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The Fall of Arthur Andersen, LLP and Enron Corporation, and the Rise of the Sarbanes-Oxley Act of 2002

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ABSTRACT: The purpose of this paper is to explain the fall of the Arthur Andersen accounting firm and the energy giant Enron Corp. as well as the rise of the Sarbanes-Oxley Act of 2002. Arthur Andersen was a Chicago-based accounting firm that engaged in auditing, tax advising, consulting and other professional services to major corporations. Arthur Andersen fell victim to the excessive greed of Enron with its disproportionate and unwarranted use of off-balance-sheet entities to hide its losses. In the end, both organizations collapsed. In the ashes of the debacle, the United States Congress stepped in, and passed the Sarbanes-Oxley Act, a law whose intent was to restore investor confidence. The Act succeeded. As time passed, several previous Arthur Andersen partners formed a new accounting firm, eventually named Andersen Global, while removing the tarnish to the Arthur Andersen name in the Supreme Court in a 9-0 decision. Enron never recovered, and several senior managers went to prison. The debacle ended, and the nation now possesses a law that will hopefully prevent overreaching greed to dominate the financial industry in the future.

KEYWORDS: Accenture Consulting, Andersen Global, Arthur Andersen, LLP, Big Four Accounting Firms, Corrupt Persuasion, Enron Corp., Sarbanes-Oxley Act

List of Abbreviations

Abbreviation	Description
AABC	Arthur Andersen Business Consulting
Andersen, DeLany	Andersen, DeLany & Co.
Andersen Tax	Andersen Tax LLP
Arthur Andersen	Arthur Andersen LLP
ADTV	Average Daily Trading Volume
AWSC	Andersen Worldwide Société Coopérative
CAARTA	Corporate and Auditing Accountability, Responsibility, and Transparency Act
CC	Coastal Corp.
CCE	Cross Country Energy
CCFAA	Corporate and Criminal Fraud Accountability Act
CEO	Chief Executive Officer
CFAA	Corporate Fraud Accountability Act
CFO	Chief Financial Officer
CHC	Crouse-Hinds Co.
CIB	Continental Illinois Bank
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CPA	Certified Public Accountant
CRA	Charles River Associates
ECRC	Enron Creditors Recovery Corp.
EDC	Enron Development Corp.
EEI	Entex Energy, Inc.
EGS	Enron Gas Services
EMDD	Employment of Manipulative and Deceptive Devices

EOT	Enron Oil Trading
Enron	Enron Corp.
ESOP	Employee Stock Ownership Plan
FEI	Financial Executives International
GRC	Governance, Risk Management, and Compliance
HNG	Houston Natural Gas Corp.
HPL	Houston Pipe Line Co.
ICFR	Internal Control on Financial Reporting
IIA	Institute of Internal Auditors
InterNorth	InterNorth, Inc.
IPO	Initial Public Offering
NBP	Northern Border Pipeline Co.
NLF	Northern Liquid Fuels Co.
NNG	Northern Natural Gas
NPC	Northern Petrochemicals Co.
NPG	Northern Propane Gas Co.
NYME	New York Mercantile Exchange
OTC	Over-The-Counter
PCAOB	Public Company Accounting Oversight Board
PCAR-IPA	Public Company Accounting Reform and Investor Protection Act
PNG	People's Natural Gas Co.
SEA34	Securities Exchange Act of 1934
SEC	Securities and Exchange Commission
SOX	Sarbanes-Oxley Act
TGS	Transportadora de Gas del Sur
TPL	Transwestern Pipeline Co.
UK	United Kingdom
VCM	Vulcan Capital Management
VGP	Valley Gas Production Co.
WCCPEA	White Collar Crime Penalty Enhancement Act
WTAS	Wealth & Tax Advisory Services, Inc.

INTRODUCTION

This paper is about tragedy and hope, as well as destruction and resurrection in the financial industry. The story starts in 1913 when Arthur E. Andersen and Clarence DeLany founded Andersen, DeLany & Co. For 30 years until the death of Arthur E, Andersen in 1947, the company was the paragon of virtue, where Andersen forged an accounting practice predicated on honesty, transparency, and integrity. However, as the years turned to decades, the once great accounting firm, Arthur Andersen LLP succumbed to the enticement of more and more profits. With the ever-expanding computer age, profits were easily made by offering computer consulting expertise to organizations hungry for the economies of scale that seemed to flow from the onslaught of automation.

The profits became so great that Arthur Andersen was divided into two companies, Arthur Andersen and Accenture. At the turn of the millennium, Arthur Andersen was entangled with Enron Corp., a company that grew by hiding its losses in off-balance-sheet organizations. In the end, both organizations experienced the devastation of excessive greed and spectacularly failed. Investors and the financial industry were stunned, losing confidence in the financial system of the United States. The situation was dire, particularly when the country had recently suffered the destruction of the two towers of the World Trade Center in New York, as well as the attack on the Pentagon. Something had to be done.

In 2002, Congress passed the Sarbanes-Oxley Act. The purpose of the Act was to restore investor confidence by mandating honesty, transparency, and integrity in the financial sector. Both publicly traded companies and external auditors were affected. Behaviors that were previously taken for granted were legally codified, where the penalties were severe. Despite its critics and its seemingly draconian requirements for small publicly-traded firms, the law was successful in restoring investor confidence.

As for Arthur Andersen, some of the partners regrouped, and formed an accounting firm that eventually became Andersen Global, currently an international accounting firm that has restored the principles of honesty, transparency, and integrity that Arthur E. Andersen so greatly valued. In the process, the partners cleared Arthur Andersen's name by doggedly taking their case to the

Supreme Court and won 9-0. As for Enron, it has yet to be resurrected, and probably never will be. Sarbanes-Oxley is still the law of the land, and will likely continue vigorously into the future. This is the tale of this paper. Let us begin the story.

BRIEF HISTORY OF ARTHUR ANDERSEN, LLP

This section contains a brief history of Arthur Andersen, LLP. The section begins by describing the founding of the accounting firm. The next subsection discusses Arthur Andersen's reputation. The third subsection outlines Arthur Andersen's relationship with Enron Corp., summarizing how the accounting firm was convicted of obstruction of justice and finally vindicated by the Supreme Court. Finally, the events in the years after the Arthur Andersen demise are discussed, observing that Andersen Global seems to be the resurrected Arthur Andersen, just like the mythological Phoenix.

Founding of the Accounting Firm

On May 30, 1885, Arthur E. Andersen was born in Plano, Illinois. Although orphaned at 16 years old, Andersen worked in the daytime as a mail boy, while at night he went to school. In 1908, Andersen graduated from the Kellogg School of Management at Northwestern University in Evanston, Illinois, with a business degree while working full-time as an assistant comptroller.[1] Also, in 1908, at 23 years of age, Andersen became the youngest Certified Public Accountant (CPA) in Illinois.[2]

In 1913, Andersen and Clarence DeLany founded the accounting firm Andersen, DeLany & Co. (Andersen, DeLany).[3] Andersen's first client was Joseph Schlitz Brewing Company in Milwaukee, Wisconsin.[4] In 1915, Andersen opened the Milwaukee office, the second office of Andersen, DeLany. In 1918, the accounting firm changed its name to Arthur Andersen & Co. (Arthur Andersen).[5]

Andersen was firmly convinced that education would be the bedrock of the accounting profession. He created the first centralized training program, where training occurred during working hours. In 1927, he was elected to the Board of Trustees of Northwestern University due to his commitment to educational, civic, and charitable entities. From 1930 to 1943, Andersen was the president of the university. He also became the chairperson of the board of CPA examiners in Illinois.[6]

Reputation of Arthur Andersen

Andersen headed the accounting firm until he died in 1947. He zealously supported lofty standards for the accounting industry. Andersen argued that an accountant's responsibility was to the investors and stockholders, not to management. This dedication to honesty was reflected in how employees referred to themselves as "Arthur Androids," providing the same service in the same manner to all its customers. At the time, Andersen's motto was "Think straight, talk straight," a saying that he learned from his mother.[7]

Andersen was also a leader in promoting accounting standards. Arthur Andersen dissociated itself from several clients in the 1970s because it was one of the first companies to recognize a potential subprime bust.[8] When stock options became a form of executive compensation, Arthur Andersen was one of the few accounting firms to suggest to the Financial Accounting Standards Board (FASB) that employee stock options should be treated as an expense like cash compensation, thereby lowering profits.[9]

In the 1980s, accounting standards declined as firms attempted to balance audit independence and their expanding consultant business. In this period, Arthur Andersen established a very profitable IT consulting business, which generated the majority of the firm's revenues because audit partners were urged to look for consulting opportunities from existing clients. Just before the turn of the millennium, Arthur Andersen had tripled its per-share revenue to its partners, where quarterly earnings reports were a source of additional business as clients desired to maximize profits.[10] In other words, greed seemingly dominated the partnership.

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[1] Mary Virginia Moore, & John Crampton, Arthur Andersen: Challenging the Status Quo, *Journal of Business Leadership* (2000-2001), *available at* https://web.archive.org/web/20100813191757/http://www.anbhf.org/pdf/moore_crampton.pdf.
[2] *Id.*
[3] *Id.*
[4] SUSAN SQUIRES, INSIDE ARTHUR ANDERSEN: SHIFTING VALUES, UNEXPECTED CONSEQUENCES 28 (FT Press. 2003).
[5] *Id.*
[6] *Id.*
[7] BARBARA LEY TOFFLER; & JENNIFER REINGOLD, FINAL ACCOUNTING: AMBITION, GREED, AND THE FALL OF ARTHUR ANDERSEN (Doubleday Publishers 2004).
[8] *Id.*
[9] *See generally*, Zvi Bodie, Robert S. Kaplan, & Robert C. Merton, For the Last Time: Stock Options Are an Expense, *Harvard Business Review* (Mar. 2003), *available at* https://hbr.org/2003/03/for-the-last-time-stock-options-are-an-expense.
[10] *See generally*, Jerry Knight, Andersen Just Had to Get Back into Consulting. Look at What Happened, *The Washington Post* (Feb. 11, 2002), *available at* https://www.washingtonpost.com/archive/business/2002/02/11/andersen-just-had-to-get-back-into-consulting-look-t-what-happened/0cba7b63-62fb-41c6-8220-6df86c8c4ee0/.

Arthur Andersen Consulting and Accenture

During the 1970s and 1980s, Arthur Andersen Consulting grew at a much faster pace than the accounting, auditing, and tax business. There was increased friction between the two divisions because the partners in the consulting business believed that they were not receiving their proportionate share of the profits. In 1989, Arthur Andersen and Arthur Andersen Consulting became separate organizations of Andersen Worldwide Société Coopérative (AWSC). At the same time, Arthur Andersen employed its accounting services to obtain clients for its more profitable consulting business. In the 1990s, Andersen Consulting experienced a large increase in profits. In 2000, the arbitrators from the International Chamber of Commerce (ICC) awarded Arthur Andersen $1.2 billion in past payments, opining that Andersen Consulting had to change its name.[11]

On January 1, 2001, Andersen Consulting changed its name to Accenture, while Arthur Andersen changed its name to "Andersen."[12] Four hours after the ruling, James Wadia, the Arthur Andersen CEO, resigned.[13] Years later, Wadia revealed that he resigned because the Arthur Andersen board of directors had passed a resolution that stated that his resignation was mandatory if Arthur Andersen was not awarded at least $4 billion for the split.[14] In an alleged breach of contract, Arthur Andersen formed a second consulting group named Arthur Andersen Business Consulting (AABC).[15] After the demise of Arthur Andersen, AABC was bought out by Deloitte & Touche (in Europe), Hitachi Consulting, PwC Consulting, and KPMG Consulting.

The Enron Scandal

When Enron Corp. (Enron) declared Chapter 11 bankruptcy because it fraudulently reported $100 billion in revenue via accounting fraud, Arthur Andersen's complicity came under intense scrutiny. The Powers Committee (appointed by Enron's board of directors in October 2001) found that Arthur Andersen was negligent in satisfying its professional duty to bring the fraud to the attention of Arthur Andersen's Audit and Compliance Committee.[16] On June 15, 2002, Arthur Andersen was convicted of obstruction of justice of shredding documents that involved its audit of Enron.[17] Because the Securities and Exchange Commission (SEC) will not accept audits from convicted felons, Arthur Andersen surrendered its CPA licenses and its ability to practice before the SEC on August 31, 2002, ensuring that the firm went out of business.[18]

On May 31, 2005, in *Arthur Andersen LLP v. United States*, the Supreme Court reversed the Arthur Andersen conviction with a 9-0 vote, observing that the trial jury's instructions were too vague to permit a reasonable jury to find that obstruction had occurred.[19] The Court opined that the instructions were worded so that Arthur Andersen could have been convicted absent proof that it had broken the law prohibiting the destruction of evidence.[20] Chief Justice William Rehnquist noted that the government's theory of "corrupt persuasion" was spurious because it involved persuading an individual to act with an improper purpose, but not knowing that the act was unlawful.[21] The point of Justice Rehnquist's argument in *Arthur Andersen LLP* is that the court simply failed to define the meaning of corrupt persuasion, thereby giving the jury carte blanche to define the term for itself.[22]

The Rise of Andersen Global

After the 2005 Court decision, Arthur Andersen was free to continue operations, only 200 employees remained with the company, down from 28,000 in 2002.[23] According to William Mateja, the attorney who supervised Arthur Andersen's appeal, said

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[11] Mitchell Martin, Arbitrator's Ruling Goes Against Accounting Arm : Consultants Win Battle Of Andersen, *The New York Times (*Aug. 8, 2000), *available at* https://www.nytimes.com/2000/08/08/business/worldbusiness/IHT-arbitrators-ruling-goes-against-accounting-arm.html.

[12] *Id.*

[13] *Id.*

[14] Philip Aldrick, Andersen Chief Quits as $14bn Claim Fails, *The Telegraph* (Aug. 8, 2000), available at https://www.telegraph.co.uk/finance/4461169/Andersen-chief-quits-as-14bn-claim-fails.html.

[15]

[16] *See generally*, Andrew Cornford, Enron and Internationally Agreed Principles for Corporate Governance and the Financial Sector, *United Nations Conference on Trade and Development* (Jun. 2004), *available at* https://unctad.org/system/files/official-document/gdsmdpbg2420046_en.pdf.

[17] Mark Mauer, Arthur Andersen's Legacy, 20 Years After Its Demise, Is Complicated, *The Wall Street Journal* (Aug. 31, 2022), *available at* https://www.wsj.com/articles/arthur-andersens-legacy-20-years-after-its-demise-is-complicated-11661938200.

[18] *Id.*

[19] *Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005), *available at* https://supreme.justia.com/cases/federal/us/544/696/#opinions.

[20] *Id.*

[21] *Id.*

[22] Jessica Ochoa, Tweeting with a Purpose: Interpreting "Corrupt Persuasion" in 18 U.S.C. § 1512(b), 28 AMERICAN UNIVERSITY JOURNAL OF GENDER, SOCIAL POLICY & THE LAW 1 (2019), *available at* https://digitalcommons.wcl.american.edu/jgspl/vol28/iss1/4.

[23] Bill Mears, Arthur Andersen Conviction Overturned, *Cable News Network* (May 31, 2005), *available at* http://www.cnn.com/2005/LAW/05/31/scotus.arthur.andersen/.

that "there's nothing left of Arthur Andersen, and to spend the taxpayers' money on another prosecution would be just—defy common sense."[24] Stephen Bokat, the vice president of the United States Department of Commerce, concurred in pronouncing that Arthur Andersen was dead.[25] Kurt Eichenwald argued that if Arthur Andersen had survived the Enron scandal, it would likely have been destroyed by accounting fraud as WorldCom came before the public eye days after Arthur Andersen was convicted of obstruction.[26] At the time, it appeared that Arthur Andersen would never rise again, returning as a viable company like a mythological Phoenix.[27] In 2014, Wealth Tax and Advisory Services (WTAS), a tax and consulting company, a firm created by several former Arthur Andersen partners, changed its name to Andersen Tax LLP (Andersen Tax), after purchasing the rights to the Andersen name. It rebranded its international firm, WTAS Global, as Andersen Global.[28] In 2018, Andersen Global obtained the rights to Andersen.com, the former domain name of Arthur Andersen. Currently Andersen Global has 14,000 professionals and over 2,000 partners with 400 offices in 170 countries. The espoused values of Andersen Global include best in class, stewardship, independence, seamless, and transparency. These values seem to be the same values that Arthur E. Andersen possessed when he and DeLany founded Andersen & DeLany & Co. in 1913.[29] Perhaps the nay-sayers were wrong after all? Arthur Andersen has been seemingly resurrected like the mythological Phoenix out of the fires and ashes of the former company. The name is slightly different, but the legacy of honesty, transparency, and integrity of Arthur E. Anderson and Clarence DeLany seems to be living on.

BRIEF HISTORY OF ENRON CORPORATION

This section contains a brief history of Enron. The first subsection discusses the founding and the pre-merger rise of the firm. The second subsection talks about the post-merger rise from 1987 to 2000. Next, the accounting scandals and the bankruptcy are highlighted. The final subsection provides a short synopsis of the post-bankruptcy sequence of events that Enron experienced as it was dissolved and attempted to obtain compensation for its creditors.

Founding and Pre-Merger Rise

Enron was an energy, commodities, and service company that was headquartered in Houston, Texas.[30] The company was founded by Kenneth Lay in 1985 when Houston Natural Gas Corp. (HNG) with InterNorth, Inc. (InterNorth) were both small regional firms.[31] HNG came into existence in 1925 as a firm to sell natural gas that was produced by the Houston Pipe Line Co. (HPL). In 1956, HNG purchased HPL because it owned 761 miles of pipeline that HNG had used since it was founded. In 1963, HNG bought Valley Gas Production Co. (VGP) and its pipelines. In 1976, HNG sold its operations to Entex Energy, Inc. (EEI). In 1984, HNG successfully fended off a hostile takeover by Coastal Corp. by hiring Kenneth Lay from Transco Energy LLC to manage the firm. In 1985 and on behalf of HNG, Lay purchased InterNorth, renaming the new company Enron Corp.[32]

InterNorth was originally named Northern Natural Gas Co. (NNG), and was founded in 1931. In the next forty years, it acquired Northern Liquid Fuels Co. (NLF), Northern Petrochemicals Co. (NPC), Northern Propane Gas Co. (NPG), Northern Border Pipeline Co. (NBP), and People's Natural Gas Co. (PNG). In 1979, NNG was reorganized as InterNorth, a holding company, and operated 36,000 miles of natural gas pipeline in North America.[33] In 1980-81, the firm made an unsuccessful takeover bid for Crouse-Hinds Co. (CHC).[34] In 1983, InterNorth bought Belco Petroleum Co. (BPC),[35] and in 1985, InterNorth purchased HNC as a poison pill as it was an arbitrage target for $2.3 billion.[36] Six months after the acquisition, the resulting company was named

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[24] Nina Totenberg, Supreme Court Throws Out Arthur Andersen Conviction, *National Public Radio* (May 31, 2005), *available at* https://www.npr.org/2005/05/31/4673930/supreme-court-throws-out-arthur-andersen-conviction.
[25] *Id.*
[26] KURT EICHENWALD, CONSPIRACY OF FOOLS (Broadway Books 2005).
[27] Ancient Origins Staff, Symbolism of the Mythical Phoenix Bird: Renewal, Rebirth and Destruction, *Ancient Origins* (Jan. 21, 2021), *available at* https://www.ancient-origins.net/myths-legends/ancient-symbolism-magical-phoenix-002020.
[28] Michael Rapoport, Tax Firm to Revive Arthur Andersen Name, *The Wall Street Journal* (Sep. 2, 2014), *available at* https://www.wsj.com/articles/tax-firm-to-revive-arthur-andersen-name-1409626508?mod=WSJ_LatestHeadlines.
[29] Andersen Global Staff, About Us, *Andersen Global* (n.d.), *available at* https://global.andersen.com/about-us/.
[30] TBT Staff, Enron Grew Out of Two Companies, *Tampa Bay Times* (Sep. 2, 2005), *available at* https://www.tampabay.com/archive/2002/03/01/enron-grew-out-of-two-companies/.
[31] *Id.*
[32] *Id.*
[33] Donna K.H. Walters, InterNorth Will Make $2.3-Billion Offer for Houston Natural Gas, *The Los Angeles Times* (May 3, 1985), *available at* https://www.latimes.com/archives/la-xpm-1985-05-03-fi-12086-story.html.
[34] James Condon, Planning Ahead at InterNorth, *The New York Times* (Jan. 12, 1981), *available at* https://www.nytimes.com/1981/01/12/business/planning-ahead-at-internorth.html.
[35] Belco Oil & Gas Corp. History, *Funding Universe* (2001), *available at* http://www.fundinguniverse.com/company-histories/belco-oil-gas-corp-history/.
[36] The Rise and Fall of Enron, *San Jose State University: Department of Economics* (Aug. 2020), *available at* https://web.archive.org/web/20200805181220/https://www.sjsu.edu/faculty/watkins/enron.htm.

Enron.[37] The merged organization quickly became a tarte for Irwin Jacobs, a corporate raider. Lay, who was president of Enron at the time, borrowed over $400 million from the employee stock ownership program to repurchase Jacobs' stock.[38] Lay then froze the Employee Stock Ownership Plan (ESOP) for seven years except for retirement or death benefits.[39] Although the corporate headquarters was originally both in Omaha, Nebraska and Houston, Texas, after the merger, it was decided in 1986 that Houston, Texas, would be the firm's only headquarters.[40]

Post-Merger Rise from 1987 to 2000

In 1987, Enron Oil Trading (EOT) reported a loss of $85 million in its 8-K filings. The actual loss that was revealed in 1993 was between $142 million and $190 million. Louis Borget, president of EOT and Tom Mastroeni, the treasurer, plead guilty to fraud and filing false tax returns.[41] In 1988, Enron decided to enter the unregulated markets arena as well as maintain its regulated pipeline business.[42] For the company, it was a decisive moment. During this period, Enron was the first U.S. company to construct a power plant, Teesside Power Station, in Great Britain.[43] In 1989, Enron formed Enron Gas Services (EGS), a gas bank, where the firm would receive acceptance contracts from gas producers as deposits and make loans of delivery contracts to gas customers.[44] The bank allowed gas producers and wholesale buyers to buy gas supplies while hedging the price risk.[45] Also in 1989, Enron began offering financing to oil and natural gas producers and the Transwestern Pipeline Co. (TPL), an Enron subsidiary, became the first merchant pipeline to no longer sell gas, but concentrate only in transporting natural gas.[46]

In 1990, Enron began selling United States natural gas to other nations.[47] In essence, Enron evolved into a natural gas market maker by trading futures and options on the New York Mercantile Exchange (NYME) and over-the-counter (OTC) market employing swaps and options.[48] In 1990, Jeffery Skilling was chosen to run EGS, the gas bank.[49] Over time, the gas bank evolved into Enron Capital and Trade Resources. (ECTR).[50] Also in 1990, Skilling hired Andrew Fastow from Continental Illinois Bank (CIB) as an account director but quickly rose because of his insightful knowledge of banking.[51] CIB failed in 1984 because the bank "aggressively competed for oil and gas loans amid the United States' drive for energy independence and funded that expansion with large-scale borrowing from money markets."[52]

In 1991, adopted mark-market accounting practices, where income and the value of assets are reported at their replacement cost.[53] Also in 1991, Rebecca Mark was hired as the Chairperson and Chief Executive Officer (CEO) of Enron Development Corp. (EDC), a subsidiary created to go after international markets.[54] Fastow formed the first off-balance-sheet partnerships at this time. Over the next decade, Fastow formed many off-balance-sheet partnerships as a mechanism to conceal ventures that lost money.[55] In 1992, Enron purchased Transportadora de Gas del Sur (TGS), the Largest natural gas extractor in Argentina.[56]

Over the next ten years, Enron consolidated its business plan, increasing profitability. The firm heavily invested in energy assets in other countries. The company shifted from a producer of energy to a company that operated as an investment firm, and at

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37 TBT Staff, *supra*, note 30.
38 JERRY W. MARKHAM, A FINANCIAL HISTORY OF MODERN U.S. CORPORATE SCANDALS FROM ENRON TO REFORM (Routledge 2006).
39 *Id.*
40 *Id.*
41 STEPHEN V. ARBOGAST, RESISTING CORPORATE CORRUPTION (Wiley-Scrivener 3rd ed. 2017).
42 LOREN FOX, ENRON: THE RISE AND FALL (John Wiley & Sons 2003).
43 PETER C. FUSARO, WHAT WENT WRONG WITH ENRON (John Wiley & Sons 2002).
44 Jeffrey Eberwein, The Enron Story, *LinkedIn.com* (Oct. 9, 2021), *available at* https://www.linkedin.com/pulse/enron-story-jeffery-eberwein-1c#:~:text=The%20'Gas%20Bank'%20idea%20was,the%20'Gas%20Bank'%20model.
45 Loren Fox, *supra*, note 42.
46 Peter C. Fusaro, *supra*, note 43.
47 *Id.*
48 *Id.*
49 *Id.*
50 *Id.*
51 Edward Iwata, A Long Fall for Enron Couple, *USA Today* (Jan. 8, 2004), *available at* http://usatoday30.usatoday.com/money/industries/energy/2004-01-08-fastowsfate_x.htm.
52 Jonathan Rose, Continental Illinois: A Bank That Was Too Big to Fail, *Federal Reserve History* (May 15, 2023), *available at* https://www.federalreservehistory.org/essays/continental-illinois.
53 Peter C. Fusaro, *supra*, note 43.
54 MIMI SWARTZ, & SHERRON WATKINS, POWER FAILURE: THE INSIDE STORY OF THE COLLAPSE OF ENRON (Doubleday, 2003).
55 Peter C. Fusaro, *supra*, note 43.
56 *Id.*

times as a hedge fund by making profits of the margins of the products it traded. These products were traded via the Enron Finance Corp., now known as the Gas Bank.[57]

Accounting Scandal Practices and Bankruptcy

Enron employed various accounting practices to hide its losses. Enron regularly created off-balance-sheet entities to remove significant liabilities from its balance sheet to make the company appear more profitable than it was. Because Enron was committed to making greater profits every quarter, more and more of-balance-sheet entities needed to be created to give the illusion was becoming more profitable.[58] In 1999, Enron created EnronOnline, an Internet trading company that was used by most of U.S. energy firms, thus making Enron the largest gas and electricity wholesaler with trades of $27 billion per quarter. By adopting mark-to-market accounting, future anticipated profits were treated as if they existed. In other words, Enron could post remarkable gains that over time could turn into losses. The fiscal health of the organization took a back seat to increasing the firm's stock price.[59]

In 2001, after the public became aware of Enron's irregular accounting procedures, seemingly condoned by its auditor Arthur Andersen, Enron filed Chapter 11 bankruptcy that involved $11 billion in shareholder losses.[60] As the bankruptcy went forward, Enron shares fell from a little over $90.00 per share in August 2000, to pennies in January 2001 as it became increasingly apparent that Enron's profits came from special-purpose limited partnerships that the company controlled.[61] [62]

On December 2, 2001, Enron filed for Chapter 11 bankruptcy. As previously noted, Arthur Andersen was dissolved. Arthur Andersen, which was at the time one of the Big Five accounting firms, was found guilty in 2002 of obstruction of justice for destroying documents involving its audit of Enron.[63] The conviction prevented Arthur Andersen from auditing public companies because the SEC was not permitted to receive audits from convicted felons. As mentioned above, in a 9-0 decision in 2005, SCOTUS dismissed the conviction.[64] The damage was done. Arthur Andersen took many years to recover and resurrect itself as a viable business.

Post-Bankruptcy for Enron

In planning to come out of bankruptcy, Enron wanted to keep three domestic pipeline companies as well as many of its overseas investments. However, after Enron emerged from bankruptcy, it sold Cross Country Energy (CCE) for $2.45 billion[65] and other pipeline assets to Vulcan Capital Management (VCM).[66] In 2006, Enron sold Prisma Energy the last of its three last energy businesses that it intended to retain.[67] The result of these three sales was that Enron no longer possessed any assets.

In 2007, the firm changed its name to Enron Creditors Recovery Corp. (ECRC) with the objective of repaying Enron's residual creditors and thus end the company's financial affairs.[68] In December 2008, Enron announced that its creditors would receive $7.2 billion as a result of its liquidation, and constituted 17 percent of its debt.[69] After suing Citigroup and JP Morgan, by May 2011, $21.8 billion, or 53 percent of Enron's debts at the time that the firm declared bankruptcy had been paid to creditors.[70]

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[57] Jerry W. Markham, *supra*, note 38.
[58] Forbes Staff, Enron the Incredible, *Forbes* (Jan. 15, 2002), *available at* https://www.forbes.com/2002/01/15/0115enron.html?sh=25ec92983c9c.
[59] KENNETH E. HENDRICKSON (ED.), THE ENCYCLOPEDIA OF THE INDUSTRIAL REVOLUTION IN WORLD HISTORY (Rowman & Littlefield Publishers 3rd ed.2014).
[60] Andrew Topf, The 10 Biggest Energy Company Bankruptcies, *Oil Price* (Oct. 10, 2014), *available at* https://oilprice.com/Energy/Energy-General/The-10-Biggest-Energy-Company-Bankruptcies.html.
[61] Gilardi Staff, Enron Corporation (ENRN Q) Common Stock Historical Price Table (PDF), *Gilardi.com* (Oct. 15, 2017), *available at* https://web.archive.org/web/20171005050722/http://www.gilardi.com/pdf/enro13ptable.pdf.
[62] Kenneth E. Hendrickson, *supra*, note 59.
[63] Kurt Eichenwald, Andersen Guilty in Effort to Block Inquiry on Enron, *The New York Times* (Jun. 16, 2002), *available at* https://www.nytimes.com/2002/06/16/business/andersen-guilty-in-effort-to-block-inquiry-on-enron.html.
[64] Arthur Andersen LLP v. United States, *supra*, note 20.
[65] Barbara Shook, Deals Mark Demise of Energy Merchant Business, *Oil Daily* (Sep. 3, 2004), *available at* https://web.archive.org/web/20150903223316/http://www.highbeam.com/doc/1G1-121550619.html.
[66] Scott Stuart, Vulcan's Pipeline Grip, *Investing Private Capital* (Aug. 2004), *available at* https://web.archive.org/web/20121028162512/http://capital.vulcan.com/pdf/release_20040809.pdf.
[67] Katherine Hunt, Enron Closes Sale of Prisma Energy to Ashmore, *MarketWatch* (Sep. 7, 2006), *available at https://www.marketwatch.com/story/enron-closes-sale-of-prisma-energy-to-ashmore.*
[68] Enron Credit Recovery Corp, *Enron Corp.* (n.d.), *available at* https://web.archive.org/web/20130726190938/http://www.enron.com/.
[69] NBC News Staff, Judge OKs Billions to Enron Shareholders, *NBC News* (Sep. 9, 2008), *available at* https://www.nbcnews.com/id/wbna26626835.
[70] Linda Sandler, Enron Creditors Get 53 Percent Payout, Aided by Lawsuit Accords, *Bloomberg* (Jan. 12, 2013), *available at* https://www.bloomberg.com/news/articles/2012-01-13/enron-creditors-pocket-21-8-billion-in-cash-stock-1-#xj4y7vzkg.

ECRC was dissolved on November 28, 2016.[71] In November 2004, Enron came out of bankruptcy. It then sued eleven financial institutions for aiding Lay, Fastow, Skilling, among others in helping disguise Enron's actual financial state. The defendants included the Royal Bank of Scotland, Deutsche Bank, and Citigroup. In 2008, the claims were settled and Enron received $7.2 billion for its creditors.[72]

COMPLIANCE CONTROLS BEFORE THE SARBANES-OXLEY ACT OF 2002

In this section, the various SEC compliance controls are outlined, including Section 9(a)(2), Rule 10b5 and its subsidiary rules, Rule 14e, and Rule 16. Each rule is discussed in turn.

Section 9(2)(a)

Section 9(a)(2) of the Securities Exchange Act of 1934 (SEA34) makes it unlawful to "effect, alone or with [one] or more other persons, a series of transactions in any security registered on a national securities exchange, any security not so registered, or in connection with any security-based swap or security-based swap agreement concerning such security creating actual or apparent active trading in such security, or raising or depressing the price of such security to induce the purchase or sale of such security by others.."[73]

The three elements that must be proven to prove that Section 9(a)(2) was violated include:[74]

- The defendant engaged in a sequence of transactions in any security that is registered on a national security exchange;
- The defendant generated actual or active trading in the security to raise or depress the price of the security; and
- The defendant's purpose was to induce the purchase of sale of the security by others.

According to the SEC, the first element includes not only securities in any national exchange but also bids for securities.[75] [76] The SEC based its opinion on dictionary definitions, legislative history, as well as reason, logic, and policy.[77] Also, as little as three transactions in two successive days have constituted a series of transactions.[78]

The second element consists of either creating actual or apparent active trading of a security or increasing or decreasing the price of a security.[79] One way to generate the appearance of active trading is for a broker-dealer to quote the price of a security thereby giving the illusion that active trading is occurring.[80] Even so, the active trading of a security does not necessarily mean that an investor intends to raise or lower a security's price. An individual may be attempting to purchase a large holding while recognizing that by doing so that person is affecting the market price.[81] [82] [83] The third element requires that the SEC establish that the stock price manipulation was to induce others to purchase the security.[84] Proof of market manipulation under Sections 10(b), 14(e), 15(c)(1), or 15(c)(2) do not require that other investors be induced to purchase the security.[85] The third element is difficult to prove because it is impossible to invade the mind of the so-called market manipulator. The third element must be ascertained by drawing inferences regarding the motives and acts that are done to further the motives.[86] [87]

Thus, the benefit of Section 9(a)(2) is that it works to prevent fraudulent manipulation of the price of a security by examining whether other investors are induced to buy or sell a security. The pitfall, if there is one, is that the third element of the

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[71] OC Staff, Enron Creditors Recovery Corp., *Open Corporates* (n.d.), *available at* https://opencorporates.com/companies/us_tx/0011128906.
[72] Karina Frayter, Enron Investors to Split Billions from Lawsuit, *Cable News Network* (Sep. 9, 2008), *available at* http://edition.cnn.com/2008/US/09/09/enron.settlement/index.html.
[73] Section 9(a)(2), 15 U.S.C. § 78i(a)(2).
[74] Lewis D. Lowenfels, Sections 9(a)(1) and 9(a)(2) of the Securities Exchange Act of 1934: An Analysis of Two Important Provisions under the Federal Securities Laws, 85 NORTHWESTERN UNIVERSITY L. REV. 698 (1990-1991), *available at* https://heinonline.org/HOL/LandingPage?handle=hein.journals/illlr85&div=37&id=&page=.
[75] *Id.* at 708.
[76] *In re.* Kidder, Peabody & Co. 18 S.E.C. 559, 569 (1945).
[77] Lewis D. Lowenfels, *supra*, note 74 at 708.
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] Id. at 710.
[82] H.R. Rep. No. 1,383, 73rd Cong. 2d Sess. 20 (1954).
[83] *Trane, Co. v. O'Connor Securities*, 561 F. Supp. 301, 302-05 (S.D.N.Y. 1983), *available at* https://law.justia.com/cases/federal/district-courts/FSupp/561/301/1894402/.
[84] Lewis D. Lowenfels, *supra*, note 74 at 711.
[85] *Id.*
[86] *Id.* at 711-12.
[87] *Crane Co. v. Westinghouse Air Brake Co.*,419 F.2d 787, 795 (2nd Cir. 1969) *cert. denied*, *available at* https://casetext.com/case/crane-company-v-westinghouse-air-brake-co.

law may be difficult to prove, if only because it is hard to understand the workings of the mind of an investor. The individual may be actively attempting to manipulate the price of a security or the person may be attempting to establish a large holding in a company. The first reason has evil intent, whereas the second reason is innocent of evil intentions. The problem is that the behavior of an investor is the same.

Rule 10b5

Rule 10b5 is a regulation that was created by the SEA34.[88] It targets security fraud. Under Rule 10b5, it is illegal for anyone to directly or indirectly use any means to defraud, make false statements, omit relevant information, or do business in a way that deceives another person when conducting transactions of stock and other securities.[89] Formally, Rule 10b5 is known as the Employment of Manipulative and Deceptive Devices (EMDD).[90]

Rule 10b5 is the main driver for the SEC to investigate security fraud claims.[91] Violations of the rule include: (1) executives making false statements to increase share prices, (2) companies hiding significant losses or decreased revenue using creative accounting practices, or (3) activities conducted to give current shareholders an increased return on investment while any deception is hidden or fraudulent.[92] Rule 10b5 also covers false statements by executives to drive stock prices down so that they might purchase more shares at a lower price.[93] Finally, Rule 10b5 involves schemes to illicit profits or attract more investors by changing the shareholder

Rule 10b5-1(c)(1), an Affirmative Defense

Rule 10b5-1(c)(1) established an affirmative defense to Exchange Act Section 10(b) and Rule 10b-5 for insider trading. An individual must show that when they buy or sell a security, material, nonpublic information was not a consideration in making the trading decision, and that the trade was performed before the person became aware of the material, nonpublic information.[94] With this defense, there was a binding contract to buy or sell a security, and there were specific instructions to execute a trade for a trader's account or a written plan was agreed upon for trading securities.[95]

Rule 10b5-2 and Selective Disclosure

Rule 10b5-2 addresses the misappropriation theory, a theory in which an individual employs insider information to commit securities fraud against an information source.[96] Rule 10b5-2 can apply under nonbusiness situations because an individual who obtains confidential information is required to maintain a duty of trust.[97]

Misappropriation theory assumes that an individual who employs insider information in trading securities has committed securities fraud against the source of the information.[98] Misappropriation theory is different from the classical theory of insider trading. Under the classical theory of insider trading, there is a corporate insider's breach of duty to shareholders in a transaction.[99] An insider could be an employee, director, or officer of the company.[100] For example, in *O'Hagan*, the defendant acted on inside information regarding a takeover bid for Pillsbury Corp.[101]

Rule 10b6 and Rule M

Rule 10b6 was an anti-manipulation rule that prohibited an issuer from buying stock before the stock had been completely distributed.[102] The purpose of the rule was to stop issuers from manipulating the market by bidding for shares before they were

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[88] Brian Dolan, Rule 10b-5: Definition and Role in Securities Fraud, *Investopedia* (Feb. 27, 2023), *available at* https://www.investopedia.com/terms/r/rule10b5.asp.
[89] *Id.*
[90] *Id.*
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] SEC Staff, Insider Trading Arrangements and Related Disclosures, *U.S. Securities and Exchange Commission* (Feb. 24, 2023), available at https://www.sec.gov/investment/insider-trading-arrangements-and-related-disclosures#:~:text=Rule%2010b5-1(c)(1)%20provides%20an%20affirmative,the%20trading%20decision%20because%2C%20before.
[95] *Id.*
[96] Brian Dolan, *supra*, note 88.
[97] *Id.*
[98] Adam Hayes, Misappropriation Theory: What It Is, How It Works, Example, *Investopedia* (Jun 1, 2022), *available at* https://www.investopedia.com/terms/m/misappropriation_theory.asp.
[99] *Id.*
[100] *Id.*
[101] *United States v. O'Hagan*, 521 U.S. 642 (1997), *available at* https://supreme.justia.com/cases/federal/us/521/642/.
[102] Will Kenton, Rule 10b-6: Meaning, History, Replacement, *Investopedia* (Jul. 21, 2022), *available at* https://www.investopedia.com/terms/r/rule-10b-6.asp#:~:text=Rule%2010b-6%20was%20designed,underwriters%20for%20newly%20issued%20shares.

available to the public, thereby artificially the price of the stock.[103] The rule leveled the playing field for investors, dealers, brokers, issuers, and underwriters for shares that were newly issued.[104] In 1996, the SEC replaced Rule 10b6 with Rule M, where the regulation became effective on March 4, 1997.[105]

Rule M consists of six rules that address various trading issues and the parties.[106] Rule M consists of Rule 100, Rule 101, Rule 102, Rule 103, Rule 104, and Rule 105. Rule 100 contains the definition for Rule M. Rule 101 is concerned with the activities of broker-dealers and underwriters regarding stock distribution. Rule 102 encompasses issuers and persons selling securities. Rule 103 is an oversight rule for passive market making in Nasdaq. Rule 104 stabilizes transaction activities by underwriters. Rule 105 guards short selling in a public offering.[107]

Rule 10b18 or Safe Harbor

Rule 10b18 is intended to reduce liability for companies when they repurchase the firm's common stock.[108] The rule is a safe harbor provision because it reduces or eliminates legal liability if the following four conditions are satisfied:[109]

- An issuer or affiliate must purchase all shares from a single broker-dealer in a single day.
- An issuer with an average daily trading volume (ADTV) less than $1 million per day or with a public float value less than $150 million cannot trade within the last 30 minutes of trading. On the other hand, companies with higher average trading volumes or public float values can trade until the last 10 minutes of trading.
- An issuer must repurchase stock at a price not greater than the highest independent bid or the last transaction price quoted.
- An issuer cannot purchase over 25 percent of the average daily volume.

If a company adheres to these four conditions when repurchasing company shares, the firm is not violating Rule 10b18. It should be noted that Rule 10b-18 is concerned with the manner, timing, price, and volume of repurchases.[110] Compliance with Rule 10b-18 is voluntary. Firms must satisfy the four conditions daily for stock repurchases to qualify for safe harbor.

Rule 14e3 and Tender Offers

Rule 14e-3 prevents insiders affiliated with the bidder and the target from revealing confidential information about a tender offer.[111] [112] With narrow exceptions, Rule 14e-3 forbids a person who possesses material information related to a tender offer from trading the securities of a target company provided that the bidder has taken substantial steps in furtherance of the bid.[113]

Rule 16 and Filing Responsibilities

Rule 16 states the regulatory responsibilities of directors, officers, and principal shareholders.[114] The rule requires filing standards for insiders, where insiders are defined to be directors, officers or stockholders that directly or indirectly possess stock that result in ownership of more than 10 percent of a company's common stock or preferred stock.[115] Rule 16 demands that insiders file Forms 3, 4, and 5 electronically or in hardcopy. Form 3 is an initial statement of securities ownership provided there is an initial public offering (IPO) of stock or bonds, or if an individual becomes a director, officer, or holds at least 10 percent of corporate stock. New directors, officers and significant shareholders are required to file Form 3 within 10 days of acquiring investment assets. If a material change of the securities owned by a company insider occurs, they are obliged to file Form 4. If an insider buys or sells stock within a given year, they must file Form 5, provided they have not filed Form 4.[116]

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103 *Id.*
104 *Id.*
105 *Id.*
106 *Id.*
107 *Id.*
108 Adam Barone, Rule 10b-18 Definition and How Compliance Works, *Investopedia* (Jan. 10, 2021), *available at* https://www.investopedia.com/terms/r/rule10b18.asp.
109 *Id.*
110 *Id.*
111 SEC Staff, Fair to All People: The SEC and the Regulation of Insider Trading, *U.S. Securities and Exchange Commission Historical Society* (n.d.), *available at* https://www.sechistorical.org/museum/galleries/it/resilience_a.php#:~:text=Rule%2014e-3%20prohibits%20insiders,a%20Rule%2010b-5%20violation.
112 *Chiarella v. United States*, 445 U.S. 222 (1980), *available at* https://supreme.justia.com/cases/federal/us/445/222/.
113 SEC Staff, *supra*, note 111.
114 James Chen, Section 16 Definition and SEC Filing Requirements, *Investopedia* (Nov. 30, 2020), *available at* https://www.investopedia.com/terms/s/section-16.asp#:~:text=According%20to%20Section%2016%2C%20anyone,statements%20required%20by%20Section%2016.
115 *Id.*
116 *Id.*

THE SARBANES-OXLEY ACT OF 2002

The Sarbanes-Oxley Act of 2002 (SOX) is a federal law that requires specific financial record-keeping and reporting for public corporations.[117] The Act was enacted on July 30, 2002, was known in the Senate as the Public Company Accounting Reform and Investor Protection Act (PCAR-IPA). In the House, the Act was called the Corporate and Auditing Accountability, Responsibility, and Transparency Act (CAARTA). SOX contains 11 titles or sections that put requirements on the board of directors, management, and public accounting firms of all United States public companies.[118] SOX was enacted as a response to major corporate and accounting scandals, such as Enron and WorldCom. The titles concern the responsibilities of the board of directors of public corporations, providing criminal penalties for specific misconduct and requiring the SEC to generate regulations to encourage public corporations obey the law.[119]

Brief History of the Sarbanes-Oxley Act

In 2002, the SOX was named after its sponsors, Sen. Paul Sarbanes (D-MD) and Rep. Michael G. Oxley (R-OH).[120] SOX was enacted in reaction to several corporate and accounting scandals, including Enron, Tyco International, and WorldCom.[121] These accounting and financial scandals cost stockholders billions of dollars, particularly when share prices dramatically declined, and unsettled public confidence is U.S. securities markets.[122] Under SOX, senior management must certify the accuracy of financial statements individually, where the penalties for fraudulent financial activities are severe.[123] SOX also enhanced the oversight required by a corporate board of directors and outside auditors who review corporate financial statements for accuracy.[124]

SOX contains eleven titles, which range from increased corporate board responsibilities to criminal penalties. The SEC was required to generate dozens of rules so that companies could comply with the law. The Act also created the Public Company Accounting Oversight Board (PCAOB), whose purpose was to oversee, regulate, inspect, and discipline accounting firms as auditors of public companies.[125] The Act also addresses auditor independence, corporate governance, internal control assessment, and better financial disclosure.[126] SOX was ratified with massive bipartisan support in both the House and Senate.

Titles in Sarbanes-Oxley Act

SOX contains the following eleven titles:

- ***Title I: Public Company Accounting Oversight Board*** – Nine sections that created the PCAOB and provided oversight of public accounting firms that provide audit services.
- ***Title II: Auditor Independence*** – Nine sections that crafted standards for external auditor independence, thereby limiting potential conflicts of interest.
- ***Title III: Corporate Responsibility*** – Eight Sections that require that senior executives take individual responsibility for the accuracy and completeness of corporate financial reports, and define the relationship between independent auditors and audit committees. The title also specifies the behavioral limitations of corporate officers, detailing forfeitures and civil penalties for non-compliance.
- ***Title IV: Enhanced Financial Disclosures*** – Nine sections that describe increased reporting requirements for financial transactions, including off-balance-sheet transactions, pro-forma figures, and stock transactions of corporate officers. The title also mandates internal controls for assuring the accuracy timeliness of financial reports and disclosures.
- ***Title V: Analyst Conflicts of Interest –*** One section that contains measures to help restore investor confidence by defining a code of conduct for securities analysts that demands disclosing known conflicts of interest.

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[117] Pub. L. 107-204, *available at* https://www.govinfo.gov/link/plaw/107/public/204.
[118] *Id.*
[119] *See generally*, SEC Staff, The Laws That Govern the Securities Industry, *U.S. Securities and Exchange Commission* (n.d.), available at https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry#sox2002.
[120] LLI Staff, Sarbanes-Oxley, *Legal Information Institute* (Apr. 2021), *available at* https://www.law.cornell.edu/wex/sarbanes-oxley_act#:~:text=The%20act%20was%20named%20after,107–204.
[121] Will Kenton, Sarbanes-Oxley Act: What It Does to Protect Investors, *Investopedia* (May 8, 2022), *available at* https://www.investopedia.com/terms/s/sarbanesoxleyact.asp#:~:text=The%20Sarbanes-Oxley%20Act%20of%202002%20came%20in%20response%20to,Tyco%20International%20plc%2C%20and%20WorldCom.
[122] *Id.*
[123] PAUL D. KIMMEL, JERRY J. WEYGANDT, & DONALD E. KIESO, FINANCIAL ACCOUNTING (John Wiley & Sons 6th ed. 2011).
[124] *Id.*
[125] Will Kenton, Public Company Accounting Oversight Board: Overview, History, *Investopedia* (Apr. 19, 2022), *available at* https://www.investopedia.com/terms/p/pcaob.asp.
[126] *Id.*

- ***Title VI: Commission Resources and Authority*** – Four sections that define practices to restore investor confidence in security analysts. The title also defines the conditions under which the SEC can censure or bar security professionals from practicing as a broker, adviser, or dealer.
- ***Title VII: Studies and Reports*** – Five sections that specify that the Comptroller General and the SEC must generate various studies, reporting on their findings. The reports include the effects of public accounting firm consolidation, credit reporting agencies and security markets, securities violations, enforcement actions, and if investment banks helped Enron and other companies manipulate earnings and hide their financial state.
- ***Title VIII: Corporate and Criminal Fraud Accountability*** – Seven sections that describe specific criminal penalties for manipulations, destruction or alteration of financial records, or interference with investigations, while providing protection for whistle-blowers. Title VIII is also known as the Corporate and Criminal Fraud Accountability Act (CCFAA) of 2002.
- ***Title IX: White Collar Crime Penalty Enhancement*** – Six sections that increase criminal penalties affiliated with white collar crimes and conspiracies. Title IX recommends strong sentencing guidelines for failure to certify corporate financial reports. Title IX is also known as the White-Collar Crime Penalty Enhancement Act (WCCPEA) of 2002.
- ***Title X: Corporate Tax Returns*** – One section that states that the CEO should sign the corporate tax return.
- ***Title XI: Corporate Fraud Accountability*** – Seven sections that identify corporate fraud and records tampering as criminal offenses, and state specific penalties by revising sentencing guidelines. Title XI is also known as the Corporate Fraud Accountability Act (CFAA) of 2002.
- ***Addendum: Obstructing an official proceeding*** – This addendum made it a felony to obstruct an official proceeding. It was used for the January 6, 2021 incident, where individuals were accused of obstructing the 2021 Electoral College vote count.

Key Provisions of the Sarbanes-Oxley Act

Under SOX, seven key provisions range from disclosure controls to criminal penalties for retaliation against whistleblowers. Each provision is discussed in turn.

Section 302: Disclosure Controls

Under Section 302, there is a civil section[127] and a criminal section.[128] Section 302 requires that a collection of internal procedures be created to ensure that financial statements are accurate. The CEO and Chief Financial Officer (CFO) who sign the financial statements must certify that they are "responsible for establishing and maintaining internal controls" and "have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared."[129] The officers are mandated to "have evaluated the effectiveness of the company's internal controls as of a date within 90 days prior to the report" and "have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date."[130] According to the SEC, the intent of Section 302 is contained in Final Rule 33-8124, which defines "disclosure controls and procedures" and is conspicuously different from "internal controls over financial reporting."[131] It should be noted that in both Sections 303 and 404, the SEC is instructed to propagate regulations that implement these two provisions.[132]

External independent auditors are obliged to issue an opinion regarding whether management effectively maintained internal controls over financial reporting. This is over and above the financial statement opinion that addresses the accuracy of the financial statements, and is in addition to the financial statement opinion regarding the accuracy of the financial statements.[133]

Section 303: Improper Influence on the Conduct of Audits

In Section 303, four rules make up the section, including:[134]

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[127] 15 U.S.C. § 7241 (Section 302), *available at* https://www.law.cornell.edu/uscode/text/15/7241.
[128] 18 U.S.C. § 1350 (Section 906), *available at* https://www.law.cornell.edu/uscode/text/18/1350#:~:text=18%20U.S.%20Code%20§%201350,Law%20%7C%20LII%20%2F%20Legal%20Information%20Institute.
[129] 15 U.S.C. § 7241(a)(4), *available at* https://www.law.cornell.edu/uscode/text/15/7241.
[130] *Id.*
[131] SEC Staff, Certification of Disclosure in Companies' Quarterly and Annual Reports, *U.S. Securities and Exchange Commission* (Aug. 29, 2002), *available at* https://www.sec.gov/rule-release/33-8124.
[132] SEC Staff, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, *U.S. Securities and Exchange Commission* (Jun. 5, 2003), *available at https://www.sec.gov/rule-release/33-8238.*
[133] *See generally*, Vice Vincente, SOX Compliance Requirements & Overview, *Audit Board* (Mar. 22, 2023), *available at* https://www.auditboard.com/blog/sox-compliance/.
[134] Sarbanes-Oxley Act of 2002, Section 303.

- ***Rules to Prohibit*** – It is unlawful for an officer, director, or any individual acting as an agent of an officer or director to engage in fraudulent influence, coercion, manipulation, or mislead an independent or certified accountant in the performance of an audit.
- ***Enforcement*** – In a civil action, the SEC has exclusive authority to enforce this section and any rule regarding Section 303.
- ***No Preemption of Other Law*** – Section 303 does not supersede or preempt any other section of SOX.
- ***Deadline for Rulemaking*** – The SEC was required to propose rules and regulation no later than 90 days after the enactment of SOX. The final rules or regulations were required to be implemented no later than 270 days after SOX was passed into law.

Section 401: Disclosures in periodic reports (Off-Balance-Sheet Items)

Fraudulent off-balance-sheet items were essentially the reason why Enron went bankrupt. SOX demands that all material off-balance-sheet items be disclosed. Section 401 required the SEC to study and report on the extent of off-balance-sheet items to better understand whether the existing accounting principles sufficiently dealt with these instruments.[135] The SEC issued an interim guidance report, followed by a final report.[136]

Section 404: Assessment of Internal Control

Section 404 is the most controversial section of SOX. It obliges management and an external auditor to report on the adequacy of the firm's internal control on financial reporting (ICFR). For public corporations, Section 404 is the most expensive section of SOX to implement because of the effort involved in documenting and testing, both manually and automatically, vital financial controls.[137]

Under Section 404, management is required to generate an internal control report as part of is annual statement to the SEC (i.e., 10-K).[138] The report must sustain "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting."[139] To lighten the costs of compliance, the PCAOB approved Auditing Standard No. 5 for public accounting firms, which superseded Auditing Standard No. 2.[140] The SEC also published a report that guided management.[141] It is generally consistent with the PCAOB report, and it is intended to guide senior managers.[142] These two standards demanded that management:[143] [144]

- Assess the design and operating effectiveness of specific internal controls for significant accounts and relevant assertions, looking for material misstatement risks;
- Understand the flow of transactions, to understand where a misstatement could occur;
- Evaluate company-level controls that correspond to items in the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework;
- Perform a risk assessment of fraud;
- Evaluate controls that are intended to prevent or detect fraud, including management override of controls;
- Evaluate controls over a financial reporting process period;
- Scale an assessment based on the size of a firm;
- Rely on management factors such as competency, objectivity, and risk;
- Evaluate the adequacy of financial reporting internal controls.

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[135] SEC Staff, Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, *U.S. Securities and Exchange Commission* (June 15, 2005), *available at* https://www.sec.gov/news/studies/soxoffbalancerpt.pdf.
[136] SEC Staff, et al., Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities, *U.S. Securities and Exchange Commission* (May 2006), *available at* https://www.sec.gov/files/rules/policy/2006/34-53773.pdf.
[137] Jiamin Wang, Sarbanes-Oxley Section 404 Places Disproportionate Burden on Smaller Public Companies, *The Heritage Foundation: Center for Data Analysis* (Aug. 20080, *available at* https://web.archive.org/web/20081024140435/http://www.heritage.org/CDA/upload/SOX-CDA-edited-3.pdf.
[138] 15 U.S.C. § 7262, *available at* https://www.law.cornell.edu/uscode/text/15/7262.
[139] *Id.*
[140] PCAOB Staff, Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, *Public Company Accounting Oversight Board* (2007), *available at* https://pcaobus.org/oversight/standards/archived-standards/pre-reorganized-auditing-standards-interpretations/details/Auditing_Standard_5.
[141] SEC Staff, Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, *U.S. Securities and Exchange Commission* (Jun. 27, 2007), *available at* https://www.sec.gov/files/rules/interp/2007/33-8810.pdf.
[142] *Id.*
[143] *See generally*, PCAOB Staff, *supra*, note 140.
[144] *See generally*, SEC Staff, *supra*, note 141.

Section 404 compliance is essentially a tax on inefficiency because it urges firms to automate their financial reporting systems. For example, in 2007, a Financial Executives International (FEI) survey found that the average compliance costs for decentralized companies was $1.9 million, whereas for centralized companies, the average cost was $1.3 million.[145] The dollar savings of centralized versus decentralized compliance was $600,000, or approximately 32 percent.

Section 802: Criminal Penalties for Influencing US Agency Investigation/Proper Administration

Section 802(a) of SOX states that:[146]

"Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both."

In other words, if an individual knowingly or even purposefully changes an entry in a document with the intent to slow down or block an investigation or the proper administration of a matter, that person has committed a felony, where the punishment is a fine or not more than 20 years in prison.

Section 806: Civil Action to Protect Against Retaliation in Fraud Cases

Section 806 is known as the whistleblower-protection provision, and outlaws any "officer, employee, contractor, subcontractor, or agent" of a publicly traded corporation from retaliating against an employee or contractor for revealing reasonable potential or actual violations of securities fraud, shareholder fraud, bank fraud, a violation of any SEC rule or regulation, mail fraud, or wire fraud.[147] Section 806 forbids retaliatory conduct such as discharging, demoting, suspending, threatening, harassing, or in any other manner discriminating against a whistleblower.[148] In 2014, the Fifth Circuit held that outing or disclosing the identity of a whistleblower is actionable retaliation.[149] The remedies under Section 806 are as follows:[150]

- Reinstatement with the same seniority status that the employee would have had, but for the discrimination;
- The amount of back pay, with interest; and
- Compensation for any special damages sustained as a result of the discrimination, including litigation costs, expert witness fees, and reasonable attorney fees.

Compliance Costs and Benefits of the Sarbanes-Oxley Act

This subsection has two parts. The first part deals with the costs of compliance, while the second part addresses the benefits of SOX.

Compliance Costs of Sarbanes-Oxley

The SEC initially estimated that § 404 compliance would cost on average $91,000,[151] A 2005 study by Charles River Associates (CRA) found that the first-year implementation costs for large accelerated corporations averaged $7.3 million, whereas the compliance costs for non-accelerated firms averaged $1.5 million.[152] For large companies, average costs were 80 times greater than the initial SEC estimate, while for smaller firms, average costs were 16 times greater than the initial SEC estimate.[153] Covered organizations consumed an average of 35,000 staff hours, spent on average approximately $1.3 million on external consultants and software, and faced an average increase in auditing fees of $1.5 million, a 35 percent jump in auditing fees expenditures.[154] It should be remembered that some of the first-year costs were one-time only outlays and that there was a learning curve that had to be overcome.[155]

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[145] FEI Staff, FEI Survey: Average 2007 SOX Compliance Cost $1.7 Million, *Financial Executives International* (Apr. 30, 2008), *available at* https://web.archive.org/web/20131106042405/http://www.financialexecutives.org/KenticoCMS/News---Publications/Press-Room/2008-press-releases/FEI-Survey--Average-2007-SOX-Compliance-Cost-$1-7-.aspx#axzz2T3FxNm4F.
[146] 18 U.S.C. § 1519, *available at* https://www.law.cornell.edu/uscode/text/18/1519.
[147] LII Staff, 18 U.S. Code § 1514A - Civil Action to Protect Against Retaliation in Fraud Cases, *Legal Information Institute* (n.d.), *available at* https://www.law.cornell.edu/uscode/text/18/1514A.
[148] *Id.*
[149] Halliburton v. Administrative Review Board, 771 F.3d 254 (5th Cir. 2014), *available at* https://casetext.com/case/halliburton-co-v-admin-review-bd-1.
[150] LII Staff, *supra*, note 147.
[151] Stephen M. Bainridge, Sarbanes-Oxley § 404 at Twenty, 78 THE BUSINESS LAWYER 3 (Summer 2023), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4201778.
[152] *Id.*
[153] *Id.*
[154] *Id.*
[155] *Id.*

According to the 2007 FEI annual survey, for 168 companies with average revenues of $4.7 billion, the average compliance costs were $1.7 million (0.036% of revenue).[156] The 2006 FEI study reported that, for 200 companies with an average revenue of $6.8 billion, the average compliance costs were $2.9 million (0.043% of revenue), a 23% decrease from 2005. The compliance costs for decentralized companies were significantly greater than the compliance costs for centralized companies.[157] Although survey scores indicated that there was a positive relationship between investor confidence, reliability of financial statements, and fraud prevention, when asked in 2006 whether Section § 404 compliance benefits exceeded compliance costs, only 22 percent of the participants agreed.[158]

The 2007 Foley & Lardner survey concentrated on the total cost changes experienced by U.S. public companies. Foley & Lardner found that cost changes were significantly affected by SOX, where external auditor fees, insurance for directors and officers, board compensation, lost productivity, and legal costs increased significantly between fiscal year 2001 and fiscal year 2006. Approximately 70 percent of survey participants stated that public companies with annual revenues below $251 million should be exempt from Section 404 compliance.[159]

In 2008, the Lord & Benoit report found that the average Section 404(a) and 404(b) compliance cost for smaller public companies (also known as non-accelerated filers) was $78,457 ($53,724 for Section 404(a) compliance and $24,733 for Section 404(b) compliance), where for a small software company, the cost was $23,000, while for a manufacturer and distributor with many locations, the cost was $197,000.[160] The compliance cost for Section 404(a) ranged from $15,000 to $162,000.[161] In 2011, the SEC reported that Section 404(b) compliance costs continued to decline particularly after the 2007 SEC accounting guidance.[162]

In 2022, the Protiviti report discovered that the average Section 404 compliance cost had increased, as well as the number of personnel hours dedicated to compliance.[163] Protiviti found that the average compliance cost for firms attempting to comply with Sections 404(a) and 404(b) was $1,477,500.[164] Large firms (also known as accelerated filers) had an average internal compliance cost of $1,450,800 in 2022.[165] Companies with more than two years of compliance experience possessed average internal compliance costs of $1,468,300.[166] The percentage of compliance costs for large organizations exceeding $2 million rose from 24 to 26 percent, while the percentage large companies spending less than $500 thousand declined from 24 to 16 percent.[167] Some of the increase in compliance expenses could be attributed to the Covid-19 pandemic.

For small public firms, non-employee director compensation increased from $5.91 per $1,000 of sales in the pre-SOX era to $9.76 per $1,000 of sales in the post-SOX period.[168] In contrast, for large public companies, non-executive director compensation rose from $0.13 per $1,000 in sales in the pre-SOX era to $0.15 per $1,000 in sales in the post-SOX period.[169] Companies with annual sales below $250 million spent on average $1.56 million on Section 404 compliance, whereas firms with annual sales of $1-2 billion paid on average $2.4 million on such costs.[170] Thus, the overall impact of Section 404 compliance was greater for smaller entities than for large entities. In other words, SOX puts a heavy burden on small organizations in contrast to large entities.

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[156] FEI Staff, FEI Survey: Average 2007 SOX Compliance Cost $1.7 Million, *Financial Executives International* (2007), *available at* https://web.archive.org/web/20110714064622/http://fei.mediaroom.com/index.php?s=43&item=204.
[157] *Id.*
[158] FEI Staff, FEI Survey: Management Drives Sarbanes-Oxley Compliance Costs Down by 23%, but Auditor Fees Virtually Unchanged, *Financial Executives International* (2007), *available at* https://web.archive.org/web/20071011142102/http://fei.mediaroom.com/index.php?s=press_releases&item=187.
[159] FL Staff, Foley Study Reveals Continued High Cost of Being Public, *Foley & Lardner LLP* (Aug. 2, 2007), *available at* https://www.foley.com/en/insights/news/2007/08/foley-study-reveals-continued-high-cost-of-being-p.
[160] LB Staff, he Sarbanes-Oxley Investment: A Section 404 Cost Study for Smaller Public Companies, *Lord & Benoit* (Apr. 1, 2008), *available at* https://www.journalofaccountancy.com/issues/2008/apr/spendingonsox.html.
[161] *Id.*
[162] SEC Staff, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers with Public Float Between $75 and $250 Million, *U.S. Securities and Exchange Commission* (Apr. 2011), *available at* https://www.sec.gov/news/studies/2011/404bfloat-study.pdf.
[163] Stephen M. Bainridge, *supra*, note 151 at 659.
[164] *Id.*
[165] *Id.*
[166] *Id.*
[167] *Id.*
[168] *Id.* at 660.
[169] *Id.*
[170] *Id.* at 661.

Compliance Benefits of the Sarbanes-Oxley Act

In 2005, a report from the Institute of Internal Auditors (IIA) observed that companies have seen improvements in their internal controls, and their financial statements are perceived to be more reliable than they were previously.[171] The IIA surveyed 171 practicing auditors.[172] The following internal control improvements seem to be gaining ground:[173]

- Engaged control environment by the board, audit committee, and management;
- Monitoring became integral to the control processes;
- Additional structure to the year-end closing process;
- Implementation of anti-fraud with defined processes;
- Greater understanding of risks associated with computer controls;
- Improved documentation controls;
- Improved definition of controls across organizations;
- Control concepts becoming part of corporate culture;
- Audit trails supporting operations as well as audit assessments; and
- Re-implementation of basic controls such as segregation of duties ad periodic reconciliation of accounts;

Lord & Benoit studied compliance data from 2,481 accelerated filers or large companies with at least two years of Section 404 experience.[174] The results of the survey indicated that there was a 27.67 percent increase in share prices for firms that possessed effective internal controls, where there was an 8.92 percent increase in year one and an 18.72 percent increase in year two.[175] Firms with ineffective internal controls in year one, but effective controls in year two, experienced a 25.74 percent increase in stock price, where there was a 0.6 percent increase in year one and a 25.14 percent increase in year two.[176] Finally, for entities with ineffective Section 404 controls in both years, there was a 5.75 percent decrease in the average stock price, where there was a 9.85 percent decrease in year one that was offset by a 4.11 percent increase in year two.[177]

In 2009, Ashbaugh-Skaife et al. found that after controlling for other risk factors, "firms with internal control deficiencies have significantly higher idiosyncratic risk, systematic risk, and cost of equity."[178] The study observed that auditor-confirmed internal control changes precipitated equity cost changes that ranged from 50 to 150 basis points.[179] In the study, the cross-sectional and intertemporal test results were consistent with corporate internal control reports that affected risk assessments and the cost of equity.[180]

In 2010, Sautner and Arping analyzed whether SOX enhanced corporate transparency.[181] The authors studied foreign companies that were cross-linked in the United States. The paper suggested that when cross-linked firms were compared to entities that were not subject to SOX, the cross-linked organizations became significantly more transparent post-SOX, where corporate transparency was measured based on dispersion and the accuracy of forecasts by financial analysts.[182]

In 2011, Rice and Weber demonstrated that only a minority of Section 404 reports gave any advanced notice of impending accounting issues.[183] The researchers noticed that a declining minority of the companies studied acknowledge their existing internal

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[171] Larry E. Rittenberg, & Patricia K. Miller, Sarbanes-Oxley Section 404 Work: Looking at the Benefits, *The IIA Research Foundation* (Jan. 2005), *available at* https://auditoresinternos.es/wp-content/uploads/2022/07/43_Sarbanes-Oxley-Section-404-Work-Looking-at-the-Benefits.pdf.
[172] *Id.*
[173] *Id.*
[174] LB Staff, Do the Benefits of 404 Exceed the Cost, *Lord & Benoit* (May 8, 2006), *available at* https://www.auditanalytics.com/doc/report-bb-2006-05.pdf.
[175] *Id.*
[176] *Id.*
[177] *Id.*
[178] Hollis Ashbaugh-Skaife, Daniel W. Collins, William R. Kinney Jr, & Ryan Lafond, The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity, 47 JOURNAL OF ACCOUNTING RESEARCH 1 (Mar. 2009), *available at* https://onlinelibrary.wiley.com/doi/10.1111/j.1475-679X.2008.00315.x#:~:text=In%20sum%2C%20we%20posit%20that,its%20accounting%20signals%20is%20impaired.
[179] *Id.*
[180] *Id.*
[181] Zacharias Sautner, & Stefan Arping, The Effect of Corporate Governance Regulation on Transparency: Evidence from the Sarbanes-Oxley Act of 2002, *University of Amsterdam: Amsterdam Business School* (Apr. 26, 2010), *available at* https://pure.uva.nl/ws/files/48494442/1475016.pdf.
[182] *Id.*
[183] Sara C. Rice, & David P. Weber, How Effective is Internal Control Reporting Under SOX 404? Determinants of the (Non-)Disclosure of Existing Material Weaknesses, 50 JOURNAL OF ACCOUNTING RESEARCH 3 (Jun. 2012), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1953536.

control faults during a misstatement period.[184] The probability of reporting existing weaknesses was negatively correlated with external capital needs, the size of a firm, non-audit fees, and the use of a large audit firm.[185] In contrast, the probability of reporting existing weaknesses was positively correlated with financial distress, auditor effort, previously reported control weaknesses and restatements, as well as recent changes in management and the external auditor employed.[186] These correlations demonstrated that detection and disclosure incentives were critical in deciding whether firms had advanced warnings under SOX.[187]

In 2017, Donelson et al. statistically researched whether firms with reported material weaknesses have significantly higher fraud.[188] The null hypothesis asserts that there was no association between material weakness in financial reporting and future revelations of fraud.[189] There were three alternative hypotheses. The first two alternatives stated that there was no association between material weaknesses that provide a specific or general opportunity respectively to commit fraud and future revelation of fraud.[190] The third alternative declared that there was no association between material weaknesses and future revelation of ‘‘non-opportunity’’ frauds.[191] The idea behind the statistical testing was to reject the null hypothesis at either a ten, five, or one percent confidence level, demonstrating that one of the three alternative hypotheses is likely.[192] The statistical study estimated the coefficients of several regression equations. This study found that there was a statistically significant relationship between material weaknesses and the future revelation of fraud. This association was present when the internal control issue demonstrated a general opportunity to commit fraud, which was revealed by entity-level material weaknesses rather than account- or process-specific control deficiencies.[193] The results support the assumptions of Auditing Standard No. 5, where specific entity-level controls reduce the risk of material misstatement because of fraud.[194]

In Protiviti’s 2022 SOX compliance survey, compliance hours and costs continued to increase for many company sizes, industries, and reporting types.[195] There are five key findings from the survey. First, costs are continuing to climb due to talent shortages, increased scrutiny from external auditors, and the PCAOB, strategic pivots, and technology-driven transformation.[196] Second, the majority of organizations increased the number of hours logged for SOX compliance in the past fiscal year.[197] Third, external auditors relied less on management controls testing.[198] Fourth, an increasing number of firms deployed automation to support SOX work, with the majority (54%) leveraging audit management and governance, risk management, and compliance (GRC) platforms.[199] Finally, organizations were restructuring their SOX compliance models to increase their efficiency with the hope of reducing costs.[200]

Positive and Negative Criticism of the Sarbanes-Oxley Act

This subsection is divided into two prongs. The first prong deals with the positive criticism of SOX, while the second prong addresses the negative criticisms of SOX.

Positive Criticism of the Sarbanes-Oxley Act

In 2005, former Federal Reserve Chairperson Alan Greenspan praised SOX, saying that he was surprised how quickly SOX was developed and enacted, and how the Act reinforced the fundamental principle that shareholders own corporations and managers

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[184] *Id.*
[185] *Id.*
[186] *Id.*
[187] *Id.*
[188] Dain C. Donelson, Matthew S. Ege, & John M. McInnis, Internal Control Weaknesses and Financial Reporting Fraud, 36 AUDITING: A JOURNAL OF PRACTICE & THEORY 3 (Aug. 2017), *available at* http://aaahq.org/portals/0/newsroom/intnl%20cntrl%20weakness%20and%20finan%20rpt%20fraud.pdf.
[189] *Id.* at 48.
[190] *Id.*
[191] *Id.* at 49.
[192] A. KOUTSOYIANNIS, THEORY OF ECONOMETRICS: AN INTRODUCTORY EXPOSITION OF ECONOMETRIC METHODS (Macmillan 2nd ed. January 1, 1977).
[193] Dain C. Donelson, Matthew S. Ege, & John M. McInnis, supra, note 188 at 65.
[194] *Id.*
[195] Protiviti Staff, Top Takeaways from the 2022 Protiviti SOX Survey Report, *Audit Board* (Jun. 9, 2022), *available at* https://www.auditboard.com/blog/takeaways-sox-survey-2022/#:~:text=This%20approach%20to%20SOX%20compliance,and%20staffing%20and%20retention%20advantages.
[196] *Id.*
[197] *Id.*
[198] *Id.*
[199] *Id.*
[200] *Id.*

must work for the benefit of shareholders.[201] SOX has also been lauded by financial industry experts, citing increased investor confidence and more accurate, reliable financial statements because CEOs and CFOs were required to own their financial statements under Section 302. Under Section 201, the Act also addressed auditor conflicts by prohibiting auditors from engaging in profitable consulting agreements with the companies that they audit. In 2007, SEC Chairperson Christopher Cox remarked that SOX helped restore trust in U.S. financial markets by augmenting accountability, speeding up reporting, and making audits more independent.[202] The FEI and IIA studies in 2007 showed that SOX improved investor confidence in investor reporting.[203] [204] This was a major goal of SOX. The IIA study demonstrated improvements in the engagement of the boards of directors, audit committees, and senior management regarding financial controls.[205]

Financial restatements were quite common after SOX became law. According to Glass, Lewis & Co. in their March 2006 report, in 2005, there were 1,195 restatements of financial earnings for U.S. firms and 100 for foreign firms for a total of 1,295 companies worldwide, almost twice the number for 2004.[206] It was approximately one restatement for every 12 publicly traded companies, while in 2004, the number of restatements was one restatement for every 23 publicly traded companies.[207]

In 2009, the SEC documented fraud from a validated whistleblower that was first brought to the attention of the Commission in 2005.[208] The action of the SEC could be attributed to SOX. The fraud occurred over 20 years and involved more than $24 million.[209] The fraud was committed by Value Line against its mutual fund shareholders and reported by Chief Quantitative Strategist, Mr. John R. Dempsey of Easton, Connecticut. The reason that he reported the fraud was because he was required by SOX to sign a Code of Business Ethics.[210] The mutual fund investors received a total of $24 million.[211] The SEC ordered Value Line to pay $43 million in disgorgement, prejudgment interest, and civil penalties. The Commission also ordered the CEO and the COO to pay civil penalties of $1 million and $250 thousand respectively, and were barred from associating with any broker, dealer, investment adviser, or investment company, and were prevented from becoming an officer or director of any public company.[212] No criminal charges were filed.

SOX has been celebrated for encouraging an ethical culture because it compels senior management to be transparent and it obliges employees to act responsibly while safeguarding whistleblowers.[213] If senior management ignores an employee's issue that could affect the firm's SEC filings, the courts have held that senior management may be violating its duty to assess and disclose material weaknesses that are present in its internal financial reporting controls.[214]

Negative Criticism of the Sarbanes-Oxley Act

Former Rep. Ron Paul (R-TX) criticized SOX, claiming that SOX was unnecessary because it put U.S. corporations as a competitive disadvantage with foreign companies by encouraging U.S. companies to move their facilities outside the country.[215] Paul's argument was that SOX and its associated SEC regulations are "damaging American capital markets by providing an incentive

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[201] Alan Greenspan, Remarks by Chairman Alan Greenspan, *The Federal Reserve Board* (May 15, 2005), *available at* https://www.federalreserve.gov/boarddocs/speeches/2005/20050515/default.htm.
[202] ABC News Staff, SOX Law Has Been a Pretty Clean Sweep, *ABC News* (Jul. 30, 2007), *available at* https://abcnews.go.com/Business/story?id=3428252&page=1#:~:text=The%20law%20forced%20public%20companies,from%20the%20market%20have%20returned.
[203] FEI Staff, *supra*, note 156.
[204] IIA Staff, IA Standard 1312 - External Quality Assessments: Results, Tools, Techniques and Lessons Learned, *Institute of Internal Auditors* (2007), *available at* https://web.archive.org/web/20110111153636/http://www.theiia.org/bookstore/product/iia-standard-1312-external-quality-assessments-results-tools-techniques-and-lessons-learned-2007-1399.cfm.
[205] *Id.*
[206] Mark Grothe, Getting It Wrong the First Time, *Glass, Lewis & Co.* (Mar. 2, 2006), *available at* https://web.archive.org/web/20110512002939/http://www.glasslewis.com/downloads/Restatements2005Summary.pdf.
[207] *Id.*
[208] In the Matter of Value Line, Inc., *U.S. Securities and Exchange Commission* (Nov. 4, 2009), *available at* https://www.sec.gov/files/litigation/admin/2009/33-9081.pdf.
[209] *Id.*
[210] Jonathan E. Glater, The S.E.C. Is Investigating Fee Practices as Value Line, *The New York Times* (Aug. 2, 2008), *available at* https://www.nytimes.com/2008/08/02/business/02fund.html.
[211] Joshua Gallu, Value Line CEO Fired, Fined in Mutual-Fund Fee Scheme, *The Seattle Times* (Nov. 5, 2009), *available at* https://www.seattletimes.com/business/value-line-ceo-fired-fined-in-mutual-fund-fee-scheme/.
[212] *Id.*
[213] *Id.*
[214] *See generally*, Ryan C. Hubbs, & Julia B. Knieshe, Top 10 Factors Leading to Hotline Distrust, *Fraud Magazine* (Jul./Aug. 2016), *available at* https://www.fraud-magazine.com/article.aspx?id=4294993654.
[215] Ron Paul, A Word from Ron Paul, *Forbes* (May 4, 2008), *available at* https://www.forbes.com/2008/03/04/election-economy-paul-oped-cx_rp_0304ronpaul.html.

for small US firms and foreign firms to deregister from US stock exchanges."[216] According to Paul and the Wharton Business School, the number of U.S. companies deregistering from public stock exchanges has tripled immediately after SOX became law.[217] [218] In 2008, Srinivasan and Piotrosky discovered that after SOX was passed, small international companies were more likely to list on stock exchanges in the United Kingdom (UK) than in U.S. stock exchanges.[219]

In November 2008, former Speaker of the House Newt Gingrich and David W. Kralik asked Congress to repeal SOX.[220] They claimed that the U.S. economy is not creating enough jobs because it is not creating enough employers.[221] Gingrich and Kralik also observed that the world's leading stock exchange for new firms is Hong Kong, not New York. As the world's largest economy, Gingrich and Kralik pointed out that there is no reason why the U.S should not have the most energetic equity markets.[222] Finally, Gingrich and Kralik aptly pointed out that "the average company will now take 12 years before it can successfully issue an initial public offering (up from five years pre-Sarbanes-Oxley) because they do not have enough capital to cover the estimated $4.36 million hidden tax in yearly compliance costs."[223] In Q2 of 2008, there were no public offerings of Silicon Valley venture capital-backed companies (not seen since 1978), while in Q3 of 2008, there was only one public offering.[224] Gingrich and Kralik concluded that SOX has devastated the venture capital market.[225]

Legal Challenges to the Sarbanes-Oxley Act

In this section, several SOX cases are reviewed. For a variety of reasons, the cases are seminal in understanding SOX.

Free Enterprise Fund v. Public Company Accounting Oversight Board

In *Free Enterprise Fund*, the constitutionality of the PCAOB was challenged.[226] The plaintiff argued that because the PCAOB possesses regulatory powers over the accounting industry, its board members should be appointed by the President rather than the SEC.[227] Because SOX does not have a severability clause, if a part of SOX is unconstitutional, the whole law is unconstitutional.[228] The federal district court dismissed the suit and the decision was affirmed by the District of Columbia Circuit. On June 28, 2010, the Supreme Court refused to deem the law unconstitutional by a 9-0 decision, but in a 5-4 decision, the Court held that the section relating to PCAOB appointments violated the Constitution's separation of powers.[229] In *Free Enterprise Fund*, and in an instance of judicial activism or legislating, the Court created a severability clause in the law.[230] [231]

Lawson and Zang v. FMR, LLC

In *Lawson and Zang*, the Court rejected a narrow interpretation of whistleblower protection, holding that SOX's anti-retaliation protection also applies to private contractors and subcontractors who work at public companies, as well as attorneys and accountants who prepare SEC filings.[232] These disclosures are only protected if the disclosures relate to fraud committed by a publicly traded company, not a violation by a private contractor.

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[216] Saylor Academy Staff, More on the Sarbanes-Oxley Act: Criticism, *Saylor Academy* (n.d.), available at https://learn.saylor.org/mod/book/tool/print/index.php?id=53794&chapterid=38020.
[217] *Id.*
[218] Knowledge at Wharton Staff, Does Sarbanes-Oxley Hurt Shareholders and Hide Poor Management?, *Knowledge at Wharton* (Dec. 1, 2004), *available at* https://knowledge.wharton.upenn.edu/article/does-sarbanes-oxley-hurt-shareholders-and-hide-poor-management/.
[219] Suraj Srinivasan, & Joseph Piotroski, Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings, 46 JOURNAL OF ACCOUNTING RESEARCH 2 (May 2008), *available at* https://dash.harvard.edu/bitstream/handle/1/29660923/piotroski%2csrinivasan_regulation-and-bonding.pdf?sequence=3.
[220] Newt Gingrich, & David W. Kralik, Repeal Sarbanes-Oxley, *SFGate* (Nov. 5, 2008), *available at* https://www.sfgate.com/politics/article/repeal-sarbanes-oxley-3186747.php.
[221] *Id.*
[222] *Id.*
[223] *Id.*
[224] *Id.*
[225] *Id.*
[226] Free Enterprise Fund v. Public Company Accounting Oversight Board, 561 U.S. 477 (2010), *available at* https://www.oyez.org/cases/2009/08-861.
[227] *Id.*
[228] Jaclyn Jaeger, High Court Ruling Alters Sarbanes-Oxley Act, *Compliance Week* (Jun. 28, 2010), *available at* https://www.complianceweek.com/high-court-ruling-alters-sarbanes-oxley-act/4801.article.
[229] *Free Enterprise Fund v. Public Company Accounting Oversight Board*, *supra*, note 226.
[230] *Id.*
[231] Floyd Norris, & Adam Liptak, Supreme Court Upholds Accounting Board, *The New York Times* (Jun. 28, 2010), *available at* https://www.nytimes.com/2010/06/29/business/29accounting.html?dbk.
[232] Lawson and Zang v. FMR, LLC, 571 U.S. 429 (2014), *available at* https://www.oyez.org/cases/2013/12-3.

Yates v. United States

In *Yates*, the Court opined that SOX only covers objects employed to record or preserve information, not necessarily all physical objects.[233] Here, when inspecting a commercial fishing vessel in the Gulf of Mexico, a federal agent discovered that the catch contained undersized red groupers, a violation of conservation regulations.[234] Yates was told to separate the undersized fish until the ship reached port. Yates told the crew to throw the small fish overboard. Yates was convicted of destroying, concealing, and covering up undersized fish to impede a federal investigation in violation of 18 U.S.C. 1519.[235] In a plurality decision, the Court ruled that SOX only applies to objects that are used to record or preserve information. It does not apply to fish.[236]

Murray v. UBS Securities, LLC

According the Shepherd, the Court agreed in 2023 to hear a SOX case that could expand worker retaliation protections.[237] Trevor Murray sued UBS Securities and its Swiss parent company, UBS AG, claiming that UBS terminated him because he reported alleged fraud.[238] Murray worked as a mortgage strategist, focusing on commercial mortgage-backed securities. Murray asserted that he was targeted for whistleblowing to his supervisors about illegal activities by colleagues to alter his independent research analysis. The Southern District of New York believed that Murray's beliefs were reasonable, while the U.S. 2nd Circuit reversed the decision. Murray posited that he need only demonstrate that his whistleblowing was a contributing factor in his termination. As of this writing, the Court has yet to rule on the case.[239]

FINAL WORDS ABOUT ARTHUR ANDERSEN, ENRON, AND THE SARBANES-OXLEY ACT OF 2002

This section contains three subsections. The first subsection talks about Arthur Andersen, LLP, while the second subsection reviews the information garnered about Enron Corporation. The third subsection discusses the Sarbanes-Oxley Act of 2002.

Arthur Andersen, LLP

This essay told a tale of destruction and rebirth. Arthur Andersen, one of the Big Five accounting firms at the turn of the millennium, crashed and burned. In 2002, it appeared that Arthur Andersen would never recover. However, some of the partners in the face of tremendous adversity, chose the path less traveled. They decided to fight to exonerate the name and legacy of Arthur E. Andersen, by contesting the firm's conviction for obstruction of justice. In 2005, after three years of fighting in the courts, and with likely millions spent on legal fees, in the Supreme Court decision in *Arthur Andersen LLP v. United States*, the company, or rather the remaining partners, was exonerated by a 9-0 decision.

The company was shattered and in ruins. A mere 200 employees remained when at its height, the firm employed 28,000 people.[240] However, like the mythological Phoenix, a new company emerged from the fire and ashes of the old one. Some of the remaining partners never resigned themselves to abandon the principles of honesty, transparency, and integrity as espoused by Arthur E. Andersen from the time he and Clarence DeLany started the firm in 1913[241] until his death in 1947.[242] At that time, and in the years that followed, the remaining partners did the impossible. These courageous partners formed an accounting firm that would eventually be known as Andersen Global.[243] Currently, Andersen Global has 14,000 professionals, and over 2,000 partners with 400 offices in 170 countries.[244] If the current partners at Andersen Global are as dedicated to the ethical principles as advocated by Arthur E. Andersen in his lifetime, then it is quite possible that Andersen Global will once again become the fifth big accounting firm in the United States. It may only be a matter of time.

Enron Corporation

In contrast, Enron's demise is a textbook example of greed gone wild. Romans 6:23 is particularly relevant in Enron's case, where the wages of sin is death.[245] By extensively creating off-balance-sheet subsidiaries to hide corporate losses, Enron gave the

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233 Yates v. United States, 574 U.S. 528 (2015), *available at* https://supreme.justia.com/cases/federal/us/574/528/.
234 *Id.*
235 *Id.*
236 *Id.*
237 Leah Shepherd, Supreme Court to Hear Whistleblower Retaliation Case, *SHRM* (May 2, 2023), *available at* https://www.shrm.org/resourcesandtools/legal-and-compliance/employment-law/pages/supreme-court-whistleblower-retaliation-case.aspx.
238 *Id.*
239 *Id.*
240 Bill Mears, *supra*, note 23.
241 Mary Virginia Moore, *supra*, note 1.
242 Barbara Ley Toffler, & Jennifer Reingold, *supra*, note 7.
243 Michael Rapoport, *supra*, note 28.
244 Andersen Global Staff, *supra*, note 29.
245 Romans 6:23, available at https://www.biblegateway.com/verse/en/Romans%206:23. Here, it states that the wages of sin is death, where sin is the act of missing the mark.

appearance of a successful firm, but in fact, was hemorrhaging money. Enron can be likened to the corporate version of Dorian Grey, a novel by late 19th Century author Oscar Wilde, where a picture that was painted of Dorian aged, but Dorian himself remained youthful.[246] Dorian had decided to sell his soul so that the picture, not he, would age. With his youth assured, Dorian lived a debauched life. After experiencing a catharsis, Dorian decided to life righteously. To change himself, Dorian chose to destroy the picture. When he did, Dorian took on the corrupted image in the picture, and finally died.[247]

In many ways, Enron's demise mirrors the fate of Dorian Grey. After the plethora of off-balance-sheet organizations were discovered, and the true financial picture of Enron became apparent, the company filed Chapter 11 bankruptcy, only to realize that its destruction was assured.[248] In the end, Enron became an assetless entity, a shell with no substance, just like Dorian Gray at the end of Oscar Wilde's novel.[249] [250] [251] Although Enron tried to pay its debts the firm was only able to repay a percentage of the money owed. Enron became a striking example of King David's lament, "Oh how the mighty have fallen."[252]

The Sarbanes-Oxley Act of 2002

Finally, there is the Sarbanes-Oxley Act of 2002. The Act put in words what should have been ingrained in the mind and heart of people working in the financial industry. They should have known that honesty, transparency, and integrity are the bedrock of financial markets. With its eleven titles, SOX detailed what corporate officers, directors, and external auditors should and ought to do. In Section 302, Sox demanded that management effectively maintain internal controls over financial reporting and that external auditors are obligated to release an opinion regarding management efforts.[253] Section 303 made it unlawful for an officer, director, or any individual acting as a agent for an officer or director to engage in fraudulent activities, coerce, manipulate, or mislead an independent or certified accountant.[254] Section 401 required the SEC to study and report on off-balance-sheet entities.[255]

Section 404, the most controversial of any of the SOX sections, demanded that management and external auditors report on the adequacy of a firm's internal controls on financial reporting.[256] Section 802 made it illegal to knowingly alter, destroy, mutilate, conceal, cover up, falsify, or make a false entry in a record, document, or tangible project with the intent to impede, obstruct, or influence an investigation.[257] Finally, Section 806 was established to protect whistleblowers who report fraudulent activity from retaliation.[258]

After SOX became law, the costs and benefits of the law became evident. In terms of percentages of revenue, in terms of millions of dollars, the burden of the Act fell upon small publicly traded companies.[259] Studies indicated that small publicly traded companies with revenues below $251 million should likely be exempt from SOX.[260] In contrast, the benefits from SOX were increased investor confidence, where share prices increased 27.67 percent for firms with effective internal controls.[261] Donalson et al. demonstrated the benefits of SOX by observing that firms with reported material weaknesses have statistically significantly higher fraud.[262]

The positive criticism of SOX lauded the law because it restored public confidence and augmented accountability.[263] The law also encouraged financial restatements,[264] protected whistleblowers, and fostered an ethical corporate culture.[265] The negative criticisms believed that the law was unnecessary because the law placed U.S. companies in a competitive disadvantage with foreign

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[246] OSCAR WILDE, THE PICTURE OF DORIAN GREY (Penguin Classics; Rev. ed. Feb. 2003). The work was originally published Jul. 1890 as a novella in Lippincott's Monthly Magazine.
[247] *Id.*
[248] Kurt Eichenwald, *supra*, note 63.
[249] Barbara Shook, *supra*, note 65.
[250] Scott Stuart, *supra*, note 66.
[251] Katherine Hunt, *supra*, note 67.
[252] 2 Samuel 1:19, *available at* https://www.biblegateway.com/verse/en/2%20Samuel%201:19. Here, David lamented, saying, "Oh how the mighty have fallen" three times while singing his memorial song for Saul, the first king of Israel and Jonathan, Saul's son and David's friend.
[253] Vice Vinsente, *supra*, note 133.
[254] Sarbanes-Oxley Act of 2002, *supra*, note 134.
[255] SEC Staff, *supra*, note 135.
[256] Jiamin Wang, *supra*, note 137.
[257] 18 U.S,C. § 1519, *supra*, note 146.
[258] LII Staff, *supra*, note 147.
[259] Stephen M. Bainridge, *supra*, note 151.
[260] FL Staff, *supra*, note 159.
[261] LB Staff, *supra*, note 174.
[262] Dain C. Donelson, Matthew S. Ege, & John M. McInnis, *supra*, note 188.
[263] ABC News Staff, *supra*, note 202.
[264] Mark Grothe, *supra*, note 206.
[265] Joshua Gallu, *supra*, note 211.

firms.[266] It was also pointed out that it now took 12 years for new companies to have initial public offerings due to undercapitalization to comply with SOX.[267] On a final note, there were legal challenges to the constitutionality of SOX,[268] expansion of the whistleblower protections,[269] and a clarification of what information SOX protected.[270]

CONCLUSION

In conclusion, SOX is here to stay. The reason is that corporations have previously engaged in financial and accounting practices that have deceived investors. When investing one's money in a publicly traded company, investors must do so with a clear knowledge that the reasons for the investment are true. Deception and any of its myriad number of forms are simply unacceptable in a market economy. It is not a matter of maximizing profits or maximizing shareholder value at any cost. Such behavior should be in the confines of moral and ethical behavior by senior management and external accounting firms. Not short of a ruthless commitment to honesty, transparency, and integrity will suffice.

MISCELLANEOUS CONSIDERATIONS

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[266] Ron Paul, *supra*, note 215.
[267] Newt Gingrich, & David W. Kralik, *supra*, 220.
[268] Free Enterprise Fund v. Public Company Accounting Oversight Board, *supra*, note 226.
[269] Lawson and Zang v. FMR LLC, *supra*, note 232.
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