' financial statements before recent scandals. The sharp decline in stock and bond prices following the Enron collapse changed this preexisting perception. It remains to be seen what impact the recent increase in stock prices will have on investor sentiment in the wake of multiple front page stories reporting arrests and some convictions of those thought responsible for much of the financial fraud uncovered in the past few years. Will investor confidence return without a serious change in our ethical climate? Will the public forget how bad things were once the markets reach the heights of the past? Did we really need to go this far to federalize and criminalize much of the worst kind of corporate misconduct? These are all questions, which remain to be answered.

It would not be prudent to assume that new legislation, alone, will make every company ethical or all corporate financial matters truly transparent. That is, one need only remember that Arthur Andersen was known for its work in the field of accounting ethics and that Enron had one of the most detailed codes of business ethics among corporations. Furthermore, the cost of implementing new regulations may be staggering. For a typical Fortune 500 company operating globally with $3 billion in revenue, one-time costs for implementing an in-house internal auditing department and in-house legal counsel to handle the new disclosure requirements of Sarbanes-Oxley range from $4 to $9 million with an additional recurring annual cost of $3 million.[95]

Before further federal regulation takes place, identification of the best level of external interference must come from a close assessment of the current market system's effectiveness to respond. This should be one of the foremost-investigated economic challenges of today. After all, ethical business practices used to be linked to a corporation's long-term best interests, contrasted against devious practices that often brought only short-term gain. Recommitting an organization to ethics cannot simply be a public relations campaign. An active commitment to ethical behavior, from top to bottom, will be the best safeguard against corruption and ultimately the only thing that will fully restore investor confidence.

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[95] *New Regulations: Preparing for the Unplanned Costs,* 2003 (January-February) FINANCIAL EXECUTIVE 17. See *infra* Appendix A.

APPENDIX A

Some Defendants In The Class-Action Shareholder Complaint In The Collapse of Enron[96]

Merrill Lynch & Co.	Credit Suisse First Boston
Citigroup	Deutsche Bank
J.P. Morgan Chase & Co.	Canadian Imperial Bank of Commerce (CIBC)
Bank of America	Barclays Bank
Lehman Brothers Holdings	Vinson & Elkins
Kirkland & Ellis	Six Officers of Arthur Andersen
24 Partners of Arthur Andersen, including ex-CEO Joseph Berardino	

[96] Kathryn Kranhold, et al, *Enron Holders' Suit Adds New Defendants*, 2002 (April 9) WALL STREET JOURNAL A1.

APPENDIX B
SEC Reporting and Disclosure Changes Summary of Estimated Impact (Incremental Costs)*

	ONE TIME /INITIAL	**ONGOING/ANNUAL**
Independent audit scope changes and fee increases	\$1,000,000 - \$5,000,000	\$1,000,000 - \$5,000,000
Internal Audit Expansion	\$250,000 - \$500,000	\$200,000 - \$300,000
External Legal Fees Increase	\$800,000 - \$1,500,000	\$500,000 - \$1,000,000
Legal Resource Expansion	\$150,000 - \$250,000	\$100,000 - \$200,000
Outside Consulting Services	\$400,000 – \$600,000	\$250,000 - \$300,000
Corporate Governance Changes	\$200,000 - \$250,000	\$200,000 - \$400,000
Finance/Accounting/Reporting Expansion	\$250,000 - \$500,000	\$250,000 - \$300,000
Required Process Improvements	\$200,000 - \$400,000	\$100,000 - \$200,000
System Enhancements	\$250,000 - \$500,000	\$200,000 - \$300,000
Total Incremental Costs	\$400,000,000 - \$9,000,000	\$3,000,000 - \$8,000,000

* Typical Fortune 500 Company with \$3 billion in sales revenue[97]

[97] *New Regulations: Preparing for the Unplanned Costs, supra* note 46, at 18.