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U.S. Sarbanes Oxley Act: Has It Positively Impacted Corporate Accountability On A Global Level?

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This paper examines the impact of the Sarbanes Oxley Act on corporate governance in the U.S. and globally. This law, which is a comprehensive reform effort, has been widely-criticized in some corners as an expensive and over-reaching compliance nightmare. Other experts and industry insiders believe that the benefit is worth the cost, both to shareholders and taxpayers, because it protects and extends investor protections. The results of this study indicate that the law has been moderately successful in reaching its stated goal of enhanced corporate accountability by increasing the oversight and transparency requirements for publicly traded companies.

Field of Research: Corporate Governance and Accountability

1. Introduction

The past decade has witnessed an increased emphasis on the importance of business ethics, both in the U.S. and globally; and this focus has lead to a variety of legislatively enacted reforms. Efforts to enhance ethical conduct are at times, however, a matter of style over substance. Politicians have been prone to making tough public statements, but then subsequently pass legislation that is watered down and actually does very little to change substantively unethical behaviour. Likewise, many multinational businesses have instituted Internal Codes of Ethics only to ignore them or joined organizations such as Business for Social Responsibility to tout their commitment to ethics as a public relations ploy but then rarely enforce their own codes.

With the passage of the Sarbanes Oxley Act (hereinafter referred to as SOX), 18 U.S.C. 1514; the U.S. took a significant step forward in legal and regulatory reform affecting corporate governance and accountability. Supporters of the law believe that many of the SOX reforms were long overdue. Conversely, critics say the law has caused a litany of ills: reform-weary executives are retiring early and public companies are going private. Some foreign firms are delisting in the U.S. and/or listing only abroad. This rather sweeping law, written in the wake of the Enron scandal, has served as a focal point of debate, in the U.S. and globally.

One widely publicized criticism of the original act was that only U.S. companies had to comply with the law as originally enacted. Then in mid-2006, an amendment was made that required foreign companies listed on U.S. exchanges to start complying with SOX, if their market capitalization exceeds $75 million.

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Companies ranging from Toyota to BP to Sony and hundreds of other companies that previously escaped the law will now be forced to comply. That was viewed as good news for U.S. companies, which had complained about not being able to compete on a level playing field. On the other hand, many non-U.S. based multinational companies complained that it was an overreaching law which was trying to create extra-territorial jurisdiction in typical U.S. “big-brother” style.

The question examined by this research paper is whether SOX has indeed worked? Is SOX accomplishing the goal more trustworthy corporate governance through the use of more stringent requirements for oversight by corporate boards, and enhanced financial transparency through modified auditing rules and procedures?

2. Literature Review

The strict regulations promulgated through SOX have caused many European firms to start chafing at the new requirements and some companies actually delisted to escape the law, according to a survey by Mazars, a Paris-based auditing firm. Only 43% of European companies think the law's benefits will outweigh its costs.

Latin American and Asian firms are more receptive. More than 72% of Asian respondents and 81% of Latin Americans think the benefits exceed the cost and none would consider delisting. That is because companies in developing economies "are willing to do anything to achieve credibility with U.S. investors," says Louis Osmont, a partner with Mazars.

At first, just as had happened in the U.S., Europe experienced an outbreak of wide-spread SOX panic. As exchanges merge and more trading moves online, it is not always clear who should have regulatory power. The then-head of Britain's Financial Services Authority, Callum McCarthy, ignited controversy when he suggested that British firms might be subject to U.S. regulation if NASDAQ acquired the London Stock Exchange, spreading the effect of SOX not only to U.S. listed multinationals but also to domestic British firms. The New York-based NASDAQ exchange has built a 25% ownership stake in its British rival. "That sent a shiver down the collective spine of Europe," says Jim Kim, editor of FierceSarbox.com.

Furthermore, SOX has received positive reviews from experts in the area of whistleblower protections. A leading expert in this area, Steven M. Kohn, Chairman of the Board of the National Whistleblower Center, expressed in his book, Concepts and Procedures in Whistleblower Law, his belief that SOX would become one of the most important developments in global corporate ethics in the past decade. “The Chamber’s proposals were clearly counter to Congress’ intent. The Department of Labor correctly rejected this blatant attempt to misuse the rulemaking process and undermine a major federal whistleblower law,” said

Kohn, in response to the outcry from the U.S. business community and its ally, the Chamber of Commerce.

According to Kohn, the SOX provision permitting OSHA to order the immediate reinstatement of a wrongfully discharged employee is an “essential and critical protection” afforded corporate whistleblowers: “The immediate reinstatement provision ensures that whistleblowers will not have to wait years for their case be be heard in court. This provision will make every publicly traded corporation think twice before they attempt to fire an employee such as Sharron Watkins or Cynthia Cooper. The Chamber’s attempt to gut this aspect of the law was disappointing and very troublesome. We sincerely hope that the Chamber will work cooperatively with whistleblowers in order to promote confidence and honesty in publicly traded corporations.”

3. Methodology And Design Of The Law

New Oversight Agencies and Increased Regulation

In a recent public speech, Senator Sarbanes spoke on the success of SOX. Sarbanes believes that SOX has not only set up a framework for improvement, but has implemented specific reforms that have lead to raised standards which have instilled new investor confidence in the capital markets. He pointed to several specific examples in various areas including:

- The Public Company Accounting Oversight Board (PCAOB)
- The Securities Exchange Commission (SEC) and
- The Board of Directors/Audit Committees of most publicly-traded corporations.

The SOX-created PCAOB was specifically charged with registering all accounting firms that conduct audits of public companies and it has done so. Furthermore, it has conducted the required inspections of those firms and has put all firms on a regular inspection schedule.

In conjunction with the passage of SOX, Congress also doubled the budget allocation of the SEC. This has allowed the SEC to hire new staff and field investigators to increase SOX enforcement. Under the direction of Bill Donaldson, the SEC has filed approximately 300 enforcement actions for financial and reporting fraud and has prevented over 100 executives from holding positions with publicly held companies.

Additionally, SOX has, according to Senator Sarbanes, one of the original sponsors, led to a significant increase in the numbers of independent directors on corporate Boards and anecdotal evidence indicates that these independent directors are more actively involved in corporate governance.

Enhanced Enforcement Through Improved Whistleblower Protections

One significant area of emphasis in SOX is to create protections for corporate whistleblowers to help create an atmosphere of regulatory compliance as a part of the culture of corporate governance. Given its diverse civil, criminal and administrative provisions, the statute may be considered, over time, to be a major step forward in offering more protection to whistleblowers.

Unlike most whistleblower laws, the SOX whistleblower protection provisions are not limited to providing a legal remedy for wrongfully discharged employees. In addition to containing employment-based protections for employee whistleblowers, the law contains other provisions directly relevant to whistleblower protection.

SOX requires that all publicly traded corporations create internal and independent audit committees. As part of the mandated audit committee function, publicly traded corporations must also establish procedures for employees to file internal whistleblower complaints and procedures which would protect the confidentiality of employees who file allegations with the audit committee.

SOX amended the federal obstruction of justice statute and criminalized retaliation against whistleblowers that provide “truthful information” to a “law enforcement officer” about the “commission or possible commission of any Federal offense. This provision of the SOX was not limited in its application to publicly traded corporations; it covers every employer operating inside the U.S. In addition, the law contains an employee protection provision that permits whistleblowers to file a complaint before the U.S. Department of Labor alleging unlawful retaliation.

SOX specifically protects whistleblowers employed by publicly traded companies from any type of employment discrimination, a provision modeled on other whistleblower laws administered by the U.S. Department of Labor (DOL), such as the laws protecting airline employees and employees who raise nuclear safety complaints. The DOL procedures incorporated into SOX were adopted directly from the airline whistleblower protection provision.

The statutory definition of protected whistleblowing is also very broad. It covers both reports to government officials, reports to supervisors and participation in SEC or shareholder legal proceedings. Under the applicable case law, protected activity covers a wide range of conduct, including contacts with the news media. Also, an auditor aggressively doing his or her job is protected under the anti-retaliation provision, even if he or she never filed an allegation of corporate wrongdoing with the SEC.

Employees who prevail in a SOX action are entitled to a full “make whole” remedy, including reinstatement, back pay and attorney fees and costs. The law also provides for the payment of “special damages,” which would include non-economic damages, such as compensation for emotional distress.

SOX expands the meaning of obstruction of justice statute to prohibit retaliation against employee whistleblowers. The new provision states as follows:

> Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.

This provision has very significant implications. The law covers disclosures for any violation under federal law. It is not limited to employee reports of criminal corporate fraud. Moreover, employers who lose civil whistleblower cases may find themselves personally accountable in a subsequent criminal proceeding. Finally, this amendment could result in whistleblowers obtaining coverage under civil RICO.

The criminal prohibition against whistleblower retaliation also directly relates back to the civil employee protection provision and the SEC’s regulatory authority. Section 3(b)(1) of the SOX states that “a violation by any person” of any provision of the SOX “shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 . . . and such person shall be subject to the same penalties, and to the same extent, for a violation of that Act.” Thus, if any publicly traded corporation discriminated against any employee for blowing the whistle concerning any federal offense, such discrimination would, not only constitute a potential criminal obstruction of justice but would also constitute a violation of the Securities Exchange Act and would subject that employer to administrative sanctions by the SEC and other enforcement actions.

Any employer who discriminates against a whistleblower in violation of a SOX whistleblower provision also commits a violation of the Securities Exchange Act of 1934. Under the SOX, any person who retaliates against a whistleblower would be subject to SEC “penalties” to the “same extent” as if that person violated the Securities Exchange Act of 1934.

Consequently, if an employer loses a SOX whistleblower claim, that employer may also be subject to criminal prosecution under the SOX obstruction of justice amendment and “penalties” under the Securities Exchange Act of 1934.

4. Findings

Effect on Multidisciplinary Practices within Large Multinational Accounting Firms

An example of a changes caused by SOX is the blow it dealt to the Big Four accounting firms' legal services initiatives and their multidisciplinary practice ambitions. The global law networks that once rivaled the world's largest law firms are in the midst of a vast restructuring. Meanwhile, in the U.S. and overseas, the migration of prominent tax lawyers into the giant accounting firms appears to have reversed course.

"It will be a long while before multidisciplinary practice turns up again, if ever" says Sherwin Simmons, the former Chair of the American Bar Association's Commission on Multidisciplinary Practice. Simmons counterpart at the American Institute of Certified Public Accountants, Richard Miller, general counsel and secretary, agrees that SOX has halted any attempt by the major firms, at least, to incorporate a wide-ranging legal service department within their firms.

This is a big change indeed considering that just a year before, in 2001, the then Big Five were assembling massive forces of lawyers with the expectation that multidisciplinary practice was the wave of the future, and that their audit clients would provide a base for unprecedented market-share growth in legal services. Collectively, in 2001, the Big Five counted more lawyers within their ranks than the largest five law firms in the world. Out in front was Andersen, the very firm to take the biggest fall as a result of the Enron scandal, which in 2001 had almost 3000 lawyers, making it the world's second largest law firm in terms of numbers, and in the top ten in revenue. All the large accounting firms had thousands of attorneys who offered legal services to foreign clients, and offered tax-advisory and other law-related services to U.S. clients. In fact, as recently as 2000, the SEC had specifically ruled that accounting firms could provide legal services to foreign clients.

Then everything changed when the U.S. Congress passed SOX. Legal services were specifically included in the list of prohibited services for audit clients. So in light of SOX, the SEC revisited the issue of legal services and despite intensive lobbying by the big accounting firms, the SEC new rules on auditor independence added a new prohibition on legal services in foreign jurisdictions. Since then, KPMG and EY have decided to discontinue legal services, and others are following that trend.

Effect on Major Accounting Firms

Deloitte & Touche Case Example:

Jim Quigley, senior partner at Deloitte & Touche, recently detailed a variety of ways in which he and his firm believe SOX has made concrete improvements in the way publicly traded businesses in America are audited, overseen and managed. Quigley, in an overview of findings by his firm, indicates a marked increase in the active nature of the role played by the audit committee on Boards of Directors, ranging from scheduling more meetings and asking more questions at those meetings to making an effort to learn more about financial and accounting issues, both those specifically related to the company on whose board they sit and more broadly across corporate America. He and others like him believe that public companies are now more "transparent" than ever before.

Specific examples cited by Quigley, as evidence that SOX is working, include both personal observations of partners in direct dealings with Deloitte clients and results of a Deloittee survey of large and important clients. Board Audit committee meetings have doubled in frequency for the average client and the committees are asking to schedule special meetings with the auditors. Meetings are lasting twice as long as they previously did. A survey of 65 of Deloitte's largest clients indicated that before SOX only 10 of 65 held 6 or more meetings of the audit committee per year; post SOX that number has tripled to 30. Furthermore, pre-SOX more than 50% of the committees met for less than an hour, now 90% meet for more than an hour per meeting. In a joint survey by Deloitte and the Financial Executives Institute of over 100 large companies, over 90% said those Board members are spending significantly more time in meetings. Thus one specific improvement resulting from SOX is that Boards and their subcommittees meet more often for longer periods of time; a clear indication that those who oversee public companies are more involved than before enactment of SOX.

Another example of SOX success lies in the change in those with whom auditors have most of their interaction. Prior to SOX, auditors dealt mostly with CEOs and CFOs; now most of their time is spent with the audit committees. This is an important change in the dynamics of the relationship between the public company and those who audit it. The CEO and CFO are inside management whereas the audit committee is now made up entirely of outsiders.

Ernst & Young Case Example:

The Chairman and CEO of E & Y, Jim Turley, testified before the Senate Banking, Housing, and Urban Affairs Committee regarding the success of SOX.[1] He believes, once again based upon both personal observation of partners at E & Y and a major survey of clients, that SOX is the most successful piece of reform legislation since the Securities Exchange Act of 1934. Turley's testimony points to success in several areas including:

- The changed behaviour of Audit Committees,
- The changed behaviour of Management, and
- The changed behaviour of Auditors.

Related to audit committees, E & Y can point to some of the same indicators of success as do other high level accounting firm executives as a way to measure the successes mentioned above. For example audit committees of E & Y clients are meeting 8-10 times a year for 6-8 hours per meeting instead the pre-SOX average of 3-4 times a year for 1 hour. Furthermore, the nature and tone of the meetings has changed significantly. Audit committees now reject management recommendations related to retaining a specific audit firm and quiz management on why a particular firm is being recommended.

In the area of management behaviour, there has been an exponential increase in dialogue within company hierarchies. CFOs routinely talk about how their opinions were sometimes ignored, and their influence was relatively weak before SOX; whereas now they seem to have an audience for what they have to say. Turley believes that is a direct result of the CEO/CFO certification requirement.

With regard to auditor behaviour, accounting firms have all enacted rules, pursuant to SEC regulations, prohibiting evaluation and compensation of audit partners based on the sale of non-audit services to audit clients, instead rewarding actions that enhance the quality of audits.

The National Association of Corporate Directors, in conjunction with CFO Magazine, conducted a SOX survey of 434 NACD members. More than 67% of the members replied that communication between Boards and management executives has improved compared to 5 years ago, with 71% stating Board members felt better informed about key financial issues. Over 40% of membership indicated that meetings were more frequent and longer and that CFO presentations at full board meetings now occurred more frequently than before, (in 2004 an average of 6 times a year).

The Society of Corporate Secretaries and Governance Professionals recently reported that more public companies are hiring chief compliance officers and that in organizations that already had CCOs, their role was being expanded.

The Council of Institutional Investors recently released an analysis of policies related to transparency in this area of executive compensation. Board's compensation committees are requiring more openness in all aspects of executive compensation, including salary, short-term incentives long-term incentives, and all other elements. Boards are making all the details public and including more information in annual proxy statements.

The effects of the Sarbanes-Oxley have been dramatically felt by companies as witnessed by the skyrocketing number of companies that have restated their financial results, Glass Lewis & Co. has found. Last year, there were 1,195 restatements by U.S. companies, almost double the 613 in 2004, as companies appear to be taking more care in filing results. But the research firm also expects that number to level off or drop, as early as this year, as companies improve their internal controls and avoid some the accounting errors that spawned SOX in the first place.

<u>Effect of SOX on the Venture Capital/IPO Industry</u>:

Most of the SOX provisions apply primarily to publicly traded corporations; however one should not overlook the effect on venture capitalists and/or small businesses. Venture capitalists (VCs) are finding they too must grapple with the effects of SOX, as well as its increased costs.

In short, the law is changing the way investors look at companies. IPOs are not looking as enticing as they did before, according to Audrey Roth at Sullivan and Worcester. The problem is that VCs will have to spend more time doing due diligence on their investments and concentrate more on building bigger companies with more robust infrastructures. VC-backed companies must be very, very sound so they can go public and absorb the extra costs in a merger and/or acquisition. The end result is that companies need to be stronger, bigger and more prepared when they launch an IPO than they did before SOX. Not only do they need deeper pockets to cover the costs of increased regulation, they also need to be large enough to attract the attention of analysts, and that group has become much less prevalent at investment banks in the post-SOX era. In fact, the number of companies "going private" as opposed to going public increased 63% in the year after passage of SOX.

5. Conclusion

Leaders in government, politics, accounting, law and finance seem to believe that SOX is making a positive difference by requiring and/or encouraging ethical behaviour in publicly traded companies. Former SEC Commissioner Cynthia Glassman speaking publicly on the effect of SOX, said that Sarbanes Oxley and the SEC rules aimed at insuring that those who act on behalf of a company are giving life to the corporate conscious. Thus in response to the question of whether SOX has been successful, the answer is yes, at least moderately so, assuming one ignores cost-related issues.

However, this study is limited to observations of those in industry and government. More long term empirical evidence will be necessary before one can conclude that the law has resulted in a permanent reduction in the instances of corporate fraud. While surely SOX has had some consequences that may be viewed as negative or overly burdensome by the business community, such as increased cost of regulatory compliance, on balance, the law has had a positive effect in terms of the perception of more effective corporate governance and accountability.

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