Sarbanes-Oxley: Back to the Future

BY THEODORE A. LEVINE AND DANIEL M. HAWKE

Passage of the Sarbanes-Oxley Act of 2002 caused great trepidation in the C-suites of corporate America. But when analyzed objectively, it is clear that the act has its roots in past enforcement efforts of the SEC.

Understanding the Sarbanes-Oxley Act's remedial provisions and their underlying theories may be useful to CLOs when they are confronted with a possible enforcement action by the SEC.

[IN BRIEF]

- From early enforcement efforts in the 1930s to today's Sarbanes-Oxley Act, the SEC has attempted to regulate American business.
- In the '70s, there were few statutorily mandated remedies available.
- In the '80s, enforcement strategies became more prosecutorial.
- Today, the SEC has a broader range of remedies and more flexibility in enforcing them than it has had before.

The Securities and Exchange Commission has long been recognized as the "statutory guardian" of the public's interest through the effective enforcement of the federal securities laws. The SEC derives its regulatory and enforcement authority from six statutes, principal among them the Securities Exchange Act of 1934. When recent corporate and accounting scandals cost investors billions of dollars in losses, many questioned whether the statutory remedies available to the SEC under the Exchange Act were adequate to protect investors and maintain the integrity of the markets.

To strengthen the SEC's enforcement effort and help restore investor confidence, Congress enacted the Sarbanes-Oxley Act in July 2002. In this act, Congress amended and supplemented the Exchange Act by, among other things, codifying a number of common-law remedial powers and equitable principles that the SEC had developed or applied through its enforcement program over many years. The codification of these remedies has bolstered the SEC's enforcement arsenal significantly.

Understanding the Sarbanes-Oxley Act's remedial provisions and their underlying theories may be useful to chief legal officers when they are confronted with a possible enforcement action by the SEC. Many of the Sarbanes-Oxley Act's remedial provisions involve remedies that trace their doctrinal roots to the SEC's enforcement program of the 1970s, a period widely considered as "the golden age" of SEC enforcement.

In the 1970s, the SEC had few statutorily mandated remedies available to it beyond its authority to seek civil injunctive relief. In cases involving particularly egregious corporate conduct, injunctive relief alone generally was insufficient to remedy the harm done by securities law violators or to adequately deter them from committing additional violations in the future. The SEC did not have the statutory authority to impose fines or penalties on issuers or their managements or to obtain disgorgement of ill-gotten gains. It was dependent on the equitable discretion of the courts to obtain such ancillary relief. In large and complex investigations, the SEC was hampered, as it had always been, by a lack of resources. As a result, it frequently sought to achieve through its enforcement actions the broadest possible impact on the public consciousness with the few remedies and resources available to it. The SEC did this by adopting creative approaches

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to enforcement that balanced the need for meaningful remedies in particular cases with the goal of helping the securities industry and corporate America improve their standards and business practices.

Over the years, the SEC's statutory remedial powers evolved as successive Wall Street scandals provoked legislative reaction to perceived weaknesses in the SEC's enforcement authority. As Congress conferred more powers on and gave more remedies to the SEC, the Commission had a greater impact with its enforcement actions. With each success, public expectations increased, and attitudes toward enforcement by the SEC changed. The expansive and creative approach to remedies in the 1970s gave way to narrower, more prosecutorial approaches in the 1980s. Under the Sarbanes-Oxley Act, the SEC's enforcement remedies have come full circle—the SEC now has the broadest range of remedies from which to choose and the greatest flexibility in applying these remedies than perhaps at any time in its history. In order to fully understand the SEC's enforcement powers, several remedial provisions of the Sarbanes-Oxley Act warrant careful attention.

Officer and Director Bars and Penalties

Section 305(a) of the Sarbanes-Oxley Act lowers the standard for the SEC to obtain an officer and director bar in an injunctive action from "substantial unfitness" to "unfitness." In addition, Section 1105 grants the SEC authority for the first time to seek officer and director bars in cease-and-desist administrative proceedings applying the "unfitness" standard. Over the years, the SEC has had some difficulty demonstrating to courts that certain officer and director conduct rendered them "substantially unfit" to hold those positions. Under the lower "unfitness" standard in the Sarbanes-Oxley Act, the SEC will have greater latitude in obtaining officer and director bars.

Section 305(b) provides that in any action or proceeding by the SEC under any provision of the securities laws, the SEC may seek and any federal court may grant any equitable relief that is appropriate or necessary for the benefit of investors. This could include increased oversight and monetary remedies. While nothing in the Exchange Act ever limited the SEC's ability to ask courts to invoke their equitable powers where necessary to effectuate the purposes of the act, Section 305(b) of the Sarbanes-Oxley Act expressly reaffirms this authority and affords the SEC greater flexibility in seeking equitable remedies.

Forfeiture of Certain Bonuses and Profits

Section 304 of the Sarbanes-Oxley Act provides that when a company "is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement," the CEO and the CFO shall reimburse the issuer for "any bonus or other incentive-based or equity-based compensation

Under the Sarbanes-Oxley Act, a company's CEO and CFO could be required to reimburse their own bonuses and profits upon a finding that others in the company engaged in the misconduct leading to the issuer's violation.

received" within 12 months of the report and "any profits" on sales of securities during that 12-month period. This provision is significant because, read literally, the misconduct giving rise to forfeiture is not necessarily limited to conduct by the CEO and CFO—that is, the CEO and CFO could be required to reimburse their own bonuses and profits upon a finding that others in the company engaged in the misconduct leading to the issuer's violation.

Code of Ethics for Senior Financial Officers

Section 406 requires the SEC to promulgate rules requiring an issuer to disclose whether or not it has adopted a code of ethics for its senior financial officers. The issuer must also disclose the reason why such rules have not been enacted. In October 2002, the SEC proposed rules expanding coverage of the code to an issuer's principal executive officer, as well as its senior financial officers.

Appearance and Practice Before the Commission

Since its earliest days, the SEC has attempted to regulate the conduct of attorneys, accountants, and others who practice and appear before it. These efforts have always been controversial. Section 602 of the Sarbanes-Oxley Act codifies aspects of the SEC's existing rules of practice and grants the SEC authority to censure or deny any person the privilege of appearing or practicing before it if it finds that, among other findings, the person is not qualified, has engaged in unethical or improper professional conduct, or has willfully violated or willfully aided and abetted violations of the federal securities laws. The codification of certain SEC rules of practice should eliminate much of this longstanding controversy.

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SEC: POWER THROUGH THE YEARS

The Sarbanes-Oxley Act of 2002 has given the Securities and Exchange Commission considerably more power than it had in the 1970s, which was considered to be "the golden age" of SEC enforcement.

1970s ENFORCEMENT	1980s ENFORCEMENT	SARBANES-OXLEY ACT OF 2002
Statutory authority limited to seeking civil injunctive relief	Deregulation; narrower, more prosecutorial enforcement	Broadest range of, and flexibility to apply, remedies
No statutory authority to impose fines or penalties	Crackdown on traditional securities fraud such as insider trading	Officer and director bar
No express statutory authority to obtain disgorgement of ill-gotten gains	Specific authority to seek civil monetary penalties for insider-trading violations	Bonus- or incentive-based compensation giveback on finding of misconduct
Expansive reading of securities laws; creative approaches to enforcement	Narrow reading of securities laws	Codification of common law remedial authority
Call to improve corporations' ethical standards	No specific focus on corporate governance	Issuer code of ethics; regulation of the conduct of those practicing before the SEC
Use of ancillary relief to augment injunctive actions	Judicial skepticism as to scope of SEC's remedial authority	Authority to temporarily escrow extraordinary payments to individuals
Use of the access theory to police capital markets	Access theory disfavored	Use of the gatekeeper theory to police capital markets
Use of consent decrees to resolve enforcement actions	More litigation, fewer settlements	Attorneys required to report wrongdoing up the ladder
Use of Section 21(a) report to warn of misconduct the SEC would pursue in the future	More punitive; less emphasis on raising industry standards	Victim-oriented; contribution of civil penalties to victim disgorgement funds

Temporary Freeze Authority for the SEC

Section 1103 of the Sarbanes-Oxley Act amends Section 21C(c) of the Exchange Act and empowers the SEC to seek a temporary order for up to 90 days from a federal district court to escrow "extraordinary payments," if it appears likely that the company will make "extraordinary payments" to an individual. This provision is aimed at preventing companies from making large payments to departing officers and others suspected of engaging in corporate wrongdoing. It enables the SEC to prevent the dissipation and squandering of corporate assets until courts have reviewed the matter.

Rules of Professional Responsibility for Attorneys

In November 2002, the SEC proposed rules, pursuant to Section 307 of the Sarbanes-Oxley Act, to govern the standards of professional conduct for attorneys appearing and practicing before the SEC. These proposed rules have significant legal consequences for CLOs, corporate law departments, and outside counsel rep-

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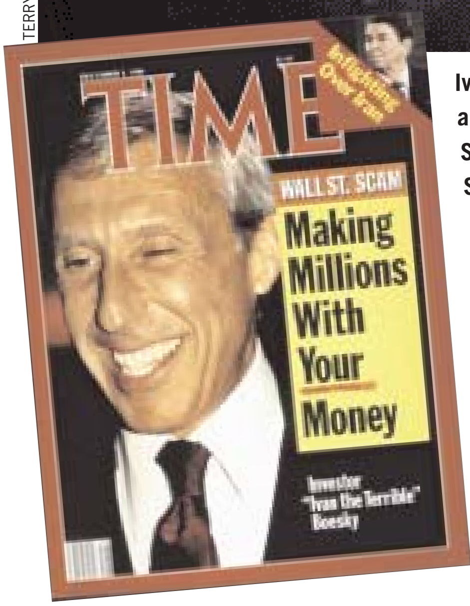

Ivan Boesky, shown at left on the cover of *Time* magazine in 1986, and Michael Milken (above, left), at an Oversight and Investigations Subcommittee hearing in 1988, were the recipients of aggressive SEC enforcement.

resenting public companies. The proposed rules would require an attorney to report "up the ladder" concerning past, ongoing, or future securities violations by an issuer—first to the company's CLO or to the CLO and the CEO. If these officers fail to "appropriately respond," then the attorney must report to the company's audit committee or full board of directors. If appropriate action is not taken by these officers, the attorney will be permitted or required to disassociate him- or herself by means of a "noisy withdrawal" from the company's SEC filing. *[Editor's Note: As of press time, the "noisy withdrawal" provision had caused a great deal of controversy, and no final ruling on it had been made.]*

Fair Funds for Investors

Section 308(a) provides that if the SEC obtains a civil penalty or order requiring disgorgement against any person (or that person agrees to a penalty or disgorgement in a settlement), the SEC can add the amount of the civil penalty to a disgorgement fund for the benefit of the victims of the violation. Historically, the SEC's position was that it was not a collection agency. It sought disgorgement—depriving the violator of ill-gotten gains—not restitution. Section 308 allows the SEC to help victims recover lost funds.

The Sarbanes-Oxley Act requires issuers to disclose their codes of ethics.

Roots in the Past

Many of the remedial provisions in the Sarbanes-Oxley Act have their origins in the SEC's mid-1970s enforcement program. Stanley Sporkin, the director of the SEC's Enforcement Division during the '70s, gave a speech in 1976 titled "Restoring Integrity to American Business" in which he proposed that companies designate a business practice officer who would be responsible for, among other things, implementing codes of ethical conduct. Under Sporkin's leadership, the SEC's Enforcement Division adopted an expansive, ingenious approach to enforcement. The division investigated suspected violations as they arose and creatively used a variety of enforcement remedies to achieve the broadest possible public impact of its actions. At the same time, the division encouraged the securities industry and corporate America to improve their business and ethical standards. Central to this approach was the SEC's use of ancillary relief to augment injunctive actions, its adoption of the "access" theory to police the capital markets, its use of consent decrees to resolve enforcement actions, and its use of reports of investigations under Section 21(a) of the Exchange Act to warn would-be violators of the types of improper conduct the SEC would pursue in the future.

Since its establishment in 1934, the SEC's primary enforcement tool has been a civil injunctive action. In the late 1960s and early 1970s, the courts recognized that injunctive relief alone was little more than a "mild prophylactic" that was usually insufficient to prevent or deter egregious frauds. To fully remedy wrongdoing, the SEC frequently sought ancillary relief from the courts. While not expressly authorized by statute, ancillary (or equitable) relief was granted by the courts where necessary to effectuate the purposes of the securities laws. Examples of ancillary relief the SEC obtained during the 1970s include disgorgement of ill-gotten gains, the appointment of special directors, the establishment of new audit committees, the appointment of special counsel, and the use of undertakings to cure weaknesses in corporate and accounting controls. None of these remedies was punitive; instead, each was structured to help violators "come clean" with respect to past violations, raise standards of conduct, and force wrongdoers to adopt measures aimed at preventing future violations.

In addition to ancillary relief, the SEC developed the "access" theory of securities law enforcement. Premised on the belief that accountants, lawyers, and securities industry professionals held the keys to their clients' abilities to use the capital-raising process, the access theory enabled the SEC to make the most of its limited resources by, in effect, putting pressure on these professionals to police

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Former SEC Chairman John Shad [above] declared in the early 1980s that he would crack down on insider trading with "hobnail boots." Under this approach, traditional, less controversial forms of securities fraud such as insider trading and market manipulation were fair game.

that process. If they failed, the professionals would face the prospect of an SEC enforcement action for their own acquiescence or participation in their client's violations.

In resolving many enforcement actions during the 1970s, the SEC relied heavily on consent decrees and, at times, Section 21(a) reports of investigation. Consent decrees typically involved settled court or SEC orders where the alleged violator settled without admitting or denying the SEC's allegations or findings. Consent decrees usually included ancillary relief—undertakings, appointment of special counsel, or the appointment of new directors—that addressed the conduct giving rise to the violations. Consent decrees were effective means of settling disputes because they avoided the cost and uncertainty of contested litigation, allowed the parties themselves to control the outcome, and encouraged both sides to agree to measures designed to prevent future violations.

Similarly, Section 21(a) reports of investigation enabled the SEC to educate the markets and issuers about the conduct it found objectionable, while signaling its intent to prosecute would-be violators in the future if they failed to implement preventive measures or otherwise heed the SEC's concerns. For example, Section 21(a) reports allowed the SEC to express its view concerning companies that issued overly optimistic press releases at a time when they were under severe financial stress (National Telephone Company); outside directors who learned details of a company's financial condition that allowed for fraudulent securities offerings (Stirling Homex); and boards of directors that failed to investigate corporate transactions tainted by management self-dealing (Gould).

The period between the late 1970s through the mid-1980s was a transition in the SEC's enforcement program. The enforcement momentum slowed considerably as Congress, in the post-Watergate reform era, amended existing laws or passed new laws—the Freedom of Information Act and the Privacy Act of 1974, the Government in the Sunshine Act, the Equal Access to Justice Act, the Right to Financial Privacy Act, and others—that required changes in the enforcement approaches of the early and mid-1970s. Enforcement generally became more difficult. Controversy surrounding the SEC's longstanding efforts to police the conduct of lawyers, accountants, and other professionals surfaced. Application of the access theory waned. Similarly, the SEC encountered a growing judicial resistance to its enforcement program, resulting in a sustained backlash in which the Supreme Court and the lower courts adopted more restrictive readings of the securities laws and rejected the SEC's efforts to expand the reach of its powers.

Enforcement in the '80s

The 1980s was an era of deregulation. Enforcement actions became less remedial, more prosecutorial, and narrower in scope. The emphasis on enhanced corporate governance of the 1970s was replaced with anti-regulation. Judicial attitudes changed. An injunction came to be viewed by the Supreme Court as a "drastic remedy." Similar skepticism extended to the SEC's use of consent decrees: Could the SEC seek relief by consent that it could not obtain in a fully litigated action? Such questions did not mean there was no enforcement. On the contrary, it meant a tougher, more criminalized, and less flexible approach to enforcement.

Symbolic of the attitudinal shift within the SEC was then-chairman John Shad's declaration in the early 1980s that he would crack down on insider trading with "hobnail boots." Under this approach, traditional, less controversial forms of securities fraud such as insider trading and market manipulation were fair game. From a policy perspective, no one could seriously argue with aggressive enforcement against the likes of Ivan Boesky, Michael Milken, Dennis Levine, and others who were responsible for the spectacular insider-trading scandals of the mid-1980s. However, elevating standards of conduct and improving corporate governance was not a primary goal of the 1980s enforcement program.

In the 1980s, Congress empowered the SEC to seek significant civil monetary penalties for insider-trading violations. The availability of such penalties, however, put the SEC in a bidding war with itself—each new enforcement action demanded ever-increasing penalty amounts. As penalty amounts increased, more defendants opted to litigate with the SEC and take their chances in court. By the end of the 1980s, the SEC employed relatively few of the remedial approaches that dominated the enforcement program of the 1970s. With fewer settlements, the SEC was required to devote increasing resources to litigation. Litigation increased the SEC's programmatic risk as the potential for judicial backlash threatened its efforts to expand the interpretive contours of its enforcement and remedial powers.

Back to the Future

The prosecutorial approaches of the 1980s moderated in the early and mid-1990s, as criminal authorities manifested less interest in prosecuting complex securities fraud actions and as the spotlight of the 1980s insider-trading scandals dimmed and public attention shifted away from the SEC's enforcement efforts.

With the enactment of the Sarbanes-Oxley Act, however, the SEC's enforcement program has come full circle. The SEC has many new powers, some of which are based on long-established approaches. The code of ethics that Stanley Sporkin called for in 1976 is now a requirement of the Sarbanes-Oxley Act. At least two provisions of the Sarbanes-Oxley Act—Section 602 (Appearance and Practice Before the SEC) and Section 307 (Professional Responsibility of Attorneys)—are doctrinal extensions of the access or "gatekeeper" theory as it is currently referred to. The SEC's express authority to obtain forfeiture of executive bonuses and profits is consistent with the SEC's historical efforts to obtain ancillary relief in the form of disgorgement of ill-gotten gains. The SEC's temporary asset freeze authority is, perhaps, the ultimate form of ancillary relief in that the SEC now has the express authority to prevent the dissipation of corporate assets before it has even shown a violation. While these provisions are remedial and prophylactic, the SEC has never had greater powers to punish or deter wrongdoing than it now has under the Sarbanes-Oxley Act. •

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FOR YOUR CONSIDERATION

The Sarbanes-Oxley Act of 2002 has significant implications for CLOs to consider:

- Has your company adopted a code of ethics for its senior financial officers? If not, have you devised an explanation for the SEC?
- Do you have a plan in place that will go into effect if the SEC deems your officers or directors unfit to hold their positions?
- Are you prepared to reimburse your compensation bonus if your company has to restate its financials?

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