

# Through the Looking Glass – Where We Go After Sarbanes-Oxley

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*'Are they in the prisoner's handwriting?' asked another of the jurymen.*

*'No, they're not,' said the White Rabbit, 'and that's the queerest thing about it.' (The jury all looked puzzled.)*

*'He must have imitated somebody else's hand,' said the King. (The jury all brightened up again.)*

*'Please your Majesty,' said the Knave, 'I didn't write it, and they can't prove I did: there's no name signed at the end.'*

*'If you didn't sign it,' said the King, 'that only makes the matter worse. You must have meant some mischief, or else you'd have signed your name like an honest man.'*

— Lewis Carroll, Alice's Adventures in Wonderland

In signing the Sarbanes-Oxley Act, President Bush pronounced the new law to be “the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt.” For six months, the nation's business establishment felt like they had taken a tumble down the rabbit hole and found themselves in Alice's Wonderland. Pillars of corporate America—Enron, WorldCom, and the accounting firm Arthur Anderson—lay in ruin. The country's understanding about how reliable the financial information that drives modern securities markets was deeply shaken. And the markets kept tumbling downward.

The political establishment in Washington reacted—we must do something, now!

*'No, no!' said the Queen. 'Sentence first—verdict afterwards.'...*

*'Off with her head!' the Queen shouted at the top of her voice. Nobody moved.*

And so the bill was rushed through the Senate, rushed through conference with the House, and sent to the White House for President Bush's signature. Everyone hoped the new law would stabilize the markets, investors would regain confidence, and there would not be too much lasting damage to the national economy.

We have all read about the most notable changes in the bill. In most cases, the new requirements are in response to the most flagrant aspects of the various corporate scandals. In response to corporate leaders employing what I call the Sergeant Schultz defense “I know nothing...,” CEOs and CFOs now have to certify the financial information filed with the SEC—not just once, but *twice*. Steep criminal sanctions—up to \$5 million in fines and 20 years’ imprisonment—can be imposed for fraudulent filings.

In response to stories about the senior management of Enron and WorldCom cashing out millions of shares before their company’s stock crashed, CEOs and CFOs will have to forfeit bonuses and profits if the company’s financial statements are materially restated as a result of material misconduct—even if it was not the misconduct of the subject CEO or CFO.

In response to articles about thousands of innocent employees of these companies having the value of their retirement plans wiped out while management sold their stock in the company, the rules on insider trading have been changed. Executives cannot sell their stock when employees are barred from selling their 401k plans.

And, in response to the restatements of earnings, Sarbanes-Oxley has established a new oversight board to regulate the accounting profession, one which prohibits independent auditors from providing certain services as a conflict of interest, enacts new requirements for Audit Committees, and requires CEOs and CFOs to certify that the corporation has effective control measures to assure accurate financial statements.

In conversations with CEOs and corporate leaders across the country, my partners and I have been told that something needed to be done—and that for the most part the major new requirements are things that make sense and can be done. This, I think, is testimony to a fact that is little noticed—and as of last summer, most definitely not politically correct to say in Washington. Namely, that the vast majority of corporate leaders in this country do have a high standard of ethics, don’t lie to their shareholders, and certainly don’t intend to commit fraud or mislead the market. They recognize the damages caused by the scandals and want to correct the course.

But are we done? Does the new law end the matter? Far from it.

Less obvious, but more far reaching, are the hundreds of new regulatory requirements – many with deadlines spread out over the next year—that leave open and therefore create uncertainty about a myriad of issues for national and international corporations that issue any form of security traded in the U.S. markets.

Many of these issues are described in great detail in material written by my partners at Mayer, Brown, Rowe & Maw, and which is contained in the folders that you have been given. I won’t take up our time today with a long list of these changes and a dry legal recitation of the various sections of Sarbanes-Oxley. Rather, I would like to focus your attention on a number of areas where the new law will have major unforeseen consequences. I will also touch on a few things that I believe the business community can, and should, do to ensure that the new law and the new regulations enhance, rather than detract, from the successful operation of free capital markets in the country.

First, consider the impact on banks and other financial institutions. They are highly regulated by one or more of the Federal Reserve, the Comptroller of the Currency, and the FDIC. Sarbanes-Oxley's new corporate certification requirements—particularly as to internal management, systems and controls—create a potential disruption of the long-established role of these bank regulators. As you know, Sarbanes-Oxley requires that the CEO and CFO certify and evaluate the corporation's "internal controls" and new "disclosure controls and procedures." On August 29th, the SEC issued regulations implementing the new CEO/CFO certification provisions of Section 302 of Sarbanes-Oxley, and signaled that more regulations would be forthcoming on the new internal control section of the annual report. Management is required to establish and maintain adequate internal control structures and procedures for financial reporting.

These are the types of structures and procedures that bank examiners regularly review for financial institutions. Each institution is given a CAMEL rating from 1-5 and the examiner notes any deficiencies. Most financial institutions in the U.S. receive high ratings (a "1" or a "2"). Unless something is done to clarify who has jurisdiction, banks and other financial institutions will face difficult legal questions. Can their CEO/CFO rely on the CAMEL rating when he or she evaluates the bank's internal controls? Conversely, if a deficiency is noted, will the CEO and CFO violate Sarbanes-Oxley if they fail to disclose it to the Board, Audit Committee, and SEC?

Who regulates publicly traded banking institutions—the SEC or the bank regulators?

If the SEC regulations predominate, Sarbanes-Oxley could restrict various existing lines of banking business with their corporate customers. For example, certain structured finance arrangements—such as the securitization of accounts receivable—must now be disclosed in annual and quarterly reports. The SEC has already taken action with respect to such financing arranged by a mid-Atlantic bank. We can expect more.

Another business practice that may be drastically affected is that of loans made by banks to executives of their prime customers. Such loans on favorable terms are often used as marketing tools. The broad prohibition on issuers "arranging for the extension of credit" on more favorable than market terms could well prohibit the banks from offering these loans. Again, there are long-standing Federal Reserve regulations that govern banks offering similar loans to their own executives. While Sarbanes-Oxley exempts such loans that meet Federal Reserve insider loan standards, it is unclear whether this exemption applies only to the loans that banks make to their own executives or also to similar loans offered to their customers.

A second major area of uncertainty is how Sarbanes-Oxley relates to existing rules governing issuers who are government contractors. Government contractors already are subject to many certification requirements, including those under the Truth in Negotiations Act that pertain to contractor disclosures of cost data to the Government. They also are subject to the Federal Acquisition Regulation and the Cost Accounting Standards, which govern how costs are accumulated and allocated under certain government contracts. These regulations also prohibit certain costs from being charged to the Government and require certification proving that unallowable costs have not been charged.

Legions of federal agency auditors and Inspectors General audit and investigate compliance with these requirements. Recognizing that such requirements, and the audit and enforcement mecha-

nisms, deter some companies from doing business with the Government, Congress has enacted a variety of reforms over the last decade to reduce the number and applicability of such requirements and certifications. Notwithstanding, these requirements still apply to the largest contracts and help the Government ensure accountability of taxpayer dollars in procurement.

Government contractors are highly sensitized to the importance of due diligence and broad data “sweeps” that are necessary under Sarbanes-Oxley to permit officials to certify financial statements. Government contractors also are highly attuned to the importance of accuracy in making such certifications. Unfortunately, however, they also are familiar with the increased risk of liability that accompanies certifications to the Government.

Sarbanes-Oxley now adds a layer of complexity in terms of accounting, disclosure, and certification requirements to the already burdened class of government contractors. Their CEOs and CFOs will need to know how the unique government contract cost accounting standards relate to the auditing standards and accounting changes that ultimately result from Sarbanes-Oxley. The CEOs and CFOs of large, publicly traded conglomerates could be required to know about the government contract cost accounting rules and internal controls that are unique to a small portion of the company’s overall business. How will the requirements to disclose information under Sarbanes-Oxley relate to contractor liability under the False Claims Act? If there are errors or omissions that do not rise to the level of criminal penalties under Sarbanes-Oxley, can the trial lawyers still get treble damages? What happens when a company runs afoul of one of the Sarbanes-Oxley disclosure requirements that is not directly related to a company’s government business? Will it face suspension or debarment as a government contractor?

A third area deals with foreign companies. There are close to 1,000 foreign companies with securities listed on the NYSE and NASDAQ. They have awoken to find tremendous new securities and corporate regulations imposed upon them by the United States. Traditionally, the SEC and the Exchanges have accommodated foreign issuers when their national securities regulations differ from our own. However, in its first rulemaking implementing the new CEO/CFO certifications under Section 302, the SEC expressly declined to use its broad rulemaking authority to exempt foreign issuers.

From an economic standpoint, there’s not a great deal of difference between a large U.S. corporation operating in Europe—say Ford Motor Company—and a European corporation operating in the U.S.—say Daimler-Chrysler.

However, we dare not forget that the U.S. is not the only regulator. What is good for the goose is good for the gander. My European partners at Mayer, Brown, Rowe & Maw tell me the European Union (EU) has new initiatives in various stages of development governing the prospectus, transparency of financial accounting, and market abuse including insider trading rules. This past June the EU adopted new International Accounting Standards for all companies with securities traded in member nations. In the past, European issuers whose stock was traded in the U.S. securities markets could use GAAP in preparing their financial statements. Not so after 2007, when they, too, must comply with the International Accounting Standards.

In many cases it is likely that these new rules will apply to U.S. companies whose stock is traded in Europe and to European companies whose stock is traded here. What happens when Sarbanes-Oxley and the enhanced European regulations conflict with each other?

For example, U.S. issuers use GAAP in preparing financial reports. To make things more complicated, the SEC made clear in their August 29th rulemaking regarding certifications that Section 302 required a broader standard than GAAP. It includes judgments about the issuer's selection and proper application of appropriate accounting policies and requires disclosure of all financial information necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operation and cash flows.

What happens when the U.S. and EU accounting standards show significantly different bottom lines for the corporation? Does the CEO/CFO certify both sets of financials? Think about how helpful that would be to investors—not. Or does management take a risk—possibly one with criminal sanctions attached to it—and choose one standard over the other? Can safety be found in certifying the financials with the most gloom and doom for the company's future? It is not at all clear that investors would be helped by that either.

Internationalization is a trend that will only continue to grow. It is critical that U.S. policymakers work with their counterparts overseas to create a system of disclosure about financial information that facilitates strong equity markets here and abroad.

With all this uncertainty about Sarbanes-Oxley, how is the business community to respond?

It is tempting to say, "Don't just sit there, do something!" Certainly the magnitude of the impact these issues will have on securities markets and national economies dictates that business leaders should have a voice. The opportunities will abound with all that the SEC and other regulations called for in the bill.

At the same time, the business community's activities must be carefully considered. A political firestorm was building over the summer. While Sarbanes-Oxley deflected the heat for now, impulsive or uncoordinated actions can still become easy fodder for the political process.

I would recommend that the following general principles be used in considering what to do.

First, support the over-arching policy goals of Sarbanes-Oxley. More disclosure of appropriate information, greater accountability for those few who do commit fraud, greater transparency of corporate results, and greater independence of auditors are good for business, good for markets, and good for America.

Second, take into account the November elections. To paraphrase Captain Renault in Casablanca, "I'm shocked, shocked to find that politics is going on in here!" But just in case, let it run its course, see who comes out on top, and then work with every potential ally you can find.

Third, be prepared to take strong positions in the SEC and other agency rulemaking. These rules are an opportunity to correct problems and avoid inconsistencies. Keep in mind that we are at the beginning of the life cycle of policy development. Sarbanes-Oxley is a relatively rare example of major legislation moving at lightning speed because of a perceived urgent national need. The markets were tumbling; the front pages were plastered with story after story of financial scandal. Investors were wondering how secure are the securities markets? Something had to be done and Sarbanes-Oxley was the result.

Normally, the issues I have mentioned today, as well as many others, would have been worked out in the give-and-take required to pass a bill. However, with Sarbanes-Oxley much of this back-and-forth must now play out in the SEC and other rulemaking bodies, not to mention the possibility of a technical correction bill next year in Congress. Be prepared to make your case in those forums.

Fourth, as representatives of the business community, you have tremendous knowledge about how many of these new regulations can and will effect real corporate decisionmaking. Organize yourselves to identify the real problems and the unintended consequences. Propose solutions that preserve the overall goals of Sarbanes-Oxley and at the same time enhance the markets. Use the SEC rulemakings to draw a road-map for the SEC in order to tell the difference between legitimate structured financing arrangements and the structures used by Enron and Global Crossing to hide their true financial situation from their investors. Propose ways to harmonize the government contracting requirements with the new Sarbanes-Oxley accounting standards. By all means, fight hard to keep the trial lawyers from finding ways to use the False Claims Act to expand corporate liability into new areas. Work with the European business community to make sure that American and European businesses don't get caught in a whipsaw of new regulations bouncing back and forth across the Atlantic.

As I say, there will be plenty of opportunities available when the SEC considers the dozens of new rules required by the bill. Some deadlines are coming up rapidly. All indications are that the Commission will try to meet them when possible.

Also, help develop the facts and analysis needed for the various studies called for in the bill. Congress recognizes that Congress and the SEC need more information to come up with the right policy in areas ranging from auditor rotation and independent audit functions, to conflict of interest standards for business, to what is "material" in financial statements.

Additionally, use this opportunity to promote other reforms that will improve the markets, be good for investors, and create a healthy business climate. One idea that seems to be gaining traction, in the press at least, is eliminating the double taxation of dividends. The argument is that double taxation has driven publicly traded companies away from paying dividends and towards compensating shareholders with increases in stock value. The downside to this development is that dividends paid in cold hard cash cannot be manipulated to show higher corporate earnings. As companies move away from paying them and towards enhanced share value, the balance sheet takes on even more importance. By eliminating double taxation, there will be more of a level playing field for those investors who would prefer to take the cash every quarter rather than speculate on the accuracy of P/E projections.

Finally, corporate America is both a reflection of our culture and a potentially potent force in shaping that culture. The scandals we see today came out of the 1990s when times were good and in areas of our culture—as diverse as politics and family life—the notion that "anything goes" seemed to prevail. Now we see that not telling the truth does have serious consequences when thousands of shareholders and employees of once-stalwart corporations are left holding the bag. My point is that as our culture ponders all this, the business community can make a serious contribution by expounding and living up to a code of ethics that at its core has been with us since Biblical times—don't lie, don't cheat, don't steal.

With luck and a great deal of hard work, we will see the Sarbanes-Oxley act make a positive contribution to our securities markets. There will be greater transparency and accountability. We will avoid the worst of Alice in Wonderland—in this case the unintended consequences, which could detract from the operation of the American securities markets. Then those markets will continue to be the most amazing and efficient creator of wealth that history has ever seen. The luck comes from Providence; the hard work will have to come from you gathered here today.

Thank you.