Truth or Consequences:
The Sarbanes-Oxley Act of 2002

By Philip Feigin

The "independent third party" has been one of the pillars on which our securities markets and our system of securities regulation are based. There can be no question that in the eyes of the Congress, the Securities and Exchange Commission, the media, and perhaps most importantly the eyes of the investing public, in recent years that system failed us.

Our laws and regulations mandate that specified categories of information must be provided by those in the marketplace, and often, by whom. In many instances, the information about a company must be provided using an intermediary, a professional (like an attorney), a certified public accountant, or an investment analyst. The professional codes of conduct, the inherent reliability and integrity—as well as the potential liability—of these independent third parties gave the corporate information emerging from their presumed gauntlet of scrutiny its patina of genuine fact on which so many relied.

Media reports, civil suits, and regulatory and criminal actions brought involving Enron, Arthur Andersen, WorldCom, and Adelphia, to name a few, in one of the most hotly contested election years in recent memory, led to a congressional paroxysm of regulatory zeal, resulting in the Sarbanes-Oxley Act of 2002, signed into law on July 30, 2002.

Rather than junk the system based so centrally on the inherent reliability of information derived by these independent third parties, Congress implemented a regime of regulation and liability based more greatly than ever before on the independence of third parties. But the parties on whom they would rely shifted in large part to the model used in investment company (mutual fund) regulation: independent directors. The SEC has been given an array of new authority representing an unprecedented federal incursion into corporate boardrooms. More and more, what was traditionally a matter of state corporate law is becoming the province of federal law and regulation, at least for those corporations whose securities are publicly traded.

Sarbanes-Oxley contains dozens of new provisions impacting public companies, their management and boards of directors, as well as individual officers and directors. In this article, we will touch on only a few of them. We are available for consultation with regard to all provisions of the act. Our focus here is on the new responsibilities of the board's audit committee, the requirement that management certify periodic financial reports and the adequacy of internal controls, and the requirement that a corporation must adopt a code of ethics (or disclose why they have not). There are three subject areas under the new law that appear to be particularly fertile areas for care and a healthy concern for adverse developments:

- Independent Directors and Audit Committee-A public company's board of directors must include independent directors; the board is required to establish an audit committee (or, in the absence of an audit committee, the entire board is treated as the audit committee) and the independent directors/audit committee is set up with its own budget, staff, and outside consultants, all as potential adversaries to management.
- Certification-The individual CEO and CFO must certify that financial reports are accurate and not fraudulent, and further, that they are "fairly stated" and representative of the true state of the corporation, and that the controls in place allow the officials to make these statements with confidence.
• Code of Ethics-Each publicly traded company must establish a code of ethics, compliance with which will in turn be subject to regulatory scrutiny, with ethics code violations likely serving as grounds for regulatory sanctions by the SEC, and perhaps by the exchange(s) on which the company is listed or the NASD, and, if and when the code becomes subject to public disclosure, it may even become the basis for private litigation and liability.

Even with a healthy addition of new staff, the SEC will never approach having the resources to police the entirety of the securities marketplace. The system must, for the most part, be "self-executing," i.e., it must be reliable on its own. The viability of the system now being instituted depends on establishing truly independent directors and employing them as internal watchdogs dedicated to protecting the investing public from the excesses of management, with the wherewithal to find wrongdoing and stop it. The congressional vision is to deputize every independent director of a public company as a "junior SEC agent," charged with rooting out evil and financial sorcery in his or her corporation. Each public company will have its own private, self-targeted, well-staffed, and financed muckraker.

This was the role purportedly to be played by "independent" auditors, but that system ended up failing in some instances. With Sarbanes-Oxley, we see a recapitulation of the same basic but newly targeted methodology that eroded over the last 20 years or so, with an array of personal, criminal, regulatory, and probably private civil liability provisions this time focused on the CEOs, CFOs, and independent director audit committee members. A big difference between the former environment and this new one is that the former was based on an uncertain fabric of policy, implied rights, and some case law. The new environment has as its stony foundation some extremely targeted and draconian statutory language.

It will be very difficult for public companies to know if they have done enough to comply. At least for the foreseeable future, what might have been considered "best practices" in the recent past have now morphed into statutory and regulatory requirements, and satisfying them will be a question of "how high is up?" This will be especially true for companies whose recent past has been called into question.

It is not much of a stretch to imagine the evolution of a corporate system of management and "anti-management," with equal or even greater authority. Unless the SEC sees real, palpable power being shifted, it is unlikely they will be satisfied that any real change has taken place. Along with this reallocation of meaningful authority, there will have to be adequate funding and staffing to carry it through. Imagine a dynamic of the corporation's (management's) lawyers, the independent directors' lawyers, management's auditors, and the independent directors' counter-auditors. Reliance on the independent CPA auditor who could not be fooled or compromised under the old system has been swapped for reliance on the independent audit committee with its own budget and staff.

However, placing these new burdens on independent directors does nothing to change the reality that most of these people have their own jobs and primary responsibilities. That opens up the potential for the independent advisers to the audit committee to wield enormous power in the day-to-day absence of their principals, without much in the way of a counterbalance.

In order to truly fulfill the mandates of Congress and the SEC, it is not unreasonable to expect that a new charter for the audit committee will have to be created and blessed by the full board, in which the committee is given its budget, duties, and power. Some irrevocable steps will have to be included in the charter, i.e., that once the power is given by the board to the committee, it cannot be revoked without the approval of two-thirds of the shareholders. In large enough companies, the committee will need to be provided with the resources to retain outside counsel
and CPAs, and there may even have to be a full-time staff. They will need to have access to everything and everyone, with the authority to back it up and enforce it. Perhaps they will have the authority to conduct their own, even unannounced, audits and inspections, with the authority to present the results to the full board without prior notice to management, as well as the power to review and question company audits and quarterly reports, including interviewing company attorneys and CPAs outside the presence of management.

How can such a system be crafted without the prospect of hog-tying the corporation? The competing interests may become so consumed by the need to protect themselves against failure, ridicule, and personal liability that they will overlook the need to run the enterprise profitably. Is it in the best interests of shareholders to issue the most negative report possible to make sure no one is assailed later for overstating? Is it in the company's best interests to infuse internal controls with so much doubt and second-guessing that nothing ever gets done? These are just some of the competing priorities.

Is it possible that quarterly and annual filings would come to be composed of "majority" and "minority" financials and disclosures? "Management's auditors have produced these results while the audit committee's auditors believe these different results better describe things, and the two auditing firms could or would not reconcile their differences." "Management's lawyers believe this to be an adequate means of disclosing these problems, but the committee's law firm believes this other statement to better describe it. We leave it up to you." With liability on the line, and knowing certainty is unattainable, why would the "second-guesser" firm ever concur with the views of management's firm?

The concept of relying on independent third parties for accuracy is undermined by an inherent flaw. Attorneys, accountants, investment bankers, analysts, and independent directors of corporate boards are people. Lawyers and accountants are service providers who compete for business and who know they can be fired and replaced at almost a moment's notice. They naturally try to develop strong professional and personal relationships with their clients based on serving their professional needs competently and being personable while they're at it. Independent directors have their own problems at their own jobs; are they to be expected to take on such adversarial relationships with the very management and affiliated directors with whom they meet, converse and dine, and share pictures of grandchildren?

Who will be the independent director of the future? Who will be willing to take on these new responsibilities? Certainly, the fees they will demand with added responsibilities and liabilities must escalate.

In sum, the very concept of the adversarial boardroom seems to call for acts against nature. Securities disclosures and accounting have proven to be far more art than the science the markets and public assumed. Regardless of the particular mechanism-independent directors, heightened penalties for wrongdoing, and more and tighter reporting requirements-there can be no question that all market participants and professionals must redouble their efforts to provide the public with accurate, reliable, and timely information if the markets are to thrive once again.

Accurate information is the lifeblood of market liquidity. It has been the single greatest factor distinguishing the American securities markets from those of the rest of the world; the intangible difference that nonetheless made the world's most expensive securities marketplace-the New York Stock Exchange-the most popular and most utilized. We dare not fail to restore, preserve, and secure that tradition lest we lose it forever.
In our next newsletter, we'll explore in greater detail potential strategies and approaches to consider in dealing with some of these vexing and imposing new requirements.

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