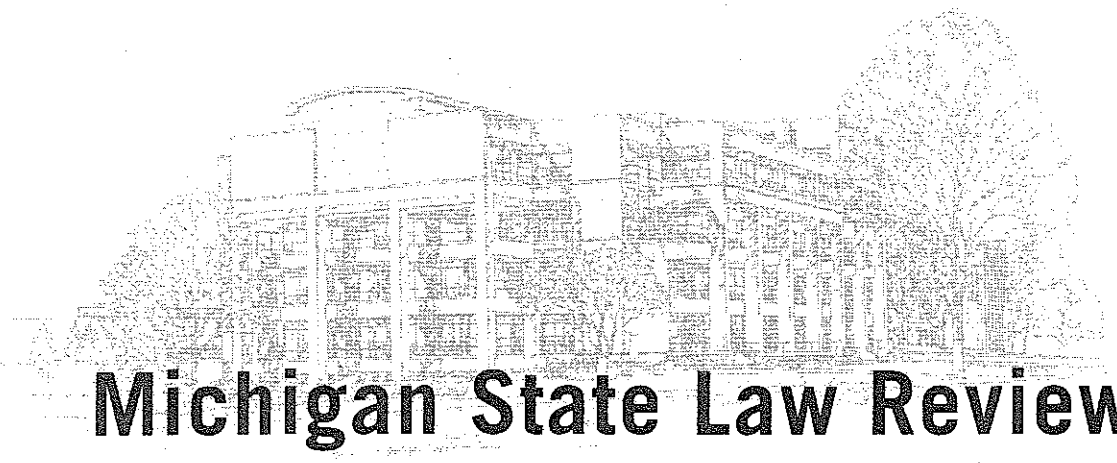

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Surveillance and Control: Privatizing and Nationalizing Corporate Monitoring After Sarbanes-Oxley

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SURVEILLANCE AND CONTROL: PRIVATIZING AND NATIONALIZING CORPORATE MONITORING AFTER SARBANES-OXLEY

Larry Catá Backer[*]

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INTRODUCTION

This article explores consequences flowing from the imposition of increasingly significant governmentally directed and enforced surveillance obligations on private actors within the economic sphere. The emerging public-private regime, exemplified by the Sarbanes-Oxley Act (SOX), has more clearly revealed its character: surveillance and control of the market and the firm by government in the name, and on behalf, of the private stakeholders traditionally charged with the development and protection of their economic arrangements. Surveillance is privatized—outside directors, auditors, outside counsel, and corporate employees now increasingly serve as the eyes and ears of the state. Enforcement is nationalized—in lieu of private action by stakeholders; the state offers "fair funds" reimbursements and state enforcement. The focus will be on the observer (who is required to survey), the observed (who must be monitored), the purpose of the surveillance (what must be monitored), and the persons or entities to whom the monitors must report.

The paper then sets out three sets of archetypal factual narratives, the consequences of which are being currently litigated. The first relates to Chancellor Corp., the second to Solucorp Industries, Ltd., and the third to part of the Enron litigation. Using these as archetypal narratives, the essay extracts a series of norms for behavior applicable to both observer and observed. These are the beginnings of a system of standards ultimately governed by and beholden to the state.

The essay then turns to an examination of the state, lying at the very center of this web of surveillance. First it analyzes the role of the state as enforcer as evidenced by the state's role in the cases considered. It considers the state as source of redress to stakeholder and market as evidenced by the SEC's campaign to widen its legislative authority to seek damages from wrongdoers and return the recovered funds to investors. Second, it examines the impact of SOX in the context of post-September 11, 2001 policies. In particular, it suggests that the elevation of monitoring as a significant state policy after September 11, 2001, may explain certain parallels between SOX and the anti-terrorism provisions adopted in 2001 and 2002. The essay ends

with a preliminary consideration of the consequences of the construction of this great panoptic system of disclosure, in which individuals, firms, and markets form the periphery while government lies at its center, and suggests that what may be emerging is a system of surveillance mercantilism.

I. BACKGROUND

"Our society is one not of spectacle, but of surveillance."[1] This observation, written in the context of the birth of modern prison and punishment systems in the West, is increasingly applicable to recent efforts by the state to assert authority over public companies in the United States. More completely displacing traditional systems of private monitoring by stakeholders and markets, an institutionalized regime of surveillance and discipline,[2] enlisting every participant in the corporate enterprise, from the lowest employee to the highest echelon of power, is being deployed to control behavior within the public corporation. The public corporation, for a long time conceived as little more than an imperfectly regulated sum of private arrangements between its participants, has become, like the nuclear family before it, a conscious object of state policy for the imposition of social (and economic) discipline. This is not to say that the new regimes of formal and informal law lack for spectacle.[3] But it does suggest a shift in the mechanics

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1. MICHEL FOUCAULT, DISCIPLINE AND PUNISH: THE BIRTH OF THE PRISON 217 (Alan Sheridan trans., Vintage Books ed. 1979) (1977).

2. As Foucault notes in the context of the criminal law, but ironically quite aptly applies in the context of the regulation of public corporations:

> "Discipline" may be identified neither with an institution nor with an apparatus; it is a type of power, a modality for its exercise, comprising a whole set of instruments, techniques, procedures, levels of application, targets; it is a "physics" or an "anatomy" of power, a technology. And it may be taken over either by "specialized" institutions . . . or by institutions that use it as an essential instrument for a particular end . . . or by pre-existing authorities that find in it a means of reinforcing or reorganizing their internal mechanisms of power . . . or by apparatuses that have made discipline their principle of internal functioning . . . or finally by state apparatuses whose major, if not exclusive, function is to assure that discipline reigns over society as a whole.

Id. at 215-16.

3. The spectacular effects of law are well known to modern theory. There is a certain element of spectacle tied to much of what can be described as corporate penalties. But now the law itself, rather than punishment, has become the locus of the spectacle attaching to the penal process. *See, e.g.*, Larry Catá Backer, *The Sarbanes-Oxley Act: Federalizing Norms for Officer, Lawyer, and Accountant Behavior*, 76 ST. JOHN'S L. REV. 897, 946-51 (2002):

> [T]he criminal provisions of the Act were directed at three primary and two secondary communities. The political benefits of the Act, both to the business and political communities in the United States, might be significantly greater, in the long term,

of interventions by greater powers (in this case, the state) into the spheres of lesser powers (the enterprise and especially the corporation) to discipline. By disciplining more efficiently, the higher powers control these lesser powers for the primary benefit of the state.

The Sarbanes-Oxley Act of 2002 (SOX),[4] in particular, marks another step in the creation of an architecture of corporate discipline—hierarchical, continuous and integrated within the heart of the functioning of the enterprise itself. SOX, like Jeremy Bentham's *Panopticon*,[5] is helping give definitive form to a structure within which corporate insiders, like Bentham's theoretical prisoners, can most effectively and economically "always feel themselves as if under inspection, at least as standing a great chance of being so."[6] SOX provides another layer of integration of surveillance and discipline organized "as a multiple, automatic and anonymous power."[7]

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than the benefits gained through the application of the criminal provisions to selected members of the American business classes.

Id.

> This has several consequences: [punishment] leaves the domain of more or less everyday perception and enters that of abstract consciousness; its effectiveness is seen as resulting from its inevitability, not from its visible intensity; it is the certainty of being punished and not the horrifying spectacle of public punishment that must discourage crime; the exemplary mechanics of punishment changes its mechanisms . . . [I]t is the conviction itself that marks the offender with the unequivocally negative sign: the publicity has shifted to the trial, and to the sentence; the execution itself is like an additional shame that justice is ashamed to impose on the condemned man.

FOUCAULT, *supra* note 1, at 9. Yet, for all of the importance of spectacle for modern lawmaking, Foucault's caution about the qualitative difference between pre and post modern legal spectacle is worth remembering.

4. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (to be codified in scattered sections of 15, 18, 28 & 29 U.S.C.).

5. JEREMY BENTHAM, THE PANOPTICON WRITINGS 29-95 (Miran Bof ovič ed., 1995) (1787).

6. *Id.* at Letter V.

> What is also of importance is, that for the greatest proportion of time possible, each man should actually *be* under inspection. This is material in *all* cases, that the inspector may have the satisfaction of knowing, that the discipline actually has the effect which it is designed to have: and it is more particularly material in such cases where the inspector, besides seeing that they conform to such standing rules as are prescribed, has more or less frequent occasion to give them such transient and incidental directions as will require to be given and enforced, at the commencement at least of every course of industry.

Id.

7. FOUCAULT, *supra* note 1, at 176.

> [F]or although surveillance rests on individuals, its functioning is that of a network of relations from top to bottom, but also to a certain extent from bottom to top and

Were the monitoring to be done by stakeholders or the markets in which corporate securities are traded, this result would be interesting but unproblematic.[8] However, I will argue here that the emerging matrices of surveillance and control, more clearly revealed and articulated by SOX, also reveals something far more significant: A shift from a market to a governmental system for developing behavior norms within firms and for disciplining actors who violate those norms. This article examines the way in which SOX constructs a panoptic system of surveillance in which every watcher is watched, and the consequences of that construction to the corporation, its stakeholders, gatekeepers, and the market.

This essay first describes the context in which surveillance is required of outside directors, auditors and counsel, and is encouraged from employees. The focus will be on (i) the observer (who is required to survey); (ii) the observed (who must be monitored); (iii) the purpose of the surveillance (what must be monitored); and (iv) the persons or entities to whom the monitors must report. The essay then examines the operation of the new context and focus of surveillance in three sets of archetypal factual narratives, the consequences of which are being currently litigated. The first relates to Chancellor Corp.,[9] the second to Solucorp Industries, Ltd.,[10] and the third to part of the Enron litigation.[11] Using these as archetypal narratives, the essay extracts a series of norms for behavior applicable to both observer and

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> laterally; this network 'holds' the whole together and traverses it in its entirety with effects of power that derive from one another.

Id. at 176-77.

8. Indeed, monitoring and disclosure regimes of informational transparency have been foundational Holy Writ supporting regimes of limited regulation of markets by governments since the 1930s.

> Historically, the proponents of the SEC's mandatory corporate disclosure system have advanced five principal arguments to justify the system. In the absence of a compulsory corporate disclosure system (1) some issuers would not disclose or would misrepresent information material to investment decisions; (2) underwriting costs and insiders' salaries and perquisites would be higher; (3) there would be less 'public confidence' in the markets; (4) neither state laws nor private associations . . . could ensure the optimal level of corporate disclosure; (5) civil or criminal legal actions would not ensure optimal levels of corporate disclosure.

LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 192-93 (3d ed. 1998).

9. *See* Plaintiff Complaint, SEC v. Chancellor Corp., No. 03-10762 MEL (D. Mass, filed Apr. 24, 2003), *available at* http://www.sec.gov/litigation/complaints/comp18104.htm (last modified May 20, 2003) [hereinafter *Chancellor* Complaint].

10. For currently reported cases in this saga, see SEC v. Solucorp Indus. Ltd., 274 F. Supp. 2d 379 (S.D.N.Y. 2003); SEC v. Solucorp Indus. Ltd., 197 F. Supp. 2d 4 (S.D.N.Y. 2002); *In re* Solucorp Indus. Sec. Litig., 2000 WL 1708186 (S.D.N.Y. 2000).

11. *See In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

observed. These are the beginnings of a system of standards ultimately governed by and beholden to the state. The essay then turns to an examination of the state, lying at the very center of this web of surveillance. First it analyzes the role of the state as enforcer as evidenced by the state's role in the cases considered. It considers the state as source of redress to stakeholder and market as evidenced by the SEC's campaign to widen its legislative authority to seek damages from wrongdoers and return the recovered funds to investors. Second, it examines the impact of SOX in the context of post-September 11, 2001 policies. In particular, it suggests that the elevation of monitoring as a significant state policy after September 11, 2003, may explain certain parallels between SOX and the anti-terrorism provisions adopted in 2001 and 2002, as well as their necessary relationship. The essay ends with a preliminary consideration of the consequences of the construction of this great panoptic system of disclosure, in which individuals, firms and markets form the periphery and government lies at its center. It suggests that the resulting system is one that shares some traits in common with old mercantilism,[12] a sort of surveillance mercantilism in which the markets are contextualized and regulated as one (important) piece in the game of nations, not to maximize stakeholder positions, but to maximize the position of the state.

12.

> The leading features of the mercantilist outlook are well known: bullion and treasure as the essence of wealth; regulation of foreign trade to produce specie inflow; promotion of industry by inducing cheap raw-material imports; protective duties on imported manufactured goods; encouragement of exports, particularly finished goods; and an emphasis upon increasing population and low wages. The core of it, of course, is the doctrine that a favorable balance of trade is desirable because it is somehow productive of national prosperity.

MARK BLAUG, ECONOMIC THEORY IN RETROSPECT 9 (1978). "But, even if we grant that state power was the sole end of mercantilist policies, with wealth valued solely as a means thereto . . . little has been said to remove the stigma of intellectual error in mercantilist theory." *Id.* at 13. Blaug noted:

> [For] a fullblown defense we must go to Keynes's provocative "Notes on Mercantilism" in *The General Theory* (1936). As soon as it is realized that an economic system does not automatically tend toward a state of full employment, Keynes argued, the whole of the classical case against protectionist policies, based upon the advantages of the international division of labor, loses much of its force . . . . In a society in which direct public investment or monetary policy is out of the question, the best that could be done was to encourage inflation through a favorable balance of trade: the export surplus would serve to keep up prices and the inflow of gold would lower interest rates, stimulating investment and employment by boosting the money supply. This, Keynes felt, was 'the element of scientific truth in mercantilist doctrine.'

Id.

SOX ought not to be considered in isolation. SOX represents only one part of a multi-part program of disclosure and transparency flowing to and under the direction of the state. Among the other parts of this more integrated global governmental agenda are the Patriot Act and the new efforts geared to the interdiction of financial fraud, money laundering and terrorist activities.[13] SOX adds significant new sources for the production of information that governments might find useful not only for the maintenance of transparent markets (in a macro sense) but also as a means of disciplining private actors and of shaping substantive rules of behavior (in a micro sense). SOX is nowhere near approaching its full potential as legislation or as an instrument of state policy. With time, what may become clearer is the way in which SOX's purpose and goals in the hands of the state may not coincide with stakeholders and market (private) preferences. In an age in which information is power,[14] SOX adds a necessary element in the state's attempt to retain dominance over politically subordinate entities and potential rivals.

II. SOX AND THE INTENSIFICATION OF CORPORATE SURVEILLANCE: "SUPERVISORS PERPETUALLY SUPERVISED."[15]

SOX is self-described as "an act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."[16] According to the SEC, "[f]rom the

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13. *See* discussion *infra* Part V.

14. And indeed, in a very broad sense, SOX is about information. The production of wealth, and especially of wealth from investment, derives to a substantial degree from the availability of information (as well as the ability to use it). Wealth maximization within a free enterprise state with strong investment markets requires stability and predictability in information flows, as well as confidence in the relative distribution of information and its utility ("accuracy").

15. FOUCAULT, *supra* note 1, at 177.

16. Sarbanes-Oxley Act pmbl., 116 Stat. at 745. SEC Commissioners emphasize a particular characterization of the new rules in SOX:

> The ultimate goal of all of these new rules is to restore investor confidence, which is at the core of your client relationships. Technical compliance with these rules is not enough, however, to cure the problems of the past. The ultimate effectiveness of all of the new corporate governance rules will be determined by the "tone at the top." Adopting a code of ethics means little if the company's chief executive officer or its directors make clear, by conduct or otherwise, that the code's provisions do not apply to them. Designating a financial expert means little if the person designated, while technically qualified, does not possess the personal qualities required to do the job effectively. Auditors must be truly independent of management and carry out their responsibilities from the perspective of the public shareholder. Lawyers should take their up-the-ladder reporting responsibilities seriously and support and encourage their corporate clients to do the right thing, not just avoid doing the wrong thing.

outset of fiscal 2002, the Commission launched several bold initiatives to address—and restore—eroding investor confidence. Some of these were later amended and codified in the Sarbanes-Oxley Act."[17] Within a year of the enactment of SOX,[18] the Securities and Exchange Commission has promulgated at least eleven sets of SOX-related final regulations,[19] and

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Cynthia A. Glassman, Speech by SEC Commissioner: SEC Initiatives Under Sarbanes-Oxley and Gramm-Leach-Bliley, ABA Trust, Wealth Management and Marketing Conference (Feb. 26, 2003), *available at* http://www.sec.gov/news/speech/spch022603cag.htm.

17. SEC, GOVERNMENT PERFORMANCE AND RESULTS ACT (GPRA) 2004 ANNUAL PERFORMANCE PLAN AND 2002 ANNUAL PERFORMANCE REVIEW 2 (Mar. 2003), *available at* http://www.sec.gov/about/gpra2004_2002.pdf.

> Highlights of the Commission's initiatives include: Streamlining investigations and expediting enforcement actions[;] Developing a risk-based inspections program for advisory firms and investment companies[;] Requiring and reviewing certified financial statements[;] Conducting in-depth disclosure reviews of the filings of Fortune 500 firms[;] Revising the Commission's fee structure to minimize impact on capital formation in the securities markets[;] Adopting rules implementing the provisions of the Sarbanes-Oxley Act.

Id.

18. The bill was signed by the President on July 30, 2002. *See* 148 CONG. REC. D866 (2002) (enacted).

19. As of August 15, 2003, according to the SEC, the following rules had been adopted: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Release Nos. 33-8238, 34-47986, IC-26068, File Nos. S7-40-02, S7-06-03 (June 5, 2003); Implementation of Standards of Professional Conduct for Attorneys, Release Nos. 33-8185, 34-47276, IC-25919, File No. S7-45-02 (Jan. 29, 2003); Strengthening the Commission's Requirements Regarding Auditor Independence, Release Nos. 33-8183, 34-47265, 35-27642, IC-25915, IA-2103, FR-68, File No. S7-49-02 (Jan. 28, 2003); Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Release Nos. 33-8182, 34-47264, FR-67, Int'l Series No. 1266, File No. S7-42-02 (Jan. 28, 2003); Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 34-47262, IC-25914, File Nos. S7-33-02, S7-40-02 (Jan. 27, 2003); Retention of Records Relevant to Audits and Reviews, Release Nos. 33-8180, 34-47241, IC-25911, FR-66, File No. S7-46-02 (Jan. 24, 2003); Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 33-8177, 34-47235, File No. S7-40-02 (Jan. 23, 2003); Insider Trades During Pension Fund Blackout Periods, Release Nos. 34-47225, IC-25909, File No. S7-44-02 (Jan. 22, 2003); Conditions for Use of Non-GAAP Financial Measures, Release Nos. 33-8176, 34-47226, FR-65, File No. S7-43-02 (Jan. 22, 2003); Certification of Disclosure in Companies' Quarterly and Annual Reports, Release Nos. 33-8124, 34-46427, IC-25722, File No. S7-21-02 (Aug. 28, 2002); Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release Nos. 34-46421, 35-27563, IC-25720, File No. S7-31-02 (Aug. 27, 2002). Press Release, SEC, Spotlight on Sarbanes-Oxley Rulemaking and Reports (Aug. 15, 2003), *available at* http://www.sec.gov/spotlight/sarbanes-oxley.htm.

proposed a number of other regulations.[20] In addition, SOX has directly and indirectly affected the scheme of Generally Accepted Auditing Standards (GAAS) under which the accounting profession has more or less substantially regulated itself within the design of the federal securities laws.[21] The accounting profession's self-regulating bodies[22] have had to propose the

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20. As of August, 15, 2003 the SEC had proposed the following rules: Certification of Disclosure in Certain Exchange Act Reports, Release Nos. 33-8212, 34-47551, IC-25967, File No. S7-06-03 (Mar. 21, 2003); Implementation of Standards of Professional Conduct for Attorney, Release Nos. 33-8186, 34-47282, IC-25920, File No. S7-45-02 (Jan. 29, 2003); Standards Relating To Listed Company Audit Committees, Release Nos. 34-47137, 33-8173, IC-25885, File No. S7-02-03 (Jan. 8, 2003); Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5, Release Nos. 33-8170, 34-47069, 35-27627, IC-25872, File No. S7-52-02 (Dec. 20, 2002); Strengthening the Commission's Requirements Regarding Auditor Independence, Release Nos. 33-8154, 34-46934, 35-27610, IC-25838, IA-2088, FR-64, File No. S7-49-02 (Dec. 2, 2002); Retention of Records Relevant to Audits and Reviews, Release Nos. 33-8151, 34-46869, IC-25830, File No. S7-46-02 (Nov. 21, 2002); Implementation of Standards of Professional Conduct for Attorneys, Release Nos. 33-8150, 34-46868, IC-25829, File No. S7-45-02 (Nov. 21, 2002); Insider Trades During Pension Fund Blackout Periods, Release Nos. 34-46778, IC-25795, File No. S7-44-02 (Nov. 6, 2002); Conditions for Use of Non-GAAP Financial Measures, Release Nos. 33-8145, 34-46768, File No. S7-43-02 (Nov. 4, 2002); Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Release Nos. 33-8144, File No. S7-42-02 (Nov. 4, 2002); Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 33-8138, 34-46701, IC-25775, File No. S7-40-02 (Oct. 22, 2002); Improper Influence on Conduct of Audits, Release Nos. 34-46685, IC-25773, File No. S7-39-02 (Oct. 18, 2002); Certification of Disclosure in Companies' Quarterly and Annual Reports, Release No. 34-46300, File No. S7-21-02 (Aug. 2, 2002).

21. For an historical explanation of the development and education of the accounting profession resulting in self-regulation of the accounting industry, see Harold Q. Langenderfer, *Accounting Education's History—A 100-Year Search for Identity*, 163 J. ACCT. 302 (1987) (discussing the development of self-regulatory regime within the accounting profession); U.S. GEN. ACCOUNTING OFFICE, SECURITIES REGULATION: SECURITIES AND EXCHANGE COMMISSION OVERSIGHT OF SELF-REGULATION, GAO/GGD-86-83 (Sept. 1986). On self-regulation after SOX, see Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation,* 38 WAKE FOREST L. REV. 961 (2003).

22. Under authority of the Sarbanes-Oxley Act, on April 25, 2003, the SEC recognized the Financial Accounting Standards Board (FASB) as the accounting standard setter. *See* SEC, Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Release No. 33-8221, *available at* http://www.sec.gov/rules/policy/33-8221.htm (last visited Sept. 16, 2003). *See also* Press Release, SEC, Securities and Exchange Commission Reaffirms Status of Pronouncements of the Financial Accounting Standards Board (Apr. 25, 2003), *available at* http://www.sec.gov/news/press/2003-53.htm. SOX Section 108(b)(1) gives the SEC authority to recognize as generally accepted for purposes of the securities laws any accounting principles established by a standard-setting body that meets the criteria described in the statute.

> The FASB is part of a structure that is independent of all other business and professional organizations. Before the present structure was created, financial

amendment of a number of auditing standards,[23] and the creation of a new Statement on Auditing Standards (SAS) entitled Review of SEC Engagements by a Reviewing Partner.[24] The accounting profession has had to begin to learn to operate within a system in which a quasi-governmental regulatory body—the Public Company Accounting Oversight Board—will have some authority to impose accounting standards.[25] Moreover, like an amoeba, SOX is equipped with the capacity for its own reproduction. SOX has caused the SEC to generate four significant reports.[26] Among them are reports that required analysis of the necessity for additional legislation.[27] Indeed, more

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> accounting and reporting standards were established first by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants (1936–1959) and then by the Accounting Principles Board, also a part of the AICPA (1959–73). Pronouncements of those predecessor bodies remain in force unless amended or superseded by the FASB.

Fin. Accounting Standards Bd., FASB Facts, *at* http://www.fasb.org/ facts/index.shtml (last visited June 3, 2004).

23. *See* AICPA Auditing Standards Bd., *Exposure Draft, Proposed Statement on Auditing Standards, Sarbanes-Oxley Omnibus* (Apr. 1, 2003), *available at* http://www.aicpa.org/members/div/auditstd/ed2003_0401_sas_s-o.asp.

24. *See id.* at 13-17.

25. In the words of SEC Commissioner Paul Atkins:

> The Act directed us to create a new Public Company Accounting Oversight Board to oversee the accounting profession and public company audits. It was created because of deep failings in the U.S. accounting profession's ability to regulate itself. The Oversight Board is a non-governmental, nonprofit corporation and must consist of five full-time independent members.

Paul S. Atkins, Speech by SEC Commissioner: Liabilities of German Companies and the Members of their Executive Boards under the Sarbanes-Oxley Act of 2002, Deutsches Aktieninstitut (Feb. 4, 2003), *available at* http://www.sec.gov/news/speech/ spch020403psa.htm.

26. *See generally* SEC, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS (Jan. 24, 2003); STUDY AND REPORT ON VIOLATIONS BY SECURITIES PROFESSIONALS: SECTION 703 OF THE SARBANES-OXLEY ACT OF 2002 (Jan. 24, 2003); REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002 (Jan. 24, 2003); REPORT PURSUANT TO SECTION 704 OF THE SARBANES-OXLEY ACT OF 2002 (Jan. 24, 2003), *available at* http://www.sec.gov/spotlight/ sarbanes-oxley.htm.

27. For example:

> Section 704 of the Sarbanes-Oxley Act directs the Commission to study enforcement actions over the five years preceding its enactment in order to identify areas of issuer financial reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management (the "Study"). In addition, Section 704 directs the Commission to report its findings to Congress, including a discussion of recommended regulation or legislation (the "report").

SEC, REPORT PURSUANT TO SECTION 704 OF THE SARBANES-OXLEY ACT OF 2002, at 5 (Jan. 24, 2003), *available at* http://www.sec.gov/news/studies/sox704report.pdf.

legislation is being considered to make it even easier for the state to recover money from corporate wrongdoers for redistribution to stakeholders.[28]

All of this frenetic activity[29] is focused on disclosure as the cure—necessarily to be administered by the state—for what some characterize as the market failures of the early twenty-first century.[30]

> In its essence, the Sarbanes-Oxley Act of 2002 is about disclosure. Crafted by Congress in the aftermath of financial collapse at corporations like Enron, Global Crossing and WorldCom, the new law establishes the framework for a new regime of accountability by public companies in the areas of financial reporting and disclosure, audits, conflicts of interest and governance.[31]

The value added by SOX to disclosure remains highly contested, at least in academic circles.[32] But it is hard to deny the effect of SOX on the regulation of the behavior of many of the principal actors involved in the functioning of corporations whose shares are registered with the federal government.[33]

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28. *See, e.g.*, The Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179, 108th Cong. (2003).

29. For example, with respect to the SEC Sarbanes-Oxley regulations promulgated through the end of February, SEC Commissioner Cynthia Glassman noted:

> The following statistics are unofficial, but I'm told our adopting releases for the 11 rules totaled over 1,000 pages (double-spaced, 10-point font) (only lawyers could take over 1,000 pages to write 11 releases), and they contained over a quarter-million words. I'm also told–off the record–that we reviewed over 113 different drafts, held over 2,700 man-hours worth of meetings, ate over 1,100 meals at our desks, and drank more than 4,800 cups of coffee!

Glassman, *supra* note 16.

30.

> Information is the investor's best tool when it comes to investing wisely. . . . Far too often, the lack of reliable, readily available, current information also opens the door to fraud. It's much easier for the unscrupulous to spread false information and to manipulate a stock's price when accurate information about the company is scarce.

SEC, Information Matters, *available at* http://www.sec.gov/ answers/infomatters.htm (last modified June 5, 2004).

31. Jenny B. Davis, *Sorting Out Sarbanes-Oxley*, 89 A.B.A. J. 44 (2003).

32. *Cf.* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 CONN. L. REV. 915 (2003); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes Oxley Act of 2002*, 28 J. CORP. L. 1 (2002) (explaining that SOX adds little or nothing to disclosure regime already in place); John C. Coffee Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002) [hereinafter *Understanding Enron*] (asserting that SOX adds important dimensions to disclosure in a number of contexts, and significantly broadens not only transparency but also broadens the context in which disclosure applies).

33. The SEC itself is quite self-conscious about the behavior modification authority inherent in Sarbanes Oxley. It recently posted to its website a summary of these sorts of actions. *See* SEC, Summary of SEC Actions and SEC Related Provisions Pursuant to the

Behavior modification does not come cost free. On the one hand, the

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Sarbanes-Oxley Act of 2002 (July 30, 2003), *available at* http://www.sec.gov/news/extra/soxpress.htm. These accomplishments were listed under the headings "Restoring Confidence in the Accounting Profession," "Improving the 'Tone at the Top,'" "Improving Disclosure and Financial Reporting," and "Improving the Performance of 'Gatekeepers'". *Id.* Among the accomplishments in "restoring confidence in the accounting profession," listed by relevant SOX section, were:

> The Act established the Public Company Accounting Oversight Board[;] Section 108(b) – On April 25, 2003, the SEC recognized the Financial Accounting Standards Board as the accounting standard setter[;] Section 108(d) – On July 25, 2003, the SEC issued a study on principles-based accounting[;] Section 109 – The Act established an independent funding source for the FASB[;] Title II – On January 22, 2003, the SEC adopted rules improving the independence of outside auditors[;] Section 303 – On April 24, 2003, the SEC adopted rules forbidding the improper influence on outside auditors[;] Section 802 – On January 22, 2003, the SEC adopted rules governing the retention of audit records by outside auditors.

Id. Among the accomplishments qualifying as improving the "tone at the top" were:

> Section 302 – On August 27, 2002, the SEC adopted rules requiring CEOs and CFOs to certify financial and other information in their companies' quarterly and annual reports[;] Section 304 – This section requires management to return bonuses or profits from stock sales received within 12 months of a restatement resulting from material non-compliance with financial reporting requirements as a result of misconduct[;] Section 306 – On January 15, 2003, the SEC adopted rule prohibiting company officers from trading during pension fund blackout periods[;] Section 402 – This section prohibits companies from making loans to insiders[;] Section 403 – On August 27, 2002, the SEC adopted rules that accelerated deadlines and mandated electronic filing of disclosures of insider transactions in company stock[;] Section 406 – On January 15, 2003, the SEC adopted rules requiring companies to disclose whether they have a code of ethics for their CEO, CFO and senior accounting personnel.

Id. SEC action under SOX listed for "improving disclosure and financial reporting" included:

> Section 401(a) – On January 22, 2003, the SEC adopted rules requiring disclosure of all material off-balance sheet transactions[;] Section 401(b) – On January 15, 2003, the SEC adopted Regulation G, governing the use of non-GAAP financial measures, including disclosure and reconciliation requirements[;] Section 404 – On May 27, 2003, the SEC adopted rules requiring an annual management report on and auditor attestation of a company's internal controls over financial reporting[;] Section 408 – This section requires that the Commission review the Exchange Act reports of each company no less frequently than once every three years.

Id. And those actions improving the performance of "gatekeepers" included:

> Section 301 – On April 1, 2003, the SEC adopted rules directing the SROs to adopt listing standards for audit committees Audit Committee Provisions[;] Section 407 – On January 15, 2003, the SEC adopted rules requiring the disclosure about financial experts on audit committees[;] Section 307 – On January 23, 2003, the SEC adopted rules governing standards of conduct for attorneys appearing and practicing before the Commission[;] Section 501 – On July 29, 2003, the SEC approved new SRO rules governing research analyst conflicts of interest.

Id.

actual costs of implementing Sarbanes-Oxley appears to have caused a large number of corporations to lag in their efforts to comply with all of the requirements of SOX.[34] Director compensation is among the most quickly rising post-SOX costs of corporate governance.[35] Audit costs are also rising dramatically,[36] while the number of auditing firms has decreased.[37] On the

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34. By August 20, 2003, "[o]f 17,000 public companies nationally, about half are having trouble meeting the standards put forth by the reform act . . . . Small businesses are especially hard-hit." Carol Elliott, *CPA's Told of Law's Probable Effects*, S. BEND TRIB., Aug. 20, 2003, at B8 (quoting Gary M. Bolinger, President & Chief Executive Officer of the Indiana CPA Society).

35. *See* Jenny Anderson, *Going Overboard—Directors Getting More $ as Workload Grows*, N.Y. POST, Aug. 25, 2003, at 29.

> Median compensation packages for directors on the boards of manufacturing companies are expected to be $70,000 in stock and cash in 2003—up from $55,000 in 2002—according to data to be released soon by the New York-based Conference Board. . . . Factors driving the change, say corporate governance experts, range from the Sarbanes-Oxley Act to increased initiatives and scrutiny by the Securities and Exchange Commission and the New York Stock Exchange.

Id.

36. "Another effect of the increased scrutiny required by Sarbanes-Oxley is that audit costs has increased by 30 percent to 50 percent for smaller publicly traded companies." Peter Zalewski, *Lawyers and Executives Have Spent Months and Money to Comply with Strict Corporate Governance Law, and More Limits Are Coming*, MIAMI DAILY BUS. REV., July 21, 2003, at 11. *See also* Bloomberg, *Firms' Audit Costs Rise on Sarbanes-Oxley*, BUSINESS REPORT (May 6, 2003), *at* www.busrep.co.za/index.php?fSectionId=565&fArticleId=140964 ("Accounting costs for companies with less than $3 billion in annual sales had more than doubled because of the Sarbanes-Oxley Act, according to a study released last week by law firm Foley & Lardner.").

These cost increases also include the expense of compliance with governmental oversight of auditing firms. For example, registration with the Public Company Accounting Oversight Board (PCAOB) can range from $250 for a registrant with no clients to $390,000 for a registrant with more than 1000 clients. *See* Pub. Co. Accounting Oversight Bd., Announcement of Registration Application Fees, Rel. 2003-010 (July 17, 2003). Moreover, the PCAOB will be conducting periodic inspections of registrants. *See* Pub. Co. Accounting Oversight Bd., Board Adopts Final Rules for Inspections of Accounting Firms (Oct. 7, 2003), *available at* http://www.pcaobus.org/pcaob_news_10-07-03a.asp?printable'true:

> The rules would establish a schedule for regular inspections that is consistent with Section 104(b)(1) of the Act, including annual inspections for firms that do the largest volume of audit work and at least triennial inspections for other firms that do some volume of audit work. Special inspections are not subject to a schedule and would be conducted as necessary or appropriate to address issues that come to the Board's attention.

Id.

37. "As of August 27—the date of the first list—fewer than 90 CPA firms of the 850+ who performed public company audits last year have yet applied." *PCAOB Lists Public Accounting Firm Registration Applicants*, ACCOUNTINGWEB.COM (Aug. 28, 2003), *at* http://www.accountingweb.com/cgi-bin/item.cgi?id=98028. Registration is the prerequisite for

other hand, the cost and difficulty of compliance has increased the number of (especially small) public companies going private.[38] Included among these costs is the expense of supporting the new governmental and quasi-governmental apparatus for monitoring and standard setting created or augmented by SOX.[39] None of this comes as a surprise. SOX has raised the cost of buying into the American securities markets for a number of sectors.[40] As costs rise, the benefits of participation to the marginally benefited company decrease, and in some cases to the point where the markets are no longer worth the costs of entry.[41] In this sense, SOX may be contributing to an increase in the markets for private financing, or at least changing the shape or characteristics of entrants into the public securities markets.[42]

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performing audits of public companies after SOX. *See* Sarbanes-Oxley Act § 1021(a) (to be codified as 15 U.S.C. § 7212) ("it shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer."). It appears that auditors are exhibiting an initial reluctance to take the risk or assume the additional costs of performing public company audits. Since the still lucrative consulting and internal controls market remains available for many companies, the loss of audit work (given the potential exposure to liability) may not be worth the returns just yet.

38.

> Good, solid small public companies may not have the resources to operate under Sarbanes-Oxley's provisions," said Bolinger. As a result, many smaller public companies are going private–buying back their stock from shareholders and de-listing from stock exchanges. Bolinger said about 50 have taken this option since July 2002.

Elliott, *supra* note 34 (quoting Gary M. Bolinger, President & Chief Executive Officer of the Indiana CPA Society).

39. For example, 15 U.S.C. § 7219 permits the PCAOB to assess an accounting support fee from issuers.

> Accounting support fees fund the Board's operations. Once each year, the Board will compute the fees based on the Board's budget for that year, as approved by the Securities and Exchange Commission. . . . The fees are due 30 days after notice is sent. Failure to pay constitutes a violation of the Securities Exchange Act of 1934, and the Board refers such failures to the Securities and Exchange Commission.

See Pub. Co. Accounting Oversight Bd., Accounting Support Fees (n.d.), *available at* http://www.pcaobus.org/pcaob_fee.asp (last visited June 3, 2004).

40. For a discussion, see Larry E. Ribstein, *International Implications of Sarbanes-Oxley: Raising the Rent on U.S. Law*, 3 J. CORP. L. STUD. 299 (2003).

41. The government, of course, takes a different view of the assessment of costs and benefits. "'The bulk of our accounting support fees are assessed against the largest equity issuers,' said PCAOB Chairman William J. McDonough. 'Small companies need not be concerned about increased costs while they and their shareholders benefit from the PCAOB's attention to the quality of audits.'" Pub. Co. Accounting Oversight Bd., PCAOB Issues Notices of Accounting Support Fees (Aug. 4, 2003), *available at* http://www.pcaobus.org/pcaob_news_8-04-03.asp.

42. I will not consider whether this change is a good or bad thing from any particular perspective. For a discussion of the issue generally, see, e.g., John C. Coates IV, *Private vs.*

SOX has done more than enhance the enforcement tools available to the SEC.[43] SOX has also changed the *dynamics* of enforcement of the disclosure system effected through the federal securities laws. The model of self-governing/self-monitoring/self-policing corporations functioning under the guidance of government and self-regulating auditor and legal agents,[44] whatever the reality of that model in fact, has given way to a very different model. This is a model predicated on surveillance. The behavior of insiders is to be constantly monitored. The public corporation has become an entity under surveillance by gatekeepers (outside directors, lawyers, and auditors) and government. It is also an entity that keeps watch on itself (through systems of reporting and control, and by threat of exposure through whistle blowers). Someone is always supposed to be watching—and the behavior of insiders is supposed to be based on this supposition. "Hence the major effect of the Panopticon: to induce in the inmate a state of conscious and permanent

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Political Choice of Securities Regulation: A Political Cost/Benefit Analysis, 41 VA. J. INT'L L. 531 (2001).

43. The SEC is quite conscious of the new or enhanced tools in its arsenal. On its website, the SEC has itemized these tools to include the following:

> Section 106 – This section addresses SEC access to foreign audit workpapers[;] Section 305 – This section sets standards for imposing officer and director bars and penalties[;] Section 308 – This section establishes FAIR Funds for Investors and requires a study of the same, which the SEC issued on January 24, 2003[;] Section 602 – This section addresses the SEC's authority over professionals who appear and practice before the Commission[;] Section 603 – This section grants federal courts the ability to impose penny stock bars[;] Section 703 – On January 24, 2003, the SEC issued a study on aiding and abetting liability under the federal securities laws[;] Section 704 – On January 24, 2003, the SEC issued a study of enforcement actions involving violations of reporting requirements and restatements[;] Section 803 – This section provides that debts are not dischargeable in bankruptcy if they were incurred as a result of securities fraud[;] Section 1103 – This section allows the SEC to temporarily freeze certain extraordinary payments made to securities law violators[;] Section 1105 – This section gives the SEC the authority in administrative proceedings to prohibit persons from serving as officers or directors.

SEC, Summary of SEC Actions and SEC Related Provisions Pursuant to the Sarbanes-Oxley Act of 2002 (July 30, 2003), *available at* http://www.sec.gov/news/extra/soxpress.htm.

44. For discussion of the classic vision of the functioning of the securities laws within the context of free open markets, see, e.g., LOSS & SELIGMAN, *supra* note 8, at 192-93.

visibility that assures the automatic functioning of power."[45] The *focus* of enforcement, however, lies ultimately with government.

Monitoring occurs on three levels: internal, external and governmental. *Internal controls* focus on two of the critical actors in the governance of corporations, officers, and directors. These internal controls provide the basis of a system of perpetual observation. Internal controls operate in a number of different but related ways: through officers monitoring employees,[46] outside directors monitoring both officers and inside directors,[47] and employees monitoring officers and directors.[48] SOX imposes an obligation on officers to pay close attention to what is going on within the corporation.[49] Certification

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45. FOUCAULT, *supra* note 1, at 201. With respect to corporate insiders, the government means to effect a self-perpetuating machinery of control:

> So to arrange things that the surveillance is permanent in its effects, even if it is discontinuous in its action; that the perfection of power should tend to render its actual exercise unnecessary; that this architectural apparatus should be a machine for creating and sustaining a power relation independent of the person who exercises it; in short, that the inmates should be caught up in a power situation of which they are themselves the bearers.

Id.

46. *See* Davis, *supra* note 31, at 48 (quoting Peter M. Menard, a partner in the Los Angeles office of Sheppard Mullin Richter & Hampton).

> Another critical element of the process is to appoint a single person to act as a disclosure-controls monitor, says Menard. This person would be responsible for documenting compliance with the company's disclosure controls and procedures, preparing each SEC filing for the committee's review, and suggesting improvements in the disclosure controls.

Id.

47. *See, e.g.*, James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1082 (2003) ("It can be safely said that the hierarchy of the public company is comprised of doers and watchers. The latter are the outside directors whose central task is to monitor the performance of senior management, most particularly the chief executive officer (CEO).").

48. *See, e.g.*, Lisa Lopez, *What Do We Do When the Whistle Blows?*, 47 BOSTON B.J. 31 (2003); Ashlea Ebeling, *Blowing the Sarbanes-Oxley Whistle*, FORBES (June 18, 2003), *at* http://www.forbes.com/2003/06/18/cx_ae_0618beltway.html.

49. Whatever else SOX has accomplished, it has substantially abandoned the rule of *Graham v. Allis-Chalmers Manufacturing Co.*:

> The precise charge made against these director defendants is that, even though they had no knowledge of any suspicion of wrongdoing on the part of the company's employees, they still should have put into effect a system of watchfulness which would have brought such misconduct to their attention in ample time to have brought it to an end. . . . On the contrary, it appears that directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong.

188 A.2d 125, 130 (Del. 1963).

requirements put teeth on that obligation.[50] Public companies are now establishing disclosure committees to aid officers in connection with their certification obligations.[51] SOX also effectively imposes specialization of sorts within the board of directors. Outside directors, with no connection to the operation of the company, are now required to form audit committees invested with significant monitoring authority over the behavior of corporate insiders[52] and outside auditors.[53] Outside directors might also have additional duties with respect to monitoring employee conduct as members of newly constituted compliance committees.[54] Internal controls also focus on a more often neglected corporate actor: the employee. The new whistle-blower protections in SOX are meant to make it easier for employees to disclose evidence of corporate fraud either up the corporate ladder or to the government.[55]

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50. This is made most clear through the certification process imposed pursuant to SOX sections 302 and 906 (to be codified at 15 U.S.C. §§ 7241, 1350). For a discussion of these certification requirements, see Backer, *supra* note 3.

51. *See, e.g.*, Pepsico, Disclosure Committee Charter, *available at* http://www.pepsico.com/investors/disclosure-committee.shtml (last visited Sept. 20, 2003) ("The Committee shall assist the Senior Officers in fulfilling their responsibility for oversight of the accuracy and timeliness of the disclosures made by the Company."). Pepsico's Committee was initially composed of the company's Controller, General Counsel, General Auditor and Head of Investor Relations. *See id.*

52. For example, the audit committee may also act as a "qualified legal compliance committee" constituted for the purpose of receiving, retaining and considering any confidential report of evidence of material violations required to be reported to the company by law subject to the "detect and report" rules imposed by SOX section 307 (to be codified at 15 U.S.C. § 7245) and the regulations thereunder. *See* 17 C.F.R. § 205.2(k)(1) (2003) (the "qualified legal compliance committee" may also consist of one member of the audit committee, and two other independent members of the board of directors.) *See also* Sarbanes-Oxley Act § 404 (to be codified at 15 U.S.C. § 7262) (requiring production by management of internal control reports).

53. *See* Sarbanes-Oxley Act § 301 (to be codified at 15 U.S.C. § 78j-1(m)(2)) (audit committee "directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer").

54. The idea of compliance committees to effectively integrate board responsibility for corporate monitoring pre-dates SOX, at least in Delaware and other jurisdictions, which interpreted their state corporate fiduciary duty of care rules to require monitoring. *See, e.g.*, H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibility in the Post* Caremark *Era*, 26 DEL. J. CORP. L. 1, 127 (2001).

55. *See* Sarbanes-Oxley Act § 802 (to be codified at 18 U.S.C. § 1519). The provisions, however, present a number of traps for the unwary. For example, the whistle blower provisions may not be available to in-house counsel with detect and report obligations under SOX section 307, even though SOX section 802 is not necessarily so limited on its face. However, the SOX section 307 regulations might be read to exempt lawyer-employees from the protections accorded other company employees. *See* 17 C.F.R. § 205.3(b)(10):

An attorney formerly employed or retained by an issuer who has reported evidence

External controls revolve around gatekeepers, specifically the lawyers and auditors monitoring the company, its officers, its directors, and each other.[56] Section 10A of the Securities Exchange Act of 1934 imposed detect and report obligations on outside auditors.[57] Section 307 of SOX, and the regulations issued thereunder, impose detect and report obligations on lawyers.[58] Lawyers and auditors failing in their regulatory duties can be disciplined by the state, and may face liability to private parties under the securities laws.[59] SOX makes it easier to monitor the corporation and effectively discipline the agents of that monitoring. With a standard of liability for gatekeepers grounded in information about the company that employs them, both in terms of the quality of the information gathered and

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> of a material violation under this part and reasonably believes that he or she has been discharged for doing so may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section.

Id. However, this provision can be read as in addition to as well as in lieu of the provisions of SOX section 802 (to be codified at 18 U.S.C. § 1519). For a discussion suggesting that in house lawyers are covered by the protections and outside counsel and auditors might be covered as well, see Backer, *Federalizing Norms*, *supra* note 3, at 939-43. For a taste of the impact of these provisions a year after passage of SOX, see Ebeling, *supra* note 48.

56. For a discussion of the extent of the obligation of lawyers and auditors under the emerging securities law regime, see Larry Catá Backer, *The Duty to Monitor: Emerging Obligations of Outside Lawyers and Auditors to Detect and Report Corporate Wrongdoing Beyond the Federal Securities Laws*, 77 ST. JOHN'S L. REV. 919 (2003).

57. *See generally* Thomas L. Riesenberg, *Trying to Hear the Whistle Blowing: The Widely Misunderstood "Illegal Act" Reporting Requirements of Exchange Act Section 10A*, 56 BUS. LAW. 1417 (2001); Jeanne Calderon & Rachel Kowal, *Auditors Whistle an Unhappy Tune*, 75 DENV. U. L. REV. 419 (1998).

58. *See* Sarbanes-Oxley Act § 307 (to be codified at 15 U.S.C. § 7245) providing that:

> (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

Id. The regulations promulgated thereunder adhere broadly to the provision's intent. The final regulations are codified at 17 C.F.R. § 205. *See* SEC, Final Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-47276, 68 Fed. Reg. 6296 (Aug. 5, 2003), *available at* http://www.sec.gov/rules/ final/33-8185.htm.

59. For a discussion of the mechanics of section 10A of the Exchange Act and Section 307 of SOX (to be codified at 15 U.S.C. § 7245) (and the regulations thereunder), see Backer, *supra* note 56.

disclosure behavior with respect to this information, gatekeepers can be monitored in a way that mimics the gatekeepers' surveillance of their client companies. Thus, like the companies they serve, firms of lawyers and auditors must also institute regimes of internal surveillance of their own employees to ensure they are adequately monitoring their clients.[60]

The state looms over this surveillance enterprise. *Governmental controls* are grounded in enforcement. Enforcement must be understood here in two distinct senses. First, the state has increased the breadth of its power to discipline those persons it has deputized with surveillance duties. Indirectly, this is accomplished by the construction of a system in which the state sits at the top of a pyramid of monitoring by others. With SOX, the SEC can more effectively control and process information through its web of deputies, especially whistle-blowing employees, officers faced with certification requirements, outside directors with fiduciary duties, auditors and outside counsel with detect and report obligations.[61] That auditors and lawyers have been so deputized is well known. That outside directors are meant to be part of this contingent of outside monitors may be less well known.[62] That employee whistle-blowers have become increasingly important is only now becoming better known.[63]

More importantly, perhaps, the state maintains a great capacity for surveillance through the use of its power to extract "cooperation" from the "observed" corporation. Cooperation requires a corporation to allow itself to

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> At Duane Morris in Philadelphia, firm general counsel Gene E.K. Pratter is making sure that every single lawyer, from firm leadership down to the newest associate, knows that he or she must bring information with potential section 307 implications to the attention of the corporate-and-securities and loss-prevention partners.

Davis, *supra* note 31, at 49.

61. The SEC took pains to publicize this new reality in the popular press. "The SEC is cracking down on a new group of corporate watchdogs: outside directors. SEC enforcement chief Stephen Cutler said his agency will pursue and punish all categories of individuals–'management, auditors, lawyers, directors, counterparties'–involved in corporate fraud." Jenny Anderson, *SEC Tells Outside Directors: Beware*, N.Y. POST, Aug. 21, 2003, at 31.

62. "By focusing on directors, the SEC is expanding its scrutiny of corporate watchdogs who oversee management." Otis Bilodeau, *SEC To Go After Directors Who Ignore Fraud*, CHI. SUN-TIMES, Aug. 21, 2003, at 51.

63. By August, 2003, the popular business press was reporting that "[t]he first whistle-blower cases under the Sarbanes-Oxley Act have already started trickling in to [sic] the Department of Labor. But OSHA has found that many of the more than 50 cases filed so far involved conduct that took place before Sarbanes-Oxley." Ebeling, *supra* note 48 (also noting that two larger corporations, Duke Energy and Coca-Cola, have also been subject to post SOX actions).

be examined with few protections or preconditions. If gatekeeper monitoring is something akin to examinations of a live patient, cooperation assumes something of the invasive character of an autopsy.[64] The government has made no secret of its desire to institutionalize cooperation on its terms through proposed legislation which would permit corporate lawyers to disclose otherwise confidential information to government investigators without otherwise waiving the attorney-client privilege against non-governmental parties.[65] In this way, the state also advances a project, the goal of which seems to be to make itself—rather than the board of directors, the stakeholders or the market—the ultimate authoritative site for corporate surveillance.

Second, the state does more than observe—*it acts*. The state appears to be appropriating for itself the role of principal disciplinarian of corporations whose insiders violate the norms of acceptable economic behavior. It has also moved to become a principal actor in the recovery of damages, penalties and other pecuniary impositions from wrongdoers. For that purpose, and in the context of the securities laws, the SEC has increasingly embraced what

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64. As former SEC Chairman Harvey Pitt noted to his colleagues at the Department of Justice just before he resigned:

> Similar to the DOJ's guidance on prosecution of corporations, we have made it known that meaningful and complete cooperation will be favorably considered by the Commission. For example, in the Homestore matter—jointly announced by DOJ and us just yesterday—we determined not to bring charges against the company itself, because of its swift and extraordinary cooperation, including by quickly reporting the potential problems to us, sharing results of its internal review, terminating the wrongdoers, and implementing remedial actions.

Harvey L. Pitt, Speech by the SEC Chairman: Remarks Before the U.S. Department of Justice Corporate Fraud Conference (Sept. 26, 2002), *available at* http://www.sec.gov/news/speech/spch585.htm.

65. Section 4 of the proposed legislation would amend section 24 of the Securities Exchange Act of 1934 (15 U.S.C. § 78x) by redesignating subsection (e) as subsection (f); and by inserting after subsection (d) the following new subsection(e):

> AUTHORITY TO ACCEPT PRIVILEGED AND PROTECTED INFORMATION- Notwithstanding any other provision of law, whenever the Commission and any person agree in writing to terms pursuant to which such person will produce or disclose to the Commission any document or information that is subject to any Federal or State law privilege, or to the protection provided by the work product doctrine, such production or disclosure shall not constitute a waiver of the privilege or protection as to any person other than the Commission.

Securities Fraud Deterrence and Investor Restitution Act of 2003, H.R. 2179, 108th Cong. § 4 (2003), *available at* http://www.theorator.com/bills108/hr2179.html (last visited June 3, 2004).

appears to be a "passive-aggressive" shareholder model.[66] The passive part of the SEC's shareholder model requires direct government enforcement action. Shareholders are increasingly characterized, at least in SEC rhetoric, as objects with little power to effectively enforce their rights. As a consequence of this perceived "failure of the market," the government is required to exercise its enforcement authority as a proxy for stakeholders. SOX makes it easier for the SEC to implement an effective real time enforcement initiative.[67] As a former Chairman of the SEC explained:

> The objective of real time enforcement is to protect investors by rapidly filing actions to halt misconduct, make public our suspicions of wrongdoing so that investors also may take steps to protect themselves, and freeze the assets of fraudsters so that, whenever possible, monies may be returned to harmed investors.[68]

SOX also increases the ability of the state to act in the place of stakeholders by making it easier for the SEC to recover funds from corporate wrongdoers and distribute those funds to investors.[69] As the SEC concluded in a report released in January, 2003:

> The Fair Fund provision is an innovative device that the Commission intends to use to return more funds to investors, though an amendment is recommended to improve its usefulness. To more fully compensate investors, the Commission also intends to continue "real time" enforcement and implement planned improvements in collection efforts.[70]

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66. "Most modern corporate scholars, especially those with a law-and- economics bent, accept shareholder passivity as inevitable." Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L REV. 520, 522 (1990) (arguing that shareholder voice may act as a constraint on managers but for institutional and legal constraints). For a traditional view of shareholders in public corporations, see, e.g., Richard A. Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. REV. 630, 641 (1985) (shareholders passive investors seeking greatest possible return on investment).

67. *See* Pitt, *supra* note 64.

68. *Id.*

69.

> As part of [SOX], Congress provided an innovative legislative response to some of the financial and legal obstacles that have hampered the Commission's ability to obtain compensation for defrauded investors. Section 308(a) of the Sarbanes-Oxley Act ("Fair Fund" provision) authorizes the Commission to take civil penalties collected in enforcement cases and add them to disgorgement funds for the benefit of victims of securities law violations.

SEC, REPORT PURSUANT TO SECTION 308(c) OF THE SARBANES OXLEY ACT OF 2002 1 (Jan. 24, 2003), *available at* http://www.sec.gov/news/studies/sox308creport.pdf [hereinafter 308(c) REPORT]. "In this way we are making good on our principal goal of taking care of innocent investors and trying to make them whole when they have been defrauded." Pitt, *supra* note 64.

70. 308(c) REPORT, *supra* note 69, at 36.

The aggressive part of the SEC's shareholder model requires shareholder 'empowerment.' Empowerment is seen as a means of furthering any number of not necessarily consistent policy goals and objectives.[71] Whatever the objective, the form of empowerment has taken singular form: In lieu of "exit," the now traditional American approach to shareholder power,[72] the SEC, along with certain sectors of the American intelligensia, would provide greater shareholder 'voice.'[73] Voice, in this case would take the form of substantially greater power for shareholders in the corporation, even those possessing relatively small interests if they act in concert, to propose competing slates of members for election to the board of directors.[74] Corporate boards would also have to provide more information about "the operation of board nominating committees and a new disclosure requirement concerning the means, if any, by which security holders may communicate with members

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71.

> For some it is about "shareholder democracy," for others the economic purpose of the modern corporation, for others the allocation of authority between boards and shareholders, for others the proper regulation of the power to influence corporate policies and decisions, for others a means of creating a solution to the perceived psychological proclivity of managers to seek the like-minded as directors, for others finding an antidote to corporate fraud and mismanagement.

Task Force on Shareholder Proposals of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association, *Report on Proposed Changes in Proxy Rules and Regulations Regarding Procedures for the Election of Corporate Directors*, 59 BUS. LAW. 109, 112-13 (2003) [hereinafter Task Force].

72. For a classic judicial expression of this understanding, see Austin v. Mich. State Chamber of Commerce, 494 U.S. 652, 679, 686-87 (1990) (Scalia, J., dissenting) ("That is the deal. . . . His only protections against such assaults upon his ideological commitments are (1) his ability to persuade a majority (or the requisite minority) of his fellow shareholders that the action should not be taken, and ultimately (2) his ability to sell his stock.")

73. For the classic account of the vectors of power and accountability within organizational structures, from which the language of "exit," "voice" and "loyalty" are now derived, *see generally* ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY (1970).

74. *See* Proposed Rule: Security Holder Director Nominations, Rel. No. 34-48626, 68 Fed. Reg. 60, 784-01 (Oct. 23, 2003) (to be codified at 17 C.F.R. §§ 240, 249, 274), *available at* http://www.sec.gov/rules/proposed/34-48626.htm.

> These proposed rules are intended to improve disclosure to security holders to enhance their ability to participate meaningfully in the proxy process for the nomination and election of directors. . . . [T]he proposed rules are intended to create a mechanism for nominees of long-term security holders . . . with significant holdings to be included in company proxy materials. . . . This mechanism would apply in those instances where evidence suggests that the company has been unresponsive to security holder concerns as they relate to the proxy process.

Id.

of the board of directors."[75] Managers would thus face discipline not only through the dynamics of the market for corporate control but also internally through shareholder action.[76] However, it is not clear whether, or to what extent, this sort of shareholder democracy will create the sort of instability in corporate governance which, when it occurs within nation-states, results in anarchy.[77] Corporations in anarchy tend to need the helping hand of outsiders—the state—more than others. Thus, the road to shareholder democracy may well lead, like that of surveillance, to the state.

The pattern of federalized private monitors focused on ensuring the good behavior of corporate insiders and employees, so well developed in SOX, is not unique to that legislation. SOX fits logically into a set of policy objectives sought by federal regulators for some time. It's current manifestation is represented by legislation stretching back at least to 1995 and the Private

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75. Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Rel. 34-48301, 68 Fed. Reg. 48,724 (Aug. 14, 2003) (to be codified at 17 C.F.R. § 240), *available at* http://www.sec.gov/rules/proposed/34-48301.htm.

76. Academics (and others) have advocated proposals of this kind primarily as an antidote to what they see as the unresponsiveness of directors and managers to shareholder desires. *See* Lucien Arye Bebchuk, The Case for Empowering Shareholders (Berkeley Olin Program Working Paper Series, Working Paper No. 86, Mar. 1, 2003), *available at* http://repositories.cdlib.org/blewp/art86.

77. Opposition to the proposed changes in the basic applied model of American "shareholder democracy" center on a number of related contentions. *See* Task Force, *supra* note 71, at 118-120 (summarizing the arguments). First, some argue that shareholder empowerment is unnecessary in light of the significant changes to corporate governance rules of the last decades, including SOX. "These reforms, the most sweeping since at least the New Deal enactment of the basic federal securities laws, are just coming into place and it is important that they be given the opportunity to function before being superceded by other approaches to regulation of the director selection process." *Id.* at 119. Another reason offered is that the attempt to expand shareholder power in this way is a futile exercise. Still others have suggested that expanding shareholder democracy "risks destabilizing corporate boards and threatening their cohesion and effectiveness . . . . Expanded access processes will likely distract the company's management and board and result in additional costs to the company." *Id.* Lastly, others suggest that the result of expanded shareholder access to the nomination process will reduce the pool of well-qualified outside directors. "Loss to an expanded access candidate will be perceived to have reputational and ego consequences unrelated to the merits of the event." *Id.* at 120.

Securities Litigation Reform Act at the federal level.[78] SOX, though, may well represent the fulfillment of policy objectives that go back to before the 1980s.[79] SOX also represents a continued federalization of critical trends in state corporate law, especially respecting the role of independent directors and the importance of monitoring under the evolving fiduciary duty law of Delaware.[80]

With SOX what more clearly emerges is a regulatory system in which "gatekeepers" have been "drafted" into government service by the

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78. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, §§ 101, 301, 109 Stat. 737, 762 (codified as amended at 15 U.S.C. § 78j-1 (2000)). *But see* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 870 (2003).

> The Supreme Court has made clear that 'fraud' as proscribed in federal law was not to be defined in a way that annexed corporate governance. And, in 1995, Congress expressed a clear desire to limit the use of federal securities fraud lawsuits, at least insofar as those lawsuits were perceived to be frivolous. Yet, as this Article demonstrates, federal securities law and enforcement via securities fraud class actions today have become the most visible means of regulating corporate governance.

Id. at 860 (footnote omitted).

79. Nearly a generation ago, the SEC had been criticized for appearing to pursue a regulatory program designed to regulate corporate internal affairs. *See* Marc I. Steinberg, *The Securities and Exchange Commission's Administrative, Enforcement, and Legislative Programs and Policies–Their Influence on Corporate Internal Affairs*, 58 NOTRE DAME L. REV. 173, 176 (1982) (citing Homer Kripke, *The SEC, Corporate Governance, and the Real Issues*, 36 BUS. LAW. 173, 187-88 (1981)); Nicholas Wolfson, *A Critique of the Securities and Exchange Commission*, 30 EMORY L.J. 119 (1981). For an extended critique of the SEC's regulatory approach from that time, see, e.g., NICHOLAS WOLFSON, THE MODERN CORPORATION: FREE MARKETS VERSUS REGULATION 115 (1984).

80.

> [SOX's] focus on monitoring was not revolutionary. For at least a decade before its enactment, the government had been increasing its focus on corporate monitoring as a means of curbing illegal or unethical behavior. Especially in the decade before passage of [SOX], federal prosecutors had started to use evidence of corporate monitoring as a factor for determining the extent and character of corporate prosecution. The Delaware courts arguably incorporated a duty to monitor under some circumstances as part of the general fiduciary duty of care. Thus, at least in this respect, [SOX] represents evidence of a broad and growing embrace by the government of monitoring as an important weapon in its regulation of corporate conduct.

Backer, *supra* note 56, at 941-42 (footnote omitted) (citing U.S. Dep't of Justice Memorandum, Office of the Deputy Attorney Gen., Bringing Criminal Charges Against Corporations (June 16, 1999), *at* http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html; amended as U.S. Dep't of Justice Memorandum, Office of the Deputy Attorney Gen., Federal Prosecution of Business Organizations (Jan. 20, 2003), *at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm; *see In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996).

implementation of an ever more tightly woven network of obligations to monitor and ever more onerous penalties for non-compliance with disclosure rules. With respect to these rules, the state, rather than markets or stakeholders, sets the standard for behavior and allocates to itself an increasing share of the power to name and enforce behavior norms in the form of rules of corporate governance and rules of corporate conduct. Accountability to the stakeholders, or even to the markets for securities, with the government as a watchdog, is yielding to a system focused on accountability to the state. More and more, the state is emerging as the central actor in the enforcement of corporate conduct norms, for the benefit of constituencies including but not limited to the investment community, stakeholders and the markets for securities.[81]

Substitution of a state-centered system for the development of behavioral norms for corporate managers in place of the traditional system of market- or stakeholder-driven systems will have substantial effects on the development of these norms. More significant still may be the effects of this new model on gatekeepers, stakeholders and the market. For the gatekeeper, the post-SOX regulatory regime constitutes a mandatory shift of the focus of primary loyalty from either the investing public (auditor) or the corporation (independent director and lawyer) to the state as the proxy-holder for the interests of both corporation and investing public.

For the stakeholder, the post-SOX regulatory regime reinforces more strongly a passive/aggressive rather than active model of behavior. In place of self-help remedies, including everything from derivative suits for common variety fraud to takeovers as a mechanism for the disciplining of inefficient

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81. Stephen Cutler, the Director of the SEC Enforcement Division articulated this understanding in a 2003 speech:

> Let me pause here to summarize what I believe is evident from even this brief discussion of the history of the securities laws. First, aggressively protecting investors and instilling in them confidence in the fairness of our markets is critical to Congress' vision of oversight of our capital markets. Second, especially in recent years, Congress has likewise emphasized the goals of efficiency and competitiveness in our capital markets, and has concluded that uniformity in regulation is a pre-requisite to achieving these goals. Third, Congress continues to believe in the efficiacy of a dual regulatory system in which both federal and state agencies serve specific, valuable functions.

Stephen M. Cutler, *Remarks of Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission at the F. Hodge O'Neal Corporate and Securities Law Symposium*, 81 WASH. U. L.Q. 545, 549 (2003), *available at* http://www.sec.gov/news/speech/spch022103smc.htm (last visited Aug. 23, 2003).

management,[82] the state offers its own enforcement mechanisms as the primary, and perhaps eventually sole, means of disciplining corporate and agent behavior and recouping losses. In return, the state may offer shareholders a California-style democratic model. [83] The potentially significant instability that may result can further shift regulatory power to the state.

For the market, post-SOX offers the possibility of changing the nature of the interests represented by the enforcing body. The market represents all potential investors. The state represents a much more varied pool of constituencies, including employees, gatekeepers, competitors, and others.[84] The state, as representative of constituencies different than that of the market (and certainly different from that represented by the stakeholders in any particular case), will, by making decisions on the basis of the interests of the stakeholders in the state, force a dynamic on corporate conduct potentially very different from that which might have been tolerable by markets and stakeholders. In this sense, ironically enough, SOX might usher in a sort of second-order era of corporate social responsibility, so successfully resisted until now.

For most corporate and securities lawyers, disclosure has a particular face. Most corporate and securities lawyers understand that SOX has changed the disclosure landscape.[85] I want to look at this new face of disclosure, one becoming more and more prominent in the ways in which corporate and securities laws are enforced in the United States. But the extent of that change

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82. Recent scholarship has confirmed the common wisdom that the legal issues of corporate governance, at least for publicly traded companies, have become increasingly the objects of federal regulation and that at least prior to SOX, private actions under the federal securities laws were the pre-eminent method of disciplining public corporations. *See* Thompson & Sale, *supra* note 78, at 872.

83. Popular democracy, in California, permits the citizenry, to petition the recall of its elected officials anytime before the completion of their terms of office. In 2003, at the instance of his political rivals, the current governor of California faced a successful drive for recall and the likelihood of a recall election and subsequent election of a new governor. To the extent such expressions of the popular will are made easy, and in the context of motivated minority factions, the state will always face the probability of recalls. For a discussion, see, e.g., THOMAS E. CRONIN, DIRECT DEMOCRACY: THE POLITICS OF INITIATIVE, REFERENDUM, AND RECALL (1989) and DAVID D. SCHMIDT, CITIZEN LAWMAKERS: THE BALLOT INITIATIVE REVOLUTION (1989).

84. The SEC also represents itself. As a constituency, it may well have an incentive to perpetuate, and even increase, its authority. *See* Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation*, 47 WASH. & LEE L. REV. 527, 529 (1990) (explaining incentives toward creation of system of arcane and complex regulation at the SEC).

85. *See* Jenny B. Davis, *Sarbanes Sells*, 89 A.B.A. J. 26 (2003) (capitalizing from the complexity of the complex new requirements of SOX, law firms have created new practice units to attract corporate clients that need counsel on the Act).

is hard to grasp merely by contemplating the statutes and regulations. The new regulatory realities of monitoring for critical outsiders, auditors, lawyers, and outside directors, are more clearly evident in three recent enforcement actions. For lawyers and auditors, the potential liability of the law firm, Vinson and Elkins, and the auditing firm, Arthur Anderson, in the Enron litigation provides significant clues.[86] For outside directors and auditors, the potential federal liability for breaches of fiduciary duty, a recently instituted action by the SEC, *SEC v. Chancellor Corp.*,[87] "will serve as a model for such enforcement actions."[88]

III. SYSTEMS OF SURVEILLANCE

Disclosure systems can be understood both as acts of power (that is, the power to impose the system itself) and as producing power (serving as the vehicle for disciplining behavior). The hierarchy and diffusion of power grounded in surveillance:

> enables the disciplinary power to be both absolutely indiscreet, since it is everywhere and always alert, since by its very principle it leaves no zone of shade and constantly supervises the very individuals who are entrusted with the task of supervising; and absolutely 'discreet', for it functions permanently and largely in silence.[89]

Systems of disciplining publicly traded corporations emerging in this century are national in scope, focused on disclosure, and targeted on officers as well a host of critical outsiders. These systems are still substantially enforced by those private parties most affected by particular acts of corporate misconduct.[90]

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86. *See generally In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

87. *See Chancellor* Complaint, *supra* note 4. *See* SEC, SEC Former Sec. & Exch. Comm'n, SEC Sues Former Top Officers, Directors and Auditors of Chancellor Corporation for Financial Fraud, Litigation Rel. No. 18104 (Apr. 24, 2003), Accounting and Auditing Enforcement Release No. 1763 (Apr. 24, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18104.htm.

88. Bilodeau, *supra* note 62. Stephen Cutler, the head of the SEC's Enforcement Division was quoted as saying that the action was the "first salvo in this area." *Id.* "The Chancellor action 'may well be a landmark case, where the person didn't profit, didn't buy and sell, but just fiddled while Rome burned,' said Stanley Sporkin, a former SEC enforcement director and retired federal judge." *Id.*

89. FOUCAULT, *supra* note 1, at 177.

90. As Robert Thompson and Hillary Sale nicely summarized:

> The Sarbanes-Oxley Act of 2002, passed by Congress in the wake of numerous corporate accountability scandals, provides new evidence of the expanded role of federal law. The move to federal corporate governance, however, is broader than that law and has a longer history than the current scandals. The ascendancy of federal law in corporate governance reflects at least three factors. First, disclosure has become

SOX, as some have argued, does not effect a revolution in traditional disclosure.[91] SOX adds, and in adding contributes, subtle but important changes which affect corporate governance based on a policy bent to the production of intelligence. SOX continues the march to a disclosure model based on greater surveillance by larger groups of actors as well as greater involvement by the state in both disclosure and discipline. SOX is likely not the last word in this new order of disclosure and discipline. It may also set the stage for further legislation that makes it easier for the state to displace private entities in the enforcement of the securities laws. The primary beneficiary of these changes may not be the investor, or even the corporation—the primary beneficiary may be the state.[92]

This section delves into the more clearly emerging post-SOX webs of disclosure. I do so not for the usual purpose—to argue the value of *what* is

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> the most important method to regulate corporate managers, and disclosure has been predominantly a federal, rather than a state, methodology. Second, state law has focused largely on the duties and liabilities of directors, and not those of officers. Yet, officers have become the fulcrum of governance in today's corporations, and federal law has increasingly occupied the space defining the duties and liabilities of officers. Third, federal shareholder litigation based on securities fraud has several practical advantages over state shareholder litigation based on fiduciary duty that have contributed to the greater use of the federal forum. As a result of these trends, federal law now occupies the largest part of the legal corporate governance infrastructure in the twenty-first century.

Thompson & Sale, *supra* note 78, at 861-862 (footnote omitted).

91. *See, e.g.*, Ribstein, *supra* note 32, at 26-35, 53 ("The Sarbanes-Oxley Act may justify little confidence because it makes only incremental changes in prior law.").

92. A colloquy between Martin Lipton, one of the best known corporate lawyers of his generation, and Warren Buffet, one of the most successful investors of the late twentieth century, nicely brings out these notions:

> **Mr. Lipton:** [D]o you think we would accomplish anything by changing the standard of performance for a CEO and making the CEO more liable to suits on behalf of shareholders or disciplinary action on the part of the SEC, or even a new disciplinary organization?
>
> **Mr. Buffett:** I think it would be very difficult, Marty. I think it's much better to have the CEO disciplined by his owners than attempt to discipline him by courts . . . . I mean, the SEC came up with the management discussion and analysis . . . . But, by codifying, essentially, what should be in an MD & A, basically there's nothing in it in nine cases out of ten.
>
> **Mr. Lipton:** Am I correctly interpreting what you said? You say that imposing more legal rules, whether increased liability or specific line item disclosure, would not, in your opinion, further the objective of making the appropriate information available? It would have just the opposite effect?
>
> **Mr. Buffett:** I really think it would, Marty, yeah.

SEC, Roundtable Discussion on Financial Disclosure and Auditor Oversight (Mar. 4, 2002) *available at* http://www.sec.gov/spotlight/roundtables/ accountround030402.htm.

sought to be disclosed.[93] Instead, I focus briefly on a description of the webs themselves. For that purpose, I will turn specifically to the observer (who is required to survey), the observed (who must be monitored), the purpose of the surveillance (what must be monitored), and the persons or entities to whom the monitors must report. Disclosure is not a unitary endeavor. What is assumed to be a system of unitary and integrated disclosure[94] is better understood as the product of information-gathering by groups of persons employed by the corporation directly: employees, officers, and inside directors; persons "independent" of the corporation but employed or otherwise engaged by it: outside directors, auditors, and lawyers, and the state. Surveillance is produced for consumption internally by the board of directors (or committees specifically charged with oversight over certain matters), externally by stakeholders and the market, and institutionally, by the state.

A. Officers and Inside Directors Monitoring Employees

SOX confirms, rather than adds, to the layers of supervision, which have been devolved from government to corporate insiders. Supervision is defined and enforced by the addition of two certification requirements imposed on certain principal corporate officers in connection with the filing of certain periodic reports required under the Exchange Act. Supervision is also enforced by the addition of transparency requirements with respect to the reporting by managers to stakeholders.[95] These requirements mandate disclosure, the completeness and accuracy of which are enforced through application of the anti-fraud provisions of the federal securities acts.

Executive certification under sections 302[96] and 906[97] of the Act centralize and expand the nature and extent of the reporting liabilities of directors and officers. Sarbanes-Oxley Act section 302 requires that the Securities and Exchange Commission adopt rules for the certification of Form 10-K and Form 10-Q reports filed with the Commission by the principal

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93. Much of the disclosure related discourse tends to concentrate on the objects of disclosure itself, or on the burdens of disclosure to parties obligated to monitor. *See, e.g.*, Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53 (2003) (examining the economics and potential perverse effects of gatekeeper liability).

94. For a standard description of the assumptions underlying systems of disclosure, and a critique, see, e.g., Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 16-17.

95. *See, e.g.*, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 789 (to be codified at 15 U.S.C. § 7262).

96. *See* Sarbanes-Oxley Act § 302 (to be codified at 15 U.S.C. § 7241).

97. *See id.* § 906 (to be codified at 18 U.S.C. § 1350).

executive and financial officers of the reporting company.[98] The certification must affirm that the report was reviewed by the signing officer and that it does not contain any untrue statements of material fact or omit to state a material fact. In addition, the officer must certify, to the best of her knowledge, that all financial statements contained in the report fairly present the financial conditions of the company. [99]

The internal control certification requirements of section 302 of the Sarbanes-Oxley Act provide a strong incentive to effective monitoring.[100] The chief executive officer and chief financial officer, upon certifying the Form 10-K and Form 10-Q reports, must affirm that they have evaluated the effectiveness of the company's internal controls and report any deficiencies or material weaknesses in such controls.[101]

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98. *See id.* § 302 (to be codified at 15 U.S.C. § 7241(a)).

99. In this regard, the statute requires that the principal executive and financial officers attest that:

> (1) the signing officer has reviewed the report; (2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading; (3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report.

Id.

100. *See id.* § 302 (to be codified at 15 U.S.C. § 7241(a)(4)).

101. In particular, the statute requires a certification from the principal executive and financial officers that:

> (4) the signing officers – (A) are responsible for establishing and maintaining internal controls; (B) have designed such internal controls to ensure that material information relating to the issuer 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; (C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and (D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;
>
> (5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function) – (A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and (B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
>
> (6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any

The regulations under SOX section 302 have read the provision broadly.[102] Modified certification rules have been created for asset-backed issuers.[103] The periodic reports have been revised to provide the form of principal officer certification that complies with the regulations, and which must be completed by each principal officer in the exact manner set forth in the Form and its instructions.[104]

Sarbanes-Oxley Act section 906 requires that the chief executive officer and chief financial officer draft a written statement to accompany all financial statements contained in periodic reports to the Securities and Exchange Commission.[105] The statement must certify that the financial statements fully comply with sections 13(a) and 15(d) of the Securities Exchange Act of 1934. Moreover, the certification must state that the information contained in the report fairly presents the financial conditions and results of the company's operations.[106] The certifying officers are subject to civil and criminal penalties for knowing and willful certification where the financial statements do not comport with the certification.[107] While the form of the certification is not specified, better practice would suggest a certification that incorporates the words of the statute without modification.

In addition to certification, additional disclosure requirements have also created greater incentives to monitor. The Sarbanes-Oxley Act section 404 requires a report by management on the company's internal controls.[108] Specifically, this provision directs the Securities and Exchange Commission

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corrective actions with regard to significant deficiencies and material weaknesses.

Id. § 302 (to be codified at 15 U.S.C. § 7201).

102. *See, e.g.*, 17 C.F.R. §§ 240.13a-14, 240.15d-14 (2003).

103. *See, e.g.*, 17 C.F.R. § 240.15d-14(e)-(g).

104. *See, e.g.*, SEC, Form 10-Q, Part I, Item 4 Controls and Procedures; Form 10-QSB, Part I, Item 3 Controls and Procedures; Form 20-F, Item 15 Controls and Procedures; Form 40-F General Instructions B; Form 10-K, Part III; Form 10-KSB, Part III, *available at* http://www.sec.gov/about/forms/secforms.htm (last modified June 2, 2004).

105. *See* Sarbanes-Oxley Act § 906 (to be codified at 18 U.S.C. § 1350(a)) (providing that the certification is required for "[e]ach periodic report containing financial statements filed by an issuer with the Securities Exchange Commission pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d))."

106. *See id.* (to be codified at 18 U.S.C. § 1350(b)). The certification by the chief executive and chief financial officer shall

> certify that the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act [of] [sic] 1934 (15 U.S.C. 78m or 78o(d)) and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

Id.

107. *See id.* (to be codified at § 1350(c)).

108. *See id.* § 404 (to be codified at 15 U.S.C. § 7262).

to create rules requiring companies to include an "internal control assessment" in their Form 10-K reports. The internal control report must state the responsibility of management for establishing and maintaining an internal control structure and procedures for financial reporting.[109] This report must include an assessment of those controls.[110] The report submitted by management also must be reviewed by the company's auditors.[111]

Pursuant to these requirements, the Commission has proposed an amendment to item 307, Regulation S-K,[112] intended to meet the requirements

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109. *See id.* (to be codified at 15 U.S.C. § 7262(a)). The report must "state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting." *Id.* (to be codified at 15 U.S.C. § 7262(a)(1)).

110. *See id.* (to be codified at 15 U.S.C. § 7262(a)(2)). The report must "contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." *Id.* Lynn E. Turner, the Chief Accountant for the Securities and Exchange Commission from 1998 to 2001, argued that the CEO and CFO should be required by the audit committee to assess the company's internal controls. He said,

> The audit committee should require the CEO and CFO to provide to the audit committee and investors a report by management that clearly states management's responsibility for establishing, maintaining and ensuring an effective system of internal control actually exists and is operating. If the executives are nervous about signing such a report, I suggest investors should be nervous about the numbers.

Accounting Reform and Investor Protection Hearings Before the Senate Comm. on Banking, Housing, & Urban Affairs, 107th Cong. 196 (2002).

111. *See* Sarbanes-Oxley Act § 404 (to be codified at 15 U.S.C. § 7262(b)). The Act provides that "each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer." *Id.* This is not an entirely new requirement. The Private Securities Litigation Reform Act of 1995 required that a company's outside auditors develop systems capable of detecting potentially illegal corporate acts and report those acts to the appropriate officers and to assess the response. The Sarbanes-Oxley Act effectively increases the nature and character of the auditor's assessment, but now more directly imposes on management substantial responsibility for the development and maintenance of internal control systems under section 404. The views of Harvey Pitt, SEC chairman at the time of the enactment of the Sarbanes-Oxley Act, on these earlier requirements have been known for some time. *See* Harvey L. Pitt & David B. Hardison, *For Outside Accountants, The New Obligations Imposed by the Securities Litigation Reform Act Go Way Beyond Classical GAAS*, NAT'L L.J., Mar. 25, 1996, at B4.

112. The current regulations require only disclosure of

> the conclusions of the registrant's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, about the effectiveness of the registrant's disclosure controls and procedures, [and] whether or not there were significant changes in the registrant's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

17 C.F.R. § 229.307(a)-(b).

of section 404 of the Sarbanes-Oxley Act.[113] The reporting requirements of proposed item 307 are divided into three parts. The first would require an evaluation of disclosure controls and procedures and internal controls and procedures for financial reporting.[114] The second would require identification of changes to internal controls and procedures for financial reporting.[115] The last would require a report on management's responsibilities for establishing and maintaining internal controls, conclusions about the effectiveness of these controls and procedures based on management's evaluation of those controls and procedures, a statement that the registered public accounting firm auditing the company's financial statements has complied with its attestation requirements, and the attestation report of the registered public accounting firm.[116] The disclosure requirements would "not specify the exact content of the proposed management report, as this likely would result in boilerplate responses of little value. We believe that management should tailor the report to the company's circumstances."[117]

The requirements of section 404 also highlight another aspect of the emerging surveillance regimes: its interconnectivity. Section 404 ties not only managers' obligations to monitor, but also lawyers' and accountants' gatekeeper obligations as well:

> The quality and sufficiency of lawyer disclosure is subject to review by company management as well as the company's outside auditors. In effect, it might be possible for both management and auditors, in the course of preparing, reviewing, and certifying a section 404 report, to review and pass on the quality and sufficiency of a lawyer's reporting obligations under section 307. In this context, the company and its auditors might be obliged, in order to meet their obligations, to provide the

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113. *See* Controls and Procedures, 67 Fed. Reg. 66,232 (proposed Oct. 30, 2002) (to be codified at 17 C.F.R. pt. 229).

114. *See id.* This section requires the principal executive and financial officers to give their conclusions "about the effectiveness of the registrant's disclosure controls and procedures and internal controls and procedures for financial reporting based on management's evaluation of these controls and procedures." *Id.*

115. *See id.* This requires reporting of

> any significant changes to the registrant's internal controls and procedures for financial reporting made during the period covered by the quarterly or annual report that includes the disclosure required by this paragraph, including any actions taken to correct significant deficiencies and material weaknesses in the registrant's internal controls and procedures for financial reporting.

Id.

116. *See id.* Section 404 of the Sarbanes-Oxley Act requires the registered public accounting firm to "attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. " Sarbanes-Oxley Act § 404 (to be codified at 15 U.S.C. § 7262(b)).

117. Proposed Disclosure, 67 Fed. Reg. 66,219 (proposed Oct. 30, 2002).

> necessary evidence to establish liability on the part of lawyers to third parties affected by section 307 disclosures. Thus, lawyers and general counsel will have a clear incentive to create systems of review designed to detect material violations. The prudent lawyer, in the course of advising management on its disclosure, as well as of its design and implementation of internal control systems, will carefully review customer and employee complaints, governmental inquiries, anonymous reports, litigation threatened or instituted, and company-generated analyses of industry-related problems.[118]

A related aspect of interconnectivity is the inclusion within SOX of a non-binding sense of Congress regarding corporate tax returns.[119] "It is the sense of the Senate that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation."[120] Such a certification provides the Chief Financial Officer incentives to carefully monitor information that will find its way to the tax return.

Monitoring is effected, to some additional extent, through the power to observe and discipline inherent in conduct codes. SOX adds an important dimension to the discliplining power of conduct codes. The Sarbanes-Oxley Act has imposed certain new disclosure requirements with respect to the maintenance by a registered company of a code of financial ethics. Section 406 of the Sarbanes-Oxley Act compels the SEC to issue rules requiring disclosure of adoption of ethics codes "for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions."[121] The Act defines a code of ethics to mean:

> such standards as are reasonably necessary to promote – (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and (3) compliance with applicable governmental rules and regulations.[122]

The Commission has adopted a new item 406 to conform Regulation S-K to the requirements of SOX. Item 406 requires disclosure of adoption of a "code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If the registrant has not adopted such a code of

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118. Backer, *supra* note 56, at 973.

119. Sarbanes-Oxley Act § 1001, 116 Stat. at 807.

120. *Id.*

121. Sarbanes-Oxley Act § 406 (to be codified at 15 U.S.C. § 7264(a)).

122. *Id.* (to be codified at 15 U.S.C. § 7264(c)). *See generally Accounting Reform and Investor Protection Issues: Hearing Before the Senate Comm. on Banking, Housing, & Urban Affairs*, 107th Cong. (2002).

ethics, explain why it has not done so."[123] A code of ethics subject to disclosure is defined as "written standards that are reasonably designed to deter wrongdoing." [124]

> (b) If the small business issuer plans to elect to disclose any amendments to, or waivers from, its code of ethics on its Internet website, disclose the small business issuer's Internet address and its intention to disclose these events on its website. If the small business issuer elects to disclose this information through its website, it must make such information available for at least a 12-month period. Following the 12-month period, the small business issuer must retain the information for a period of five years. Upon request, the small business issuer must furnish to the Commission or its staff a copy of any or all information retained pursuant to this requirement.[125]

The instructions to item 406 counsel registrants to avoid a cookie-cutter approach to ethics codes.[126]

These codes of ethics are not to remain buried within the pile of opaque documents and procedures that mark the operation of large enterprises. Instead, the SEC has sought to ensure that these codes of ethics become and remain well publicized. The purpose is easy enough to discern: With widespread knowledge of particular provisions of ethics codes widely disseminated, more people—stakeholders, employees, and others—will be more likely to more effectively monitor the objects of these ethics codes, that is, the corporate insiders. Thus, the regulations require companies to file copies of the code of ethics with the SEC,[127] post the text of the code of ethics

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123. 17 C.F.R. § 229.406.

124. *Id.* The regulation provides a bit more specificity with respect to the means by which codes of ethics ought to be designed to achieve its purpose. These include the inclusion of provisions to

> [P]romote: (1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (2) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant; (3) Compliance with applicable governmental laws, rules and regulations; (4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and (5) Accountability for adherence to the code.

17 C.F.R. § 229.406(b) (2003).

125. Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, 67 Fed. Reg. 66,231 (Oct. 30, 2002) (to be codified at 17 C.F.R. § 229.406).

126. *See* 17 C.F.R. § 229.406 (2003) (Instruction 1) "A registrant may have separate codes of ethics for different types of officers" *Id.*

127. *Id.* at 229.406(c)(1) (the registrant must "[f]ile with the Commission a copy of its code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, as an exhibit to its annual report").

to the internet,[128] or provide a copy of the code of ethics to any person who asks for one.[129] In addition, and to make monitoring even more constant (and effective), the regulations require posting of all decisions to provide waivers from the codes of ethics.[130]

SOX's new regulations of the monitoring obligations of lawyers[131] have a 'spillover' effect on officers' duty to monitor. The SEC, in its release of the proposed section 307 regulations, summarized the legislative history to this effect:

> This appears to have been the expectation of the Senators who drafted [s]ection 307 of the Act . . . or the SEC shall make one rule in particular, and it is a simple rule with two parts. No. 1, a lawyer with evidence of a material violation has to report that evidence either to the chief legal counsel or the chief executive officer of the company. No. 2, if the person to whom that lawyer reports doesn't respond appropriately by remedying the violation, by doing something that makes sure it is cured, that lawyer has an obligation to go to the audit committee or to the board. It is that simple. . . . If the CEO can do a short investigation, for example, and figure out that no violation occurred, then the obligation stops there. But if there is a serious violation of the law, the appropriate response is clear: *The CEO has to act promptly to remedy the violation. If he doesn't, the lawyer has to go to the board. It is that simple.*[132]

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128. *Id.* at 229.406(c)(2) (the registrant must "[p]ost the text of such code of ethics on its Internet website and disclose, in its annual report, its Internet address and the fact that it has posted such code of ethics on its Internet Website") Instruction 2 to Item 406 mandates accessibility for codes of ethics posted to the internet.

129. *Id.* at 229.406(c)(3) (the registrant must "[u]ndertake in its annual report filed with the Commission to provide to any person without charge, upon request, a copy of such code of ethics and explain the manner in which such request may be made.")

130. *Id.* at 229.406(d) (If the registrant intends to satisfy the disclosure requirement under Item 10 of Form 8-K regarding an amendment to, or a waiver from, a provision of its code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and that relates to any element of the code of ethics definition enumerated in paragraph (b) of this Item by posting such information on its Internet website, disclose the registrant's Internet address and such intention.). *Id.* This provision in particular was meant to avoid a practice that, when abused by the insiders at Enron might have contributed to the securities laws violations of the company.

131. *See* Sarbanes-Oxley Act § 307 (to be codified at 15 U.S.C. § 1245).

132. Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,681 n.38 (quoting 148 Cong. Rec. S6552 (July 10, 2002) (statement of Sen. Edwards)) (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205) (emphasis added); *Accord* 148 CONG. REC. at S6555 (statement of Sen. Enzi);

> This amendment instructs the Commission to establish rules that require an attorney, with evidence of material legal violation by the corporation or its agent, to notify the chief legal counsel or the chief executive officer of such evidence and the appropriate response to correct it. If these officers do not promptly take action in response, the Commission is instructed to establish a rule that the attorney then has a duty to take

The increasing interrelatedness of the surveillance provisions is a hallmark of the new privatization regime. Tightly woven multiple lines of observation, reporting, and correction, permits devolution, to a significant respect, of both self-policing and self-correction. The state's investment in privatization consequently provides some reward.

B. Outside Directors Monitoring Officers and Inside Directors

The reshaping of the duties and functions of a corporation's board of directors has been one of the most dynamic areas of corporate governance for the last decade. Before SOX, the two great sources of development were changes to federal prosecutorial practice, which had a tremendous effect on corporate board behavior, and changes in state corporate law.

The development of new prosecutorial strategies for charging corporations for unlawful activity resulted in an increased emphasis on the monitoring and disclosure obligations of corporations with respect to their internal operations.[133] In its Principles of Federal Prosecution of Business Organizations,[134] the Department of Justice described the principles that prosecutors are to use in determining whether to seek charges against a corporation.[135] The principles suggest a number of factors prosecutors ought to consider in making this determination.[136] Among them is "the existence and adequacy of the corporation's compliance program."[137] The document, citing

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> further appropriate action, including notifying the audit committee of the board of directors or the board of directors themselves, of such evidence and the actions of the attorney and others regarding this evidence.

148 CONG. REC. at S6555 (statement of Sen. Corzine);

> [W]hen lawyers are aware of a potential violation, they do have a duty to investigate. And if they determine there is a material violation of law—not some small violation, some insignificant rule—that violation should be remedied by the corporation. If it is not remedied, it is the duty of the lawyer, under our language, to report it to the board.

Id. at S6556.

133. *See* Memorandum from the Deputy Attorney General to all Component Heads and U.S. Attorneys of the U.S. Dep't of Justice (June 16, 1999), *at* http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html; Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Dep't Components and U.S. Attorneys of the U.S. Dep't of Justice (Jan. 20, 2003), *at* http://www.usdoj.gov/dag/cftf/ corporate_guidelines.htm [hereinafter New Guidelines].

134. *See* New Guidelines, *supra* note 133.

135. *See id.* at Part I (finding that "[c]orporations should not be treated leniently because of their artificial nature").

136. *See id.* at Part II (listing nine factors that should be considered in reaching a decision on how to properly treat a corporate client).

137. *Id.*

Caremark, states that: "In evaluating compliance programs, prosecutors may consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct."[138] The "existence and adequacy of the corporation's compliance program" is one of the factors prosecutors use to determine whether to charge a corporation.[139] There are a number of monitoring factors prosecutors are to consider:

> For example, do the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations; are the directors provided with information sufficient to enable the exercise of independent judgment, are internal audit functions conducted at a level sufficient to ensure their independence and accuracy and have the directors established an information and reporting system in the organization reasonable [sic] designed to provide management and the board of directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law.[140]

Such emphasis on monitoring and disclosure, however, proved instrumental in shaping innovations to the nature and scope of state fiduciary duty of care principles, especially in the state of Delaware.[141] The focus by Delaware courts on monitoring "has been given special importance by an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements, including environmental, financial, employee and product safety as well as assorted other health and safety regulations."[142]

Chancellor Allen explained that the increased penalties for corporate misconduct under the federal sentencing guidelines "offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts."[143]

At its narrowest, the developing state law stands "for the proposition that, absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees."[144] Chancellor Allen rejected the notion that a "corporate board

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138. *Id.* at Part VII.B.

139. *Id.* at Part II.A.5.

140. New Guidelines, *supra* note 133, at Part VII.B (citing *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996)).

141. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 969 (Del. Ch. 1996); Cheryl L. Wade, *Racial Discrimination and the Relationship Between the Directorial Duty of Care and Corporate Disclosure*, 63 U. PITT. L. REV. 389, 403–20 (2002).

142. *In re Caremark*, 698 A.2d at 969.

143. *Id.*

144. *Id.*

has no responsibility to assure that appropriate information and reporting systems are established by management."[145] The "essential predicate"[146] for reasonable compliance with a duty to detect and report is "relevant and timely *information*."[147]

> Obviously the level of detail that is appropriate for such an information system is a question of business judgment. . . . Thus, I am of the view that a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance.[148]

Referring to *Caremark*, the Chief Justice of the Delaware Supreme Court suggested that "[a]lthough *Caremark* is dictum in a Court of Chancery case approving a settlement of a derivative action, and is not Supreme Court precedent, my personal view is that the expectations of directors, therefore, progressed in the thirty-plus years from *Allis-Chalmers* to *Caremark*."[149]

SOX added to the scope of the surveillance obligations of outside directors. One of the great innovations of SOX was its institutionalization of a set of minimum obligations on outside directors to monitor officers and inside directors. Increasingly, the federal government has imposed obligations to monitor and discipline inside directors, officers and employees on outside directors—or face discipline in turn.

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145. *Id.* at 969–70. Such a proposition "would not, in any event, be accepted by the Delaware Supreme Court in 1996." *Id.* at 970.

146. *Id.*

147. *In re Caremark*, 698 A.2d at 970.

148. *Id.* Referring to *Caremark*, the Chief Justice of the Delaware Supreme Court suggested that:

> Such compliance systems could reasonably be expected to identify wrongdoing when a compliance program could benefit the corporation under federal sentencing guidelines. Although Caremark is dictum in a Court of Chancery case approving a settlement of a derivative action, and is not Supreme Court precedent, my personal view is that the expectations of directors, therefore, progressed in the thirty-plus years from Allis-Chalmers to Caremark. . . . It was not a sudden leap of thirty years, however. In a 1980 law review article in The Business Lawyer that I co-authored with William Manning, Esquire, of the Delaware Bar, we noted that such expectations may already have evolved in the then-seventeen years following Graham.

E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 446 (2003) (citing E. Norman Veasey & William E. Manning, *Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 929–30 (1980)).

149. Veasey, *supra* note 148, at 446 (citing Veasey & Manning, *supra* note 148, at 929-30).

At the core of the new surveillance efforts is the audit committee of the board of directors. The SEC has explained that:

> The board of directors, elected by and accountable to shareholders, is the focal point of the corporate governance system. The audit committee, composed of members of the board of directors, plays a critical role in providing oversight over and serving as a check and balance on a company's financial reporting system.[150]

The SEC has a well-developed vision of the ways in which the audit committee is to function within the web of surveillance necessary to preserve the system of transparency and disclosure at the heart of the federal system of regulation.[151] The audit committee, according to the SEC is to provide:

> [A] forum separate from management in which auditors and other interested parties can candidly discuss concerns. By effectively carrying out its functions and responsibilities, the audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices and internal controls, and that the outside auditors, through their own review, objectively assess the company's financial reporting practices.[152]

SOX section 301 directed the SEC to issue rules relating to the listing requirements of companies whose shares are traded on most exchanges.[153] These requirements focused on the composition and duties of the audit committees of listed companies. In the final regulations, issued in April, 2003,[154] the SEC divided the standards adopted into five broad categories. First, all audit committee members must be independent in accordance with

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150. Final Rule: Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 18,788, 18,789 (Apr. 6, 2003) [hereinafter Final Rule].

151. *See id.*

> Accurate and reliable financial reporting lies at the heart of our disclosure-based system for securities regulation, and is critical to the integrity of the U.S. securities markets. Investors need accurate and reliable financial information to make informed investment decisions. Investor confidence in the reliability of corporate financial information is fundamental to the liquidity and vibrancy of our markets.

Id.

152. *Id.* at 18,789.

153. In particular, section 301, adding new section 10A(m) to the 1934 Act (to be codified at 15 U.S.C. § 78f(m)), obliged the SEC "[e]ffective not later than 270 days after the date of enactment of this subsection, . . . by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements" for auditor independence described in Section 10A(m). Sarbanes-Oxley Act § 301 (to be codified at 15 U.S.C. § 78j-1).

154. *See* 17 C.F.R. § 240.10A-3 (2003) (Listing Standards Relating to Audit Committees). The regulations required by SOX section 301 are also found in a number of other provisions of 17 C.F.R. sections 228, 229, 240, 249 and 274.

minimum criteria imposed by the SEC.[155] As with outside auditor/gatekeepers,[156] the primary purpose of the independence rules is to provide a legitimating mechanism for audit committee determinations. This is accomplished through the creation of a caste of outsiders reviewing the work of insiders against some sort of imposed standard. The final regulations impose two criteria for independence. The first relates to compensation. Audit committee members are forbidden "from accepting any consulting, advisory or other compensatory fee from the issuer or any subsidiary thereof, other than in the member's capacity as a member of the board of directors and any board committee."[157] The second relates to status as an "affiliate" of the company, as the term is commonly defined in the federal securities laws.[158] "We are defining 'affiliate' of, or a person 'affiliated' with, a specified person, to mean 'a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.'"[159]

Second, the audit committee must be vested with certain minimum responsibilities, including direct responsibility for the appointment, compensation, retention and oversight of the work of accounting firms performing audit or attest services for the company.[160] "These oversight responsibilities include the authority to retain the outside auditor, which includes the power not to retain (or to terminate) the outside auditor. In addition, in connection with these oversight responsibilities, the audit

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155. 17 C.F.R. § 240.10A-3(b)(1) ("Each member of the audit committee must be a member of the board of directors of the listed issuer, and must otherwise be independent" *Id.* at 240.10A-3(b)(1)(i)).

156. For a discussion of the auditor independence rules, developed three years before the audit committee independence rules under SOX, see below at notes 226-269.

157. Final Rule, *supra* note 150, at 18,791 ("To prevent evasion of the requirement, disallowed payments to an audit committee member includes payments made either directly or indirectly.").

158. *See* Exchange Act Rule 10A-3(e), 17 C.F.R. § 240.10A-3(e).

159. Final Rule, *supra* note 150, at 18,793 (Control is defined "as 'the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.'" *Id.*).

160. *See* 17 C.F.R. § 240.10A-3(b)(2):

> The audit committee of each listed issuer, in its capacity as a committee of the board of directors, must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee.

Id.

committee must have ultimate authority to approve all audit engagement fees and terms."[161]

Third, audit committees are required to establish procedures for monitoring corporate insiders, to be evidenced by the required establishment of procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.[162] The purpose of these rules, in part, is to make it easier for the audit committee to be less dependant on information supplied by insiders, the object of committee monitoring . "Since the audit committee is dependent to a degree on the information provided to it by management and internal and outside auditors, it is imperative for the committee to cultivate open and effective channels of information."[163]

Fourth, the independence of the audit committee is to be assured by the mandatory delegation to it of authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties.[164] These rules are meant to deepen the independence of the audit committee. Like the rules encouraging employee intelligence free the audit committee from dependence on insiders for information, the rules relating to the power to hire outside advisors free the audit committee from dependence on insider's advisors.[165]

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161. Final Rule, *supra* note 150, at 18,796.

162. *See* 17 C.F.R. § 240.10A-3(b)(3).

163. Final Rule, *supra* note 150, at 18,798. ("Management may not have the appropriate incentives to self-report all questionable practices. A company employee or other individual may be reticent to report concerns regarding questionable accounting or other matters for fear of management reprisal.").

164. *See* 17 C.F.R. § 240.10A-3(b)(4).

165. "To perform its role effectively, therefore, an audit committee may need the authority to engage its own outside advisors, including experts in particular areas of accounting, as it determines necessary apart from counsel or advisors hired by management, especially when potential conflicts of interest with management may be apparent." Final Rule, *supra* note 150, at 18,798.

Fifth, the company must ensure that the audit committee is appropriately funded so that it may exercise its authority effectively.[166] This rule is meant to complement, and deepen, audit committee independence. "An audit committee's effectiveness may be compromised if it is dependent on management's discretion to compensate the independent auditor or the advisors employed by the committee, especially when potential conflicts of interest with management may be apparent."[167]

In addition, section 407 of the Sarbanes-Oxley Act requires the Commission adopt rules that

> require each issuer, together with periodic reports required pursuant to sections 78m(a) and 78o(d) of [the Securities Exchange Act of 1934], to disclose whether or not, and if not, the reasons therefore [sic], the audit committee of that issuer is comprised of at least 1 member who is a financial expert, as such term is defined by the Commission.[168]

The Act provides a fairly detailed framework within which the Commission is to develop a definition for the term "financial expert." The Act requires the Commission to

> consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions – (1) an understanding of generally accepted accounting principles and financial statements; (2) experience in – (A) the preparation or auditing of financial statements of generally comparable issuers; and (B) the application of such principles in connection with the accounting for estimates, accruals, and reserves; (3) experience with internal accounting controls; and (4) an understanding of audit committee functions.[169]

To that end, the Commission proposed Regulation S-K, item 309. In framing proposed item 309, the Commission stated that item 309 should not be construed as imposing a higher degree of individual responsibility on designated financial experts, nor to decrease the obligations of non-expert

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166. *See* 17 C.F.R. § 240.10A-3(b)(5). The funding rules affect three broad categories of expenses:

> (i) Compensation to any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer; (ii) Compensation to any advisers employed by the audit committee under paragraph (b)(4) of this section; and (iii) Ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.

Id.

167. Final Rule, *supra* note 150, at 18,798.

168. Sarbanes-Oxley Act § 407 (to be codified at 15 U.S.C. § 7265(a)).

169. *Id.* (to be codified at 15 U.S.C. § 7265(b)).

members of the audit committee or the board in general. Moreover, the Commission was careful to distinguish an item 309 financial expert from an expert for purposes of section 11 of the Securities Act of 1933.[170]

Proposed item 309 requires disclosure of the names of the persons determined to be financial experts, and whether those experts are independent.[171] The definition of financial expert closely follows the language in the Sarbanes-Oxley Act provision.[172] As required by the Sarbanes-Oxley Act, proposed Item 309 also requires a company which does not have a named expert on the audit committee to disclose the reasons why it does not have such an expert.[173]

C. Employees Monitoring Officers and Directors

Employees of public corporations increasingly have become both empowered and deputized. They are encouraged to act as guardians of good behavior by their superiors. In a sense, much of the obligations imposed on directors, officers and gatekeepers, all fall on employees. Employees are usually the people who actually gather the information necessary for the functioning of the due diligence, monitoring, or information systems mandated by SOX and related statutes. Employees tend also to be responsible for first cut analysis and decisions with respect to the relevance of particular bits of information. To a large extent, a large firm must rely on its employees, a large number of whom must be trusted to gather, analyze and produce information that is essential for the compliance by responsible officers, directors and gatekeepers of their legal obligations.

Increasingly, employees are also encouraged to report bad behavior to outsiders within the corporate hierarchy, when corporate management fails to

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170. Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, SEC Rel. No. 33-3138 (Oct. 22, 2002). The Commission stated that "The role of the financial expert is to assist the audit committee in overseeing the audit process, not to audit the company. A conclusion that a financial expert is an 'expert' for purposes of Section 11 might suggest a higher level of due diligence than is consistent with the audit committee's oversight responsibilities." *Id.*

171. 17 C.F.R. § 229.309 (2003).

172. *See id.* at Instruction 1. In addition, the proposed instruction provides that a financial expert includes any person who through education or experience has served as a public accountant or auditor, or principal financial officer, controller or principal accounting officer in companies subject to the reporting requirements of the Exchange Act. *See id.* Instructions 2 and 3 require disclosure of the basis for any determination of expert status and provides guidance on evaluating the education and experience of a person for purposes of making that determination. *See id.*

173. *See id.*

act appropriately. Thus, for example, the SEC has imposed on company audit committees the responsibility for creating mechanisms for the receipt of reports from employees.[174] In particular, the company is to provide for its employees effective mechanisms for the anonymous and confidential submission of "concerns."[175]

To encourage these non-traditional sources of intelligence, SOX provides a measure of 'whistleblower' protection to certain employees under certain circumstances.[176] Whistleblower provisions are not new.[177] SOX continues a trend in the law that now has a substantial pedigree. SOX section 806 provides protection for employees who act as whistleblowers in a corporation subject to federal securities laws reporting requirements.[178] The section prohibits a corporation "or any officer, employee, contractor, subcontractor, or agent of such company," from discharging, demoting, suspending, harassing, or discriminating against any employee for whistle-blowing.[179] Any

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174. "The establishment of formal procedures for receiving and handling complaints should serve to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems before they have serious consequences." Final Rule, *supra* note 150, at 18,798. *See also supra* notes 151-53.

175. *See* Final Rule, *supra* note 150, at 18,798.

176. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 806, 116 Stat. 745 (to be codified at 18 U.S.C. § 1514). The SEC is aware of the way in which, for example, the rules imposed on (outsider) audit committees for the mining of intelligence are related to the rules providing protection to employees against retaliation by insiders. *See* Final Rule, *supra* note 150, at 18,798.

177. For a discussion of the historical development in whistleblower law, see, e.g., Bruce D. Fong, *Whistleblower Protection and the Office of Special Counsel: The Development of Reprisal Law in the 1980s*, 40 AM. U. L. REV. 1015 (1991). For examples of earlier versions of whistleblower protections made available under federal law, see the Energy Reorganization Act of 1974, Pub. L. No. 93-438, 88 Stat. 1233 (codified at 42 U.S.C. § 5801 (2000)) (protection for employees who provide information on the violation of the Atomic Energy Act of 1954, 42 U.S.C. § 2011 (2000)); Whistleblower Protection Act of 1989, Pub. L. No. 101-12, 103 Stat. 16 (protection for federal employees).

178. *See* Sarbanes-Oxley Act § 806 (to be codified at 18 U.S.C. § 1514A). The provision applies only to companies with a class of securities registered under section 12 of the 1934 Act or companies required to file reports under section 15(d) of the 1934 Act. *See id.* (to be codified at 18 U.S.C. § 1514A(a)). For a discussion, see Leonard M. Baynes, *Just Pucker and Blow?: An Analysis of Corporate Whistleblowers, the Duty of Care, the Duty of Loyalty, and the Sarbanes-Oxley Act*, 76 ST. JOHN'S L. REV. 875 (2002).

179. Sarbanes-Oxley Act § 806 (to be codified at 18 U.S.C. § 1514A) (describing acts constituting protected whistle blowing). In order to be protected the employee must have a reasonable belief that the information she provides, or causes to be provided, constitutes a violation of federal shareholder anti-fraud laws and the information is provided only to the classes of individuals identified in the statute. Failure to meet any of these requirements results in a loss of protection under this provision. The courts are likely to have to clarify the standards used to assess an employee's reasonable belief as well as the circumstances under which the

action by a whistleblower must "be commenced not later than 90 days after the date on which the violation occurs" by filing a complaint with the Secretary of Labor.[180] However, this whistleblower provision suffers from a number of ambiguities and limitations.[181]

The utility of whistleblower protections remains to be seen. The great whistle blower of the Enron scandal, Sherron Watkins, remains pessimistic.[182]

> [S]he described standing up against corporate excess as a "lonely road to take" and said she disliked the term whistleblower because it had a pejorative ring to it. . . . Other "corporate sentinels" were treated like pariahs–driven to divorce and alcoholism–and things would not change as long as bosses labeled as troublemakers those who warned of wrongdoing inside businesses.[183]

Yet, the whistleblower provisions of SOX does appear to protect employees from time to time. Utilizing the administrative provisions of SOX, an

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provision of information is delivered to the statutorily designated individuals. *See id.*

180. *Id.* (to be codified at 18 U.S.C. § 1514A(b)(1)(A)) (providing that a person seeking protection under the whistle-blower provisions must file a complaint with the Secretary of Labor); *See id.* (to be codified at 18 U.S.C. § 1514A(b)(2)(D)) (stating that action must be commenced within 90 days of the date on which the violation occurs).

181. I noted in another context that:

> These provisions raise a number of issues. . . . [With respect to the reasonable belief standard], [t]he Act does not make clear whether a subjective or objective standard is to be used. . . . Moreover, the statute creates some traps for the unwary employee. For example, an employee that conveys the information to the press or inferior employees may not be subject to the protection of the Act, since these groups are not included within the class of persons to which information may be conveyed. If the information conveyed is not connected to the violations referenced in the Act, the conveyance of that information, including perhaps otherwise confidential business information which might, after the fact, not be deemed to constitute information relating to a covered violation, would not be protected by the Act. Moreover, the affected employee must file a complaint with the Secretary of Labor within "90 days after the date on which the violation occurs." Failure to meet this requirement, like similar failures in the context of race and sex discrimination, may have jurisdictional, and therefore preclusive, effect. One can speculate that this very short statute of limitations will operate as a fairly effective trap for the unwary. Many employees otherwise entitled to protection will find themselves unable to rely on the protection of the Sarbanes-Oxley Act for waiting too long to assert their rights.

Backer, *supra* note 3, at 940 (footnotes omitted).

182. Terry Macalister, *Corporate Emperors Still Rule, Says Enron Whistleblower*, THE GUARDIAN (Dec. 10, 2003), *at* http://www.guardian.co.uk/business/story/0,3604,1103481,00.html.

183. *Id.*

administrative law judge ordered a company to rehire a whistleblower with back pay and to pay the whistleblower's attorney's fees.[184]

D. Gatekeepers Monitoring Employees, Officers, Directors and Each Other

The two great gatekeepers to emerge from the late twentieth century's burst of regulation are lawyers and accountants. Each increasingly has been reconstituted as a profession with quasi-fiduciary (and now statutory) duties to third parties for whom they do not work directly. Each has also been deputized with increasingly important obligations to monitor and report statutory violations by their corporate clients; substituting their efforts for those of the paid agents of the state. Auditors and outside counsel are increasingly viewed as strategically placed to supplement the inside monitoring by corporate management and the outside institutional monitoring by agencies of the federal and state government.[185] SOX has added significantly to the obligations of auditors and lawyers to observe and report corporate wrongdoing.

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184. *See* Welch v. Cardinal Banshares Corp., No. 2003SOX00015 (Jan. 28, 2004), *available at* http://www.oalj.dol.gov/DMSSearch/CaseDetails.cfm?CaseId=213438. Cardinal Bankshares fired its chief financial officer, David Welch, after Welch refused to meet with the corporation's audit committee investigators unless Welch could have his personal attorney present. Welch had previously reported what he thought were irregularities with respect to the corporation's internal controls and financial reporting, as well as suspicions about insider trading. The corporation claimed that the termination had nothing to do with the prior reporting of financial irregularities, but rather was motivated solely by the insubordination of Welch, as evidenced by his refusal to meet with the audit committee alone. The decision is likely to be appealed. For a discussion of the case, see Molly McDonough, *Fired CFO Wins Early Sarbanes Claim: Whistle-Blower Wanted His Own Lawyer at Internal Hearing*, ABA JOURNAL E-REPORT (Feb. 13, 2004), *available at* http://www.moreombudsman.com/cfo_win.asp (last visited June 3, 2004).

185. *See, e.g.*, Coffee, *supra* note 32, at 1414-20 (providing an academic articulation of this position and discussing the necessary role of auditors and lawyers as gatekeepers and approaches to correcting the problems leading to gatekeeper failure, like that of the Enron collapse). *See generally* H. Lowell Brown, *The Dilemma of Corporate Counsel Faced with Client Misconduct: Disclosure of Client Confidences or Constructive Discharge*, 44 BUFF. L. REV. 777 (1996) (discussing how inside counsel face different constraints than out of house counsel, the options open to counsel who discover corporate misconduct, and solutions for both the corporate client and the former counsel who dissociate because of disclosure of illegality).

1. Attorneys

Section 307 of the Sarbanes-Oxley Act[186] has introduced an important provision relating to the regulation of lawyers practicing before the SEC.[187] In addition, the SEC has been given broad authority to discipline accountants and firms performing audits for companies subject to federal securities laws.

The SOX provision affecting lawyers obligates the SEC to adopt new rules of professional conduct applicable to attorneys practicing before it in the representation of issuers. These rules are to include:

> (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.[188]

The SEC is also given the authority to censure any persons appearing before it.[189] The rule would apply both to corporate in-house attorneys and outside counsel.

It has been argued that the new reporting rules of section 307 of the Sarbanes-Oxley Act mirror the requirements under the Model Rules of Professional Conduct.[190] Section 1.13(b) of the Model Rules requires an attorney, who knows that any person associated with the company will act or refuse to act in a manner that might be construed as a violation of law imputable to the corporation, to take action.[191] The actions the attorney can take include seeking reconsideration, advising that a separate legal opinion is necessary, or seeking referral of the matter to higher authority in the organization, including, if appropriate, the board of directors.[192] Section 1.13(c) permits a lawyer to resign in the event the highest authority of the company insists on action "that is clearly a violation of law."[193] In this sense, it is possible to view the section 307 requirements as part of a package of

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186. *See* Sarbanes-Oxley Act § 307 (to be codified at 15 U.S.C. § 7245).

187. For a discussion, see Backer, *supra* note 3, at 922-33.

188. Sarbanes-Oxley Act § 307 (to be codified at 15 U.S.C. § 7245).

189. *See id.* § 602 (to be codified at 15 U.S.C. § 78d-3) (adding section 4C to the Securities Exchange Act of 1934).

190. *See* Backer, *supra* note 3, at 923-24.

191. *See* MODEL RULES OF PROF'L CONDUCT R. 1.13(b).

192. *See id.*

193. *Id.* at R. 1.13(c).

institutional requirements to correct failures in the market for gatekeeping services,[194] but in keeping with the spirit of the Model Rules of Professional conduct.[195]

The SEC regulations[196] have taken an expansive view of the regulatory objective of section 307.[197] The definition of attorneys subject to the provisions of the regulation is broad. This portion of the regulations remains both controversial and unsettled. While the SEC initially proposed a very broad definition,[198] it substantially narrowed its definition in the Final Regulations which now includes within the definition any attorney:

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194. Thus, Professor John Coffee suggests that underlying the extent of the market reaction to the corporate scandals from Enron

> lies the market's discovery that it cannot rely upon the professional gatekeepers—auditors, analysts, and others–whom the market has long trusted to filter, verify and assess complicated financial information. Properly understood, Enron is a demonstration of gatekeeper failure, and the question it most sharply poses is how this failure should be rectified.

Coffee, *supra* note 32, at 1404-05. With respect to lawyers, at least, the failure is rectified through a focused fortification of a lawyer's representation of corporate clients.

195. This sentiment appears to have been expressed by then S.E.C. Chairman Harvey Pitt in a speech delivered at the A.B.A. 2002 Annual Meeting. Chairman Pitt said:

> We've been directed to ensure that appropriate standards of ethics and competency are established, implemented and enforced. The profession should examine itself and provide guidance about how its members should behave that is broader than technical legality, and truly in the public interest. The Report produced by Jim Cheek's Task Force is in the best tradition of this kind of private sector self-examination. It reiterates that "the *organization* is the lawyer's client and that the lawyer owes that client an obligation of protection from harm," and embodies the idea in Sarbanes-Oxley that lawyers should fulfill their responsibilities to their ultimate client. . . . While there will be details that we must consider as we develop rules for attorney conduct, the underlying principle of Sarbanes-Oxley is unassailable attorneys must be vigilant in protecting the interests of their true clients.

Pitt, *supra* note 64 (footnote omitted).

196. 17 C.F.R. § 205.2.

197. For more detailed discussion of the materials that follow, see Backer, *supra* note 56.

198. As the SEC explained:

> This broad definition was intended to reflect the reality that materials filed with the Commission frequently contain information contributed, edited or prepared by individuals who are not necessarily responsible for the actual filing of the materials, and was consistent with the position the Commission has taken as *amicus curiae* in cases involving liability under Section 10(b) of the Exchange Act (15 U.S.C. 78j(b)).

Final Rule: Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296, 6297 (proposed Feb. 6, 2003) (to codified at 17 C.F.R. pt. 205), *available at* http://www.sec.gov/rules/final/33-8185.htm (last modified Sept. 26, 2003) [hereinafter Final 307 Rule Release].

> (i) Transacting any business with the Commission, including communications in any form; (ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena; (iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or (iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission.[199]

The definition was narrowed to meet concerns raised by the commentators.[200] In addition, determination of the existence of an attorney-client relationship between a lawyer and the issuer for purposes of SOX section 307 will be treated as a federal question, rather than as a question of state law.[201]

The regulations also institutionalize, as a federal rule of conduct, the idea, implicit in the Model Rules of Professional Conduct, that a lawyer acting for a corporation owes a duty to the corporation separate from any he might owe to individuals who are corporate officers or directors:

> An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients.[202]

The regulations require an attorney subject to its provisions who "becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer . . . [to] report such evidence to the issuer's chief legal officer . . . or to both the issuer's chief legal officer

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199. 17 C.F.R. § 205.2(a)(1).

200. For a discussion of the SEC's rationale, see Final 307 Rule Release, *supra* note 198.

201. The SEC explained:

> The Commission intends that the issue whether an attorney-client relationship exists for purposes of this part will be a federal question and, in general, will turn on the expectations and understandings between the attorney and the issuer. Thus, whether the provision of legal services under particular circumstances would or would not establish an attorney-client relationship under the state laws or ethics codes of the state where the attorney practices or is admitted may be relevant to, but will not be controlling on, the issue under this part.

Final 307 Rule Release, *supra* note 198, at Part II.205.2(a).

202. 17 C.F.R. § 205.3(a) (2003).

and its chief executive officer . . . forthwith."[203] If the attorney does not believe that the initial response is appropriate,[204] or if the attorney reasonably believes that reporting to the chief legal officer would be futile,[205] then the attorney is obligated to report the evidence of material violation to the audit

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203. *Id.* § 205.3(b). The regulations define "evidence of a material violation" as: "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." *Id.* § 205.2(e). The SEC has explained that this standard is meant to provide an objective standard. *See* Final 307 Rule Release, *supra* note 198, at Part II 205.2(e). The SEC explained the way the "under the circumstances" language of the definition affected the obligation to report:

> The "circumstances" are the circumstances at the time the attorney decides whether he or she is obligated to report the information. These circumstances may include, among others, the attorney's professional skills, background and experience, the time constraints under which the attorney is acting, the attorney's previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer may consult. Under the revised definition, an attorney is not required (or expected) to report "gossip, hearsay, [or] innuendo." Nor is the rule's reporting obligation triggered by "a combination of circumstances from which the attorney, in retrospect, should have drawn an inference," as one commenter feared.

Id.

204. *See* 17 C.F.R. § 205.3(b)(3) (2003). Section 205.2(b) of the Regulations define "appropriate response" as:

> a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes: (1) That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur; (2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or (3) That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to § 205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either: (i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or (ii) Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

Id. § 205.2(b). The SEC has stated that the appropriateness of the response will be measured against a reasonableness standard. *See* Final 307 Rule Release, *supra* note 198, at Part II 205.2(b) ("The Commission's intent is to permit attorneys to exercise their judgment as to whether a response to a report is appropriate, so long as their determination of what is an 'appropriate response' is reasonable.").

205. *See* 17 C.F.R. § 205.3(b)(4) (2003).

committee of the board, another board committee designated to receive such disclosure, or the board as a whole.[206] Provision is also made for obligations of supervisory and subordinate attorneys under this rule.[207]

The regulations define a "material violation" as a "material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law."[208] Congress and the SEC appear to have meant to paint with a broad brush. The securities laws are defined to include the provisions of SOX itself.[209] As such, among those activities that lawyers must bring to the attention of the company are failures by company lawyers (and others) to comply with their reporting obligations under section 307. Lawyers now have both a duty to report, if they fall within the ambit of section 307, and such reports necessarily include reports of the failure by other lawyers to themselves report "material evidence" as required by section 307. The regulations define 'breach of fiduciary duty' as "any breach of fiduciary or similar duty to the issuer recognized under an applicable Federal or State statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions."[210] On the other hand, the phrase "or similar material violation of any United States federal or state law" is not further defined.[211] However, the SEC explained that, though "[t]he rule does not define the term 'similar violation' . . . it appears from the context in which it is used in section 307 that the term is intended to extend beyond a breach of fiduciary duty or a violation of the securities laws."[212]

Significant legal contingencies—actual or threatened lawsuits or other legal action—can have a significant effect on financial statement amounts. To the extent that legal action is unresolved, or unfiled, auditors may be required under GAAP to disclose the contingencies in a footnote to the financial

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206. *See id.* § 205.3(b)(3), (4).

207. *See id.* § 205.4(b) ("A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in § 205.5(a), that he or she supervises or directs conforms to this part.").

208. *Id.* § 205.2(i).

209. *See* Sarbanes-Oxley Act §§ 2(a)(15) & (b) (to be codified at 15 U.S.C. § 78(c)(47)).

210. 17 C.F.R. § 205.2(d) (2003).

211. *Id.* § 205.23(d)(i).

212. *Id.* § 205.2(d)(i). Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,679 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205).

statements.[213] In that respect, management might be under a separate obligation to disclose contingent liability arising out of actual or threatened legal action. [214]

> The literal language of the regulation thus suggests a broad scope of reportable activity. The *primary focus* of the reporting required by the regulation is on material violations by corporate agents of their obligations under the federal securities laws and state fiduciary duty laws, including [SOX] itself. But lawyers' obligations extend beyond violations of those sorts of provisions to cover similar material violations *of any United States or state law*. These similar material violations must include illegal acts that have a direct effect on the corporation and its financial condition. They may, however, include violations of any law with a direct, indirect, or contingent effect on the company. Among these could be violations of discrimination, environmental, and other laws.[215]

Section 307 does not merely impose on lawyers an obligation to monitor their clients. It also seems to require lawyers to monitor each other in the service of corporate clients. For purposes of Sarbanes-Oxley, the securities laws include the provisions of the Sarbanes-Oxley Act itself.[216] As such, among those activities that lawyers must bring to the attention of the company are failures by a company's lawyers, as well as other outside lawyers, to comply with their respective reporting obligations under section 307. Violations of the regulations under SOX section 307 can be treated as violations of the 1934 Act, subjecting lawyers to similar penalties.[217]

In addition, lawyers may be subject to censure or to the temporary or permanent denial of the privilege of appearing or practicing before the

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213. *See* FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS STATEMENT NO. 5: ACCOUNTING FOR CONTINGENCIES (Mar. 1975), *available at* http://www.fasb.org/pdf/fas5.pdf (last visited June 3, 2004).

214. *See, e.g.*, Reg. S-K, Section 103 (Legal Proceedings), 17 C.F.R. § 229.103 (2003).

215. Backer, *supra* note 56, at 944 (footnotes omitted).

216. *See* Sarbanes-Oxley Act §§ 2(a)(15) & (b) (to be codified at 15 U.S.C. § 78(c)(47)).

217. *See* 17 C.F.R. § 205.6(a) (2003).

> Paragraph 205.6(a) of the proposed rule tracked the language of Section 3(b) of the Act (which expressly states that a violation of the Act and rules promulgated thereunder shall be treated as a violation of the Exchange Act, subjecting any person committing such a violation to the same penalties as are prescribed for violations of the Exchange Act).

Final 307 Rule Release, *supra* note 198, at Part II.205.6.

Commission.[218] Section 602 of the Sarbanes-Oxley Act[219] added Section 4C to the Securities Exchange Act of 1934.[220] This provision vests the S.E.C. with the authority to "censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission"[221] for, among other reasons, willful violation or willful aiding and abetting the violation of the securities law or the rules and regulations issued thereunder.[222]

For all of the monitoring and disclosure obligations now imposed on lawyer-gatekeepers, the Sarbanes-Oxley Act does little to protect gatekeepers from retaliation. In particular, the Sarbanes-Oxley Act is not clear about the relationship between the section 307 requirements and the protections afforded under the section 806 whistle-blower provisions. While section 802 extends protection to employees of a company against retaliation by the employer under certain specified circumstances, it may not extend to suits by unrelated parties for acts undertaken as an employee. The section 307 regulations suggest that the protections of the whistle blower provisions do not extend to

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218. *See* 17 C.F.R. § 205.6(b). According to the SEC,

> paragraph 205.6(b) of the proposed rule was based on Section 602 of the Act (adding Section 4C(a) to the Exchange Act, which incorporates that portion of Rule 102(e) of the Commission's Rules of Practice prescribing the state-of-mind requirements for Commission disciplinary actions against accountants who engage in improper professional conduct).

Final 307 Rule Release, *supra* note 198, at Part II.205.6.

219. *See* Sarbanes-Oxley Act § 602 (to be codified at 15 U.S.C. § 78d-3). The provision states:

> In any cease-and-desist proceeding under subsection (a) of this section, the Commission may issue an order to prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who has violated section 78j(b) of this title or the rules or regulations thereunder from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 78*l* of this title, or that is required to file reports pursuant to section 78o(d) of this title, if the conduct of that person demonstrates unfitness to serve as an officer or director of any such issuer.

Id. § 1105 (to be codified at 15 U.S.C. § 78u-3(f)).

220. The addition provides that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found by the Commission, after notice and opportunity for hearing in the matter – (1) not to possess the requisite qualifications to represent others; (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations issued thereunder.

Id. § 602 (to be codified at 15 U.S.C. § 78d-3(a)).

221. *Id.*

222. *See id.*

lawyers, even lawyers acting under the requirements of section 307.[223] The SEC's explanation of this provision is not helpful.[224] The SEC has not otherwise suggested that lawyers may fall within the whistleblower protection provisions of section 802.

2. Auditors

While lawyers have only come lately to deputization, auditors have increasingly played this role over the course of the last ten or fifteen years. Auditor gatekeeper regulation focuses on two primary themes: the first is auditor independence, the second is auditor duty to report accounting wrongdoing. Auditor independence rules serve as an important threshold barrier to entry. Only conforming auditors may participate in the market for accounting work which overlaps areas of federal regulation. Auditor "detect and report" rules serve as a behavioral roadmap for independent auditors. Underlying both are the substantive rules of financial and related disclosure that forms the object of this gatekeeper's charge.[225]

a. Auditor Independence

Regulation has increasingly regulated the form, substance and character of auditor independence.[226] In 2000, the SEC modified Regulation S-X to

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223. *See* 17 C.F.R. § 205.3(b)(10). Rule 205.3(b)(10) provides:

> An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this part and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section.

Id.

224. The SEC explained only that "This provision, an important corollary to the up-the-ladder reporting requirement, is designed to ensure that a chief legal officer (or the equivalent thereof) is not permitted to block a report to the issuer's board or other committee by discharging a reporting attorney." Final 307 Rule Release, *supra* note 198, at Part II 205.3(b)(10).

225. For a discussion of governmental involvement in substantive standard setting, see notes 413-495, *infra*.

226. The basic provisions governing the standards of accountant independence are set forth in 17 C.F.R. § 210.2-01(b). That rule is fashioned in general terms:

> The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement.

Id.

impose tighter rules regulating auditor independence.[227] In addition, Rule 10-01(d) of Regulation S-X and item 310(b) of Regulation S-B were amended to require that an independent public accountant review a company's interim financial statements before the company files its quarterly report with the SEC.[228] In addition, pro forma financial information contained in any periodic or other report filed with the SEC may not contain an untrue statement or omit to state a material fact in order to make the pro forma financial statement not misleading.[229]

For purposes of determining independence, the SEC will apply a facts and circumstances approach. The rule specifies that "the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission."[230] The rule affects accountants,[231] accounting firms,[232] audit

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227. *See, e.g., id.* § 210.2-01 (amending Regulation S-X rules on 'Qualifications of Accountants,' to impose stricter auditor independence rules). For a discussion of the requirements, see SEC Final Rule: Revision of the Commission's Auditor Independence Requirements Rel. No. 33-7919, *available at* http:// www.sec.gov/rules/final/33-7919.htm (last visited Nov. 15, 2000); Lynn E. Turner, Speech by S.E.C. Staff: Current SEC Developments: Independence "Matters", Remarks at the 28th Annual National Conference of Current SEC Developments (Dec. 6, 2000), *available at* http://www.sec.gov/news/speech/spch445.htm (last visited Mar. 16, 2004) (Mr. Turner was then SEC Chief Accountant).

228. *See* 17 C.F.R. §§ 210.10-01(d), 228.310(b).

229. *See* Sarbanes-Oxley Act § 401 (to be codified at 15 U.S.C. § 7261).

230. 17 C.F.R. § 210.2-01(b) (2003).

231. *See id.* § 210.2-01(f)(1) which defines *accountant* as "a certified public accountant or public accountant performing services in connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated." *Id.*

232. *See id.* § 210.2-01(f)(2) defines *accounting firm* as:

> an organization (whether it is a sole proprietorship, incorporated association, partnership, corporation, limited liability company, limited liability partnership, or other legal entity) that is engaged in the practice of public accounting and furnishes reports or other documents filed with the Commission or otherwise prepared under the securities laws, and all of the organization's departments, divisions, parents, subsidiaries, and associated entities, including those located outside of the United States. Accounting firm also includes the organization's pension, retirement, investment, or similar plans.

engagement teams,[233] close family members,[234] and covered persons in a firm.[235] However, the rules have built in some flexibility. Thus, for example, to avoid technical traps, the regulations provide that an "accounting firm's independence will not be impaired solely because a covered person in the firm is not independent of an audit client."[236] For larger accounting firms, this flexibility comes at a price—the imposition of quality control systems.[237]

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233. *See id.* § 210.2-01(f)(7) which defines the term to include:
all partners, principals, shareholders, and professional employees participating in an audit, review, or attestation engagement of an audit client, including those conducting concurring or second partner reviews and all persons who consult with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

234. *See id.* § 210.2-01(f)(9) which includes "a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling." Immediate family member is defined as "a person's spouse, spousal equivalent, and dependents." 17 C.F.R. § 210.2-01(f)(13).

235. *See id.* § 210.2-01(f)(11). The term includes:
the following partners, principals, shareholders, and employees of an accounting firm: (i) The "audit engagement team"; (ii) The "chain of command"; (iii) Any other partner, principal, shareholder, or managerial employee of the accounting firm who has provided ten or more hours of non-audit services to the audit client for the period beginning on the date such services are provided and ending on the date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide ten or more hours of non-audit services to the audit client on a recurring basis; and (iv) Any other partner, principal, or shareholder from an "office" of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit.
Id. The regulations define "chain of command" as "all persons who: (i) Supervise or have direct management responsibility for the audit, including at all successively senior levels through the accounting firm's chief executive; (ii) Evaluate the performance or recommend the compensation of the audit engagement partner; or (iii) Provide quality control or other oversight of the audit." *Id.* § 210.2-01(f)(8).

236. *Id.* § 210.2-01(d). This savings provision is available only if the covered person did not know of the circumstances giving rise to the lack of independence, the covered person's lack of independence is corrected as soon as possible, and the accounting firm has a quality control system in place that provides reasonable assurance that the accounting firm and its employees do not lack independence.

237. *See id.* § 210.2-01(d)(4) provides that:
For an accounting firm that annually provides audit, review, or attest services to more than 500 companies with a class of securities registered with the Commission under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78*l*), a quality control system will not provide such reasonable assurance unless it has at least the following features: (i) Written independence policies and procedures; (ii) With respect to partners and managerial employees, an automated system to identify their investments in securities that might impair the accountant's independence; (iii) With respect to all professionals, a system that provides timely information about entities from which the accountant is required to maintain independence; (iv) An annual or on-going firm-wide training program about auditor independence; (v) An annual

Rule 2-01(c) provides a bit of specificity. It "sets forth a non-exclusive specification of circumstances inconsistent with paragraph (b)."[238] The specifications fall into five separate categories: "[f]inancial relationships,"[239] "[e]mployment relationships,"[240] "[b]usiness relationships,"[241] "[n]on-audit services,"[242] and "[c]ontingent fees."[243]

Financial relationships form a core of the new rules on independence. "An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a direct financial interest or a material indirect financial interest in the accountant's audit client."[244] The rule specifies a number of circumstances under which a financial relationship can compromise accountant independence. These include "[i]nvestments in audit clients,"[245] "[o]ther financial interests in [an] audit client,"[246] and an audit

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> internal inspection and testing program to monitor adherence to independence requirements; (vi) Notification to all accounting firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with auditor independence requirements; (vii) Written policies and procedures requiring all partners and covered persons to report promptly to the accounting firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from that audit client's engagement and to review promptly all work the professional performed related to that audit client's engagement; and (viii) A disciplinary mechanism to ensure compliance with this section.

Id.

238. 17 C.F.R. § 210.2-01(c) (2003).

239. *Id.* § 210.2-01(c)(1).

240. *Id.* § 210.2-01(c)(2).

241. *Id.* § 210.2-01(c)(3).

242. *Id.* § 210.2-01(c)(4).

243. *Id.* § 210.2-01(c)(5).

244. 17 C.F.R. § 210.2-01(c)(1).

245. *Id.* § 210.2-01(c)(1)(i). The rule provides that an accountant is not independent when the accounting firm, or his immediate family members have any direct investment in an audit client. *See id.* 210.2-01(c)(1)(i)(A). *Direct investment* also includes investment through an intermediary if the accountant, her form or immediate family

> alone or together with other persons, supervises or participates in the intermediary's investment decisions or has control over the intermediary; or (2) The intermediary is not a diversified management investment company, . . . and has an investment in the audit client that amounts to 20% or more of the value of the intermediary's total investments.

Id. §§ 210.2-01(c)(1)(i)(A)(*1*)-(*2*).

246. *Id.* § 210.2-01(c)(1)(ii). These include loans or the establishment of a debtor/creditor relationship. "Any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or record or beneficial owners of more than ten percent of the audit client's equity securities." *Id.* § 210.2-01(c)(1)(ii)(A). An exception is provided for certain loans. *See* 17 C.F.R. § 2-01(c)(1)(ii)(G).

client's investment in the accountant's business.[247] Limited exceptions are provided for financial interests acquired by inheritance.[248] in the context of certain new engagements,[249] and for interests in employee compensation and benefit plans.[250]

Certain employment relationships also affect accountant independence under the rules. "An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has an employment relationship with an audit client."[251] This includes the employment of the accountant in the management of the audit client,[252] the employment of a "[c]lose family member"[253] of a "[c]overed person"[254] at an audit client,[255] the employment at an audit client of certain former employees of the accountant,[256]

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247. *See id.* § 210.2-01(c)(1)(iv). The rule provides with respect to client investment and underwriting that an

> accountant is not independent when: (A) Investments by the audit client in the accounting firm. An audit client has, or has agreed to acquire, any direct investment in the accounting firm, such as stocks, bonds, notes, options, or other securities, or the audit client's officers or directors are record or beneficial owners of more than 5% of the equity securities of the accounting firm. (B) Underwriting. An accounting firm engages an audit client to act as an underwriter, broker-dealer, market-maker, promoter, or analyst with respect to securities issued by the accounting firm.

Id. § 210.2-01(C)(1)(iv)(A)-(B).

248. *See id.* § 210.2-01(c)(1)(iii)(A).

> Any person acquires an unsolicited financial interest, such as through an unsolicited gift or inheritance, that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and the financial interest is disposed of as soon as practicable, but no later than 30 days after the person has knowledge of and the right to dispose of the financial interest.

Id.

249. *See id.* § 210.2-01(c)(1)(iii)(B).

250. *See* 17 C.F.R. § 210.2-01(c)(1)(iii)(C).

251. *Id.* § 210.2-01(c)(2).

252. *See id.* § 210.2-01(c)(2). An accountant is not independent if "[a] current partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client or serves as a member of the board of directors or similar management or governing body of the audit client." *Id.* § 210.2-01(c)(2)(i).

253. *Id.* § 210.2-01(f)(9).

254. *Id.* § 210.2-01(f)(11).

255. 17 C.F.R. § 210.2-01(c)(2)(ii). An accountant is not independent if a "close family member of a covered person in the firm is in an accounting role or financial reporting oversight role at an audit client, or was in such a role during any period covered by an audit for which the covered person in the firm is a covered person." *Id.*

256. *See id.* § 210.2-01(c)(2)(iii). An accountant is not independent if a "former partner, principal, shareholder, or professional employee of an accounting firm is in an accounting role or financial reporting oversight role at an audit client." *Id.* § 210.2-01(c)(2)(iii)(A)-(C). A limited exception is provided.

and the employment by the accountant of certain former employees of the audit client.[257]

Business relationships between an accountant and the audit client are as important as financial and employment relationships to accountant independence.

> An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders.[258]

Certain non-audit services also impair the independence of accountants.[259] This provision reflects certain changes mandated by the Sarbanes-Oxley Act. These non-audit services include bookkeeping or other services related to the audit client's accounting records or financial statements.[260] "Financial information systems design and implementation,"[261]

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257. *See id.* § 210.2-01(c)(2)(iv). An accountant is not independent if:

> [A] former officer, director, or employee of an audit client becomes a partner, principal, shareholder, or professional employee of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit client covering any period during which he or she was employed by or associated with that audit client.

Id.

258. 17 C.F.R. § 210.2-01(c)(3). The rule further provides that "[t]he relationships described in this paragraph do not include a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business." *Id.*

259. *See id.* § 210.2-01(c)(4).

260. *See id.* § 2-01(c)(4)(i). These include any services involving "(1) Maintaining or preparing the audit client's accounting records; (2) Preparing the audit client's financial statements that are filed with the Commission or form the basis of financial statements filed with the Commission; or (3) Preparing or originating source data underlying the audit client's financial statements." *Id.* § 210.2-01(c)(4)(i)(A)(1)-(3). An exception is provided. *See id.* § 210.2-01(c)(4)(i)(B).

261. 17 C.F.R. § 210.2-01(c)(4)(ii). The regulations apply the rule to the operation or supervision of the audit client's information system or the management of the audit client's local area network. *See id.* § 210.2-01(c)(4)(ii)(A). Also covered are the design or implementation of hardware or software systems "that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements taken as a whole." *Id.* § 210.2-01(c)(4)(ii)(B).

"[a]ppraisal or valuation services or fairness opinions,"[262] "[a]ctuarial services,"[263] "[i]nternal audit services,"[264] "[m]anagement functions,"[265] "[h]uman resources,"[266] "[b]roker-dealer services,"[267] and "[l]egal services."[268]

The last category of independence impairing conduct identified in the regulations are contingency fees. "An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee or a commission, or receives a contingent fee or commission from an audit client."[269]

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262. *Id.* § 210.2-01(c)(4)(iii). An accountant's independence is impaired where the accountant provides any

> appraisal service, valuation service, or any service involving a fairness opinion for an audit client, where it is reasonably likely that the results of these services, individually or in the aggregate, would be material to the financial statements, or where the results of these services will be audited by the accountant during an audit of the audit client's financial statements.

Id. § 210.2-01(c)(4)(iii)(A). An exception to this provision is made for certain valuations. *See id.* § 210.2-01(c)(4)(iii)(B).

263. 17 C.F.R. § 210.2-01(c)(4)(iv).

264. *Id.* § 210.2-01(c)(4)(v). The regulations identify two forms of internal audit services which compromise accountant independence: (1) "Internal audit services in an amount greater than 40% of the total hours expended on the audit client's internal audit activities in any one fiscal year" of audit clients with less than $200 million in total assets, and (2) "internal audit services, or any operational internal audit services unrelated to the internal accounting controls, financial systems, or financial statements, for an audit client" these services are subject to narrow exceptions. *Id.* § 210.2-01(c)(4)(v)(A)-(B).

265. *Id.* § 210.2-01(c)(4)(vi) ("Acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client").

266. *Id.* § 210.2-01(c)(4)(vii). A number of human resources functions impair independence, including executive search functions, employee evaluations, reference checks, and negotiating with employees.

267. *Id.* § 210.2-01(c)(4)(viii)

> Acting as a broker-dealer, promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.

268. 17 C.F.R. § 210.2-01(c)(4)(ix). ("Providing any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a United States jurisdiction.").

269. *Id.* § 210.2-01(c)(5).

b. Auditor Gatekeeping Rules

Auditor gatekeeping predates the Sarbanes-Oxley Act by more than five years. But it was not until SOX was passed that the SEC began to use it aggressively to police auditor-monitors. In 1995, the federal government enacted the Private Securities Litigation Reform Act (PSLRA).[270] While the Act's principal thrust was against the plaintiffs' bar, section 301 created the new section 10A of the Securities Exchange Act of 1934.[271] This section imposed a duty on a reporting company's outside auditors to investigate and report to corporate management information indicating that an illegal act had taken place or might occur.[272] The enactment of SOX in 2002 amplified actual and potential monitoring obligations of auditors.[273]

Section 10A of the PSLRA requires accountants performing audits for registered companies to build procedures into their audits that are designed to provide reasonable assurance of detecting illegal acts that would have a direct material effect on the issuer's financial statements, identify related party transactions, and evaluate the issuer's ability to continue as a going concern.[274] Section 10A(a)(1) imposes on auditors of 1934 Act reporting companies an obligation to include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the

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270. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1996) (codified as amended at scattered sections of 15 U.S.C.).

271. *See* Private Securities Litigation Reform Act § 301, 109 Stat. at 762 (codified as amended at 15 U.S.C. § 78j-1).

272. *See id. See generally* Riesenberg, *supra* note 57 (providing a fairly partisan discussion of this provision and describing the statutory scheme, legislative history, and impact of the Private Securities Litigation Reform Act).

273. *See, e.g.*, Sarbanes-Oxley Act §§ 201–209 (to be codified at 15 U.S.C. §§ 7231-7234, 78c(a)(58), 78j-1(g)-(k)); *see also* Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1136 (2003) ("In this sense Sarbanes-Oxley can be seen as attempting to calibrate the mandatory disclosure system to a world in which the board of a public corporation will have insufficient incentives to undertake high-powered monitoring of corporate finance and, therefore, market monitoring must be strengthened."). Those acknowledging this focus have also criticized the new monitoring regime. *See, e.g.*, Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 50 (2003).

> Post-Enron reforms, including Sarbanes-Oxley, rely on increased monitoring by independent directors, auditors, and regulators who have both weak incentives and low-level access to information. This monitoring has not been, and cannot be, an effective way to deal with fraud by highly motivated insiders. Moreover, the laws are likely to have significant costs, including perverse incentives of managers, increasing distrust and bureaucracy in firms, and impeding information flows.

Id. (quoting Ribstein, *supra* note 32, at 3).

274. *See* 15 U.S.C. § 78j-1(a) (2000).

determination of financial statement amounts."[275] If an auditor "detects or otherwise becomes aware of information"[276] during the course of an audit, the auditor is required to determine "whether it is likely that an illegal act has occurred; and . . . if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer."[277] In addition, the auditor is required to "*inform* the appropriate level of the management . . . and *assure* that the [board's] audit committee . . . or the board of directors . . . is adequately informed with respect to illegal acts that have been detected." [278] The auditor is required to "directly report its conclusions to the board of directors."[279] In the event the auditor concludes that the illegal act has a material effect on the issuer's financial statements, management has not taken or has not been caused to take "timely and appropriate remedial actions," and the failure to take such measures will prevent the auditor from issuing a standard audit report.[280]

The auditor is also required to resign from its engagement or furnish the SEC with a description of its report to the board, should the board, itself, fail to furnish such a report to the SEC with a copy to the auditor.[281] Should the auditor resign, it must furnish a copy of its report to the SEC.[282] Should the SEC determine that the auditor "willfully violated" its obligations, the SEC can impose civil penalties.[283] However, auditors are protected against civil liability "in a private action for any finding, conclusion, or statement expressed in a report made" pursuant to Section 10A.[284]

If there is a determination that an illegal act has or may have occurred, the auditor is required under section 10A to make an additional determination as to the effect of the illegal act on the financial statements of the issuer.[285] This reporting requirement applies to all "illegal act[s] (whether or not perceived to have a material effect on the financial statements of the issuer)"[286] if the auditor determines that "it is likely that an illegal act has occurred."[287]

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275. *Id.* § 78j-1(a)(1).
276. *Id.* § 78j-1(b)(1).
277. *Id.* § 78j-1(b)(1)(A)(i)–(ii).
278. *Id.* § 78j-1(b)(1)(B) (emphasis added).
279. *Id.* § 78j-1(b)(2).
280. 15 U.S.C. § 78j-1(b)(2)(A)-(C).
281. *See id.* § 78j-1(b)(3)(A)-(B).
282. *See id.* § 78j-1(b)(4).
283. *Id.* § 78j-1(d).
284. *Id.* § 78j-1(c).
285. *See id.* § 78j-1(b)(1).
286. 15 U.S.C. § 78j-1(b)(1).
287. *Id.* § 78j-1(b)(1)(A)(i).

If the effect is determined to be other than inconsequential, section 10A(b) imposes on auditors the duty to report detected illegal acts to management and to the audit committee.[288] If the reported breach of law is not corrected in a timely manner and the failure to take remedial action will warrant a departure from the standard report of the auditor, the auditor is required formally to report to the board of directors.[289] If the company fails to inform the SEC of the receipt of this report, the auditor is required to resign or to furnish the SEC with a copy of the report.[290]

The term "illegal act"is defined in the statute as "an act or omission that violates any law, or any rule or regulation having the force of law."[291] The actual meaning of the term, however, has been the subject of some debate. The black letter of the statute suggests that Congress intended a broad meaning of "illegal act." Under this view, auditors would have to report all acts or omissions "that violates any law, or any rule or regulation having the force of law,"[292] unless the likely "illegal act" discovered by the auditor is "clearly inconsequential."[293] This view is the position echoed by the SEC in promulgating regulations under section 10A.[294] The SEC staff has taken a position with respect to materiality under section 10A that also suggests a very broad interpretation of illegal acts for purposes of section 10A.[295]

c. Government Disciplining Employees, Directors, and Gatekeepers

Privatizing monitoring and enforcement of federal law is subject to the same rules of incentive and shirking that characterize the relationships between

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288. *See id.* § 78j-1(b)(1).
289. *See id.* § 78j-1(b)(2).
290. *See id.* § 78j-1(b)(3).
291. *Id.* § 78j-1(f).
292. 15 U.S.C. § 78j-1(f) (2000).
293. *Id.* § 78j-1(b)(1)(B).
294. *See* Implementation of Section 10A of the Securities and Exchange Act of 1934, Exchange Act Release No. 34-38387, 62 Fed. Reg. 12,743, 12,744 n.2 (Mar. 18, 1997) (to be codified at 17 C.F.R. pts. 210, 240) (implementing Section 10A of the Securities Exchange Act of 1934).
295. *See* Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,154–55 (Aug. 19, 1999) (to be codified at 17 C.F.R. pt. 211) [hereinafter SAB 99]. An SAB does not have the same force or effect as a regulation. It represents the views of the SEC staff, and not necessarily those of the Commission itself. *See id.* at 45,150. The staff rejected the idea that an issuer could either net the financial effects of misstatements to determine the scope of its reporting obligation or rely on quantitative thresholds to trigger disclosure. *See id.* They also took the position that illegal acts "include personal misconduct by the entity's personnel unrelated to their business activities." *Id.* at 45,154 n.41.

owners and managers.[296] To be sure, privatizing surveillance creates efficiencies of operation. The federal securities acts now provide an increasingly creative array of enforcement mechanisms. These effectively permit the government to enforce rules one step removed. Efficiency is achieved by limiting enforcement to the relatively smaller number of gatekeepers, who remain responsible, as the front line enforcers, of statutory behavior norms.

Privatization, however, also produces incentives to shirk[297]—and the need to create mechanisms for the monitoring and disciplining of deputies. SOX represents another, and important, step in the construction of a complex system of devolution of surveillance and control. In the prior parts of this section, I have sketched out some of the principle vehicles for the implementation of surveillance. In this section I describe some of the mechanisms used to control shirking. Ironically enough, though the state is eager to devolve the burdens of surveillance on private parties, it appears loath to devolve responsibility for controlling shirking. In the name of the protection of the market and private ordering, the state is in the process of constructing a system which forces on non-governmental actors in the market, and principally stakeholders, a passive role. It is increasingly for the government, and not stakeholders or market, to norm, order, and discipline.

There are a number of good examples of the diversion of enforcement to the state. One example of this diversion is the new "fair funds" provisions of SOX.[298] In testimony to Congress, the chief of the SEC Enforcement Division described the Fair Funds provision as 'novel' on its introduction, but a novelty enthusiastically embraced.[299] The director of the SEC Enforcement Division also noted that "Within the first six months of the enactment of Sarbanes-Oxley, the Commission already has authorized the Division of Enforcement at the SEC to seek approval of Fair Fund distributions on more than a dozen occasions."[300] The SEC has recently proposed amending its rules to

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296. There is much good work on the theory and implications of the relationship of principal and agent, however constituted. For an elegant description, see, e.g., WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES (8th ed. 2002).

297. On shirking, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

298. *See* Sarbanes-Oxley Act § 308(a) (to be codified at 15 U.S.C. § 7246), which permits the government to add certain fines and penalties to a "disgorgement fund for the benefit of the victims of such violation." *Id.*

299. *See It's Only Fair: Returning Money to Defrauded Investors: Hearing Before the House Comm. on Fin. Serv's*, 108th Cong. 5, 28 (2003) (testimony of Steven M. Cutler).

300. *Id.*

consolidate its authority with respect both to fair funds amounts and disgorgements.[301]

Another example concerns the willingness of Congress and the SEC to limit private rights of action, especially against gatekeepers. Neither SOX section 307, nor the regulations thereunder create private rights of action against attorneys for violation of its provisions.[302] Instead, enforcement is vested solely in the SEC.[303] The government painted with a broad brush in creating this monopoly for itself. The SEC explained that:

> The Commission is of the view that the protection of this provision should extend to any entity that might be compelled to take action under this part; thus it extends to law firms and issuers. The Commission is also of the opinion that, for the safe harbor to be truly effective, it must extend to both compliance and non-compliance under this part.[304]

In a way this makes perfect sense. If the gatekeepers are the tools of the state, then it should be for the state, and not private parties, to control and discipline them with respect to their duty to the state.

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301. *See* SEC, Proposed Rule: Proposed Amendments to the Rules of Practice and Related Provisions (17 C.F.R. Parts 200, 201, and 240), Rel. No. 34-48832, 68 Fed. Reg. 68,186 (Dec. 5, 2003). The SEC explained:

> Certain requirements for Fair Funds would suggest that the Commission's Rules should make some distinctions between Fair Funds and disgorgement funds. For example, Fair Funds must be disbursed to the investors harmed by the securities law violations at issue. The purpose of disgorgement is to require a wrong-doer to pay back the ill-gotten gains that the wrong-doer obtained by virtue of his or her violation. Thus, the Commission can order a wrong-doer to disgorge ill-gotten gains whether or not investors suffered any damages as a result of the violation. Where there are no identifiable victims of a violation, the Commission proposes to permit that the disgorgement and civil money penalty amounts be paid to the United States Treasury. The Commission asks for comment on this proposal. . . . In other respects, the Commission believes that the requirements for Fair Funds and disgorgement funds should be similar. In some cases, the Commission may conclude that it is in the public interest to impose a civil money penalty and order disgorgement even though the relative value of the ill-gotten gains and the number of potential claimants would result in high administrative costs and *de minimis* distributions to individual investors. Under such circumstances, the Commission would continue its practice of ordering that the disgorgement and civil penalty amount be paid directly to the United States Treasury.

Id. at 68,188 (citation omitted).

302. The regulations provide that: "Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions." 17 C.F.R. § 205.7(a).

303. *See id.* § 205.7(b).

304. Implementation of Standards and Professional Conduct for Attorneys, Release Nos. 33-8151, 34-47276, 68 Fed. Reg. 6296, 6315 (Feb. 6, 2003).

While non-state actors have no right of action against gatekeepers who breach their "detect and report" duties, the state has acquired additional power to discipline. SOX has, for instance, provided the SEC with direct authority to punish lawyers who breach their obligations as gatekeepers. Failure to comply with the section 307 reporting requirement might constitute grounds for lawyer censure under section 602 of the Sarbanes-Oxley Act.[305] The power to censure extends to lawyers and auditors.[306]

Other provisions of SOX either also limit private rights of action or are silent. SOX section 303, makes it unlawful for officers or directors of corporations or persons acting under their direction, in contravention of SEC rules, to "take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading."[307] The

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305. Section 602, adding new Section 4C to the 1934 Act, permits the SEC to:

> [C]ensure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found by the Commission, after notice and opportunity for hearing in the matter—"(1) not to possess the requisite qualifications to represent others;["] "(2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct;["] or "(3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the rules and regulations issued thereunder.["]

Sarbanes-Oxley Act § 602 (to be codified at 15 U.S.C. § 78d–3(a)).

306. *See id.* (to be codified at 15 U.S.C. § 78d-3(b)), provides standards for assessing accountant misconduct.

307. *Id.* § 303(a) (to be codified at 15 U.S.C. § 7242). As the SEC explained:

> New rule 13b2-2(b)(1) specifically prohibits officers and directors, and persons acting under their direction, from coercing, manipulating, misleading, or fraudulently influencing (collectively referred to herein as "improperly influencing") the auditor of the issuer's financial statements when the officer, director or other person knew or should have known that the action, if successful, could result in rendering the issuer's financial statements materially misleading. New rule 13b2-2(b)(2) provides examples of actions that improperly influence an auditor that could result in "rendering the issuer's financial statements materially misleading." This paragraph also clarifies that such actions should not occur at any time that the auditor is called upon to exercise professional judgment related to the issuer's financial statements. New rule 13b2-2(c) applies similar provisions to audits of investment companies' financial statements.

Final Rule: Improper Influence on Conduct of Audits, Release No. 34-47890 (June 27, 2003) (to be codified at 17 C.F.R. pt. 240), *available at* http://www.sec.gov/rules/ final/34-47890.htm.

SEC is given exclusive authority to enforce this section.[308] On the other hand, SOX section 807, adding a broad new anti-fraud provision,[309] is silent on the availability of private rights of action.[310]

The censure power complements the older authority to issue cease and desist orders.[311] The "SEC's cease and desist order is arguably the more potent enforcement tool to be used against securities lawyers. For the first time in its history, the SEC has the authority to proceed against individuals and entities that it does not directly regulate, without securing the acquiescence of a court."[312] Interesting enough, the SEC has noted that the power to prosecute corporate insiders and gatekeepers under the civil and criminal law has perversely impeded its ability to use the reimbursement provisions of the Fair Funds process as effectively as it might have otherwise.[313]

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308. *See* Sarbanes-Oxley Act § 303(b) (to be codified at 15 U.S.C. § 7242) ("In any civil proceeding, the Commission shall have exclusive authority to enforce this section and any rule or regulation issued under this section."). The types of conduct prohibited under the regulations include: Offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services; Providing an auditor with an inaccurate or misleading legal analysis; Threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting; Seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting; Blackmailing; and Making physical threats. Final Rule: Improper Influence on Conduct of Audits, Release No. 34-47890 (June 27, 2003) (to be codified at 17 C.F.R. pt. 240).

309. *See* Sarbanes-Oxley Act § 807 (to be codified at 18 U.S.C. § 1348).

310. At least one set of commentators has argued that the inclusion of a direct limitation on private rights of action under SOX § 303 and its absence in SOX § 807 suggests that a private right of action may be available under the latter provision. *See* LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES LAW 164 (2d ed. 2004).

311. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 102, 104 Stat. 931 (codified as 15 U.S.C. § 78a) (permitting the SEC to seek administrative orders forbidding violation or potential violation of the federal securities laws).

312. Lisa H. Nicholson, *A Hobson's Choice for Securities Lawyers in the Post-Enron Environment: Striking a Balance Between the Obligation of Client Loyalty and Market Gatekeeper*, 16 GEO. J. LEGAL ETHICS 91, 123 (2002).

313. Stephen Cutler noted, for example, that:

> In many cases, some of the Commission's most effective investor protection remedies may contribute to defendants' or respondents' inability to pay amounts owed. For example, to help prevent future violations, the Commission can obtain orders barring wrongdoers from the securities industry, from service as officers or directors, or in other capacities. Such bars, however, limit an individual's employment opportunities, and thus may reduce defendants' ability to pay. Furthermore, state or federal criminal authorities may also prosecute securities law violators. As a result, these individuals may be incarcerated and unable to earn money with which to pay their disgorgement or penalty orders.

It's Only Fair: Returning Money to Defrauded Investors: Hearing Before the House Committee on Fin. Servs., 108th Cong. 5, 28 (2003) (testimony of Stephen M. Cutler), *available at* http://www.sec.gov/news/testimony/022603tssmc.htm (last visited Jan. 13, 2004).

Officers and directors face a more complex array of enforcement incentives after Sarbanes-Oxley. The Sarbanes Oxley Act amended Section 21C of the 1934 Act by adding new subsection (f).[314] This new section grants the SEC the authority to bar a person from serving as an officer or director if that person violated sections 10(b) or 15(d) of the 1934 Act.[315] In addition, section 8A of the 1933 Act is amended by adding new subsection (f). This new provision grants the SEC the same authority to bar persons who violate Section 17(a) of the 1933 Act.[316] In addition, under new Section 21C(c)(3) of the 1934 Act, the SEC is given authority to freeze the extraordinary payment to any officer, director, partner, controlling person, agent or employee of an issuer during an investigation of possible securities laws violations.[317] The freeze on payment can be extended, subject to court approval, if the "individual affected by such order is charged with violations of the Federal securities laws by the expiration of the 45 days" of the temporary freeze period.[318] The SEC has sought additional powers.[319]

In addition, SOX effects a modification of a number of criminal provisions. SOX revised the criminal penalties for both attempt and

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314. *See* Sarbanes-Oxley Act § 1105(a) (to be codified at 15 U.S.C. § 78u-3(f)).

315. *See id.* (adding § 21C(f) to the 1934 Act).

316. *See id.* § 1105(b) (to be codified at 15 U.S.C. 77h-1) (adding 8A to the 1933 Act).

317. *See id.* § 1103 (adding § 21C(c)(3) to the 1934 Act):

> Whenever, during the course of a lawful investigation involving possible violations of the Federal securities laws by an issuer of publicly traded securities or any of its directors, officers, partners, controlling persons, agents, or employees, it shall appear to the Commission that it is likely that the issuer will make extraordinary payments (whether compensation or otherwise) to any of the foregoing persons, the Commission may petition a Federal district court for a temporary order requiring the issuer to escrow, subject to court supervision, those payments in an interest-bearing account for 45 days.

Id.

318. *See id.*

319. For example, the SEC sought to advance passage of the proposed Securities Fraud Deterrence and Investor Restitution Act in 2003. H.R. 2179, 108th Cong. (1st Sess. 2003). The Securities Fraud Deterrence and Investor Restitution Act of 2003 Hearing Before the Subcomm. on Capital Markets, Ins. and Gov. Sponsored Ent. of the Comm. on Fin. Servs. 108th Congress 7, 60 (2003) (testimony of Stephen M. Cutler) (June 5, 2003), *available at* http://www.sec.gov/news/testimony/060503tssmc.htm (last visited June 3, 2004). The proposed act would have made it harder for people to shelter assets from SEC levy by claiming homestead or other exemptions under the Bankruptcy Code, permitted the SEC to seek penalties in cease and desist proceedings, significantly increase the amount of civil penalties that could be assessed, obtain financial records without notice to the owners thereof, permit lawyers to waive the attorney client privilege in government investigations without waiving the privilege in private party actions, make it easier to obtain information from grand jury proceedings, provide for nationwide service of civil trial subpoenas, permit privatization of debt collection, and expand the Fair Funds provisions.

conspiracy to commit criminal fraud offenses,[320] for mail and wire fraud involving financial crimes,[321] and for criminal violation of the Employee Retirement Income Security Act of 1974.[322] SOX also provided authority for reconsideration of current sentencing guidelines relating to certain white-collar offenses under the securities laws.[323] SOX added new crimes as well. One criminalizes tampering with a record or otherwise impeding an official proceeding.[324] The other criminalizes the knowing execution of (or attempt to execute) a scheme or artifice to "defraud any person in connection with any

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320. *See* Sarbanes-Oxley Act § 902(a) (to be codified at 18 U.S.C. § 1349) (providing that "[a]ny person who attempts or conspires to commit any offense under this chapter shall be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy.")

321. *See id.* § 903 (to be codified at 18 U.S.C. § 1341, 1343) (increasing the penalties for mail (section 1341) and wire fraud (section 1343) from a five to a ten-year maximum term).

322. *See id.* § 904 (to be codified at 29 U.S.C. § 1131). Section 904 amended Section 501 of the Employee Retirement Income Security Act of 1974 "(1) by striking '$5,000' and inserting '$100,000'; (1) by striking 'one year' and inserting '10 years'; and (3) by striking '$100,000' and inserting '$500,000'." *Id.*

323. *See id.* § 1104 (Amendment to Federal Sentencing Guidelines). The amendment requests:

> [T]he United States Sentencing Commission is requested to–(1) promptly review the sentencing guidelines applicable to securities and accounting fraud and related offenses; (2) expeditiously consider the promulgation of new sentencing guidelines or amendments to existing sentencing guidelines to provide an enhancement for officers or directors of publicly traded corporations who commit fraud and related offenses; and (3) submit to Congress an explanation of actions taken by the Sentencing Commission pursuant to paragraph (2) and any additional policy recommendations the Sentencing Commission may have for combating offenses described in paragraph (1).

Id. In addition, new SOX section 1104 provided some guidance to the Sentencing Commission, including that its sentencing revisions:

> (1) [E]nsure that the sentencing guidelines and policy statements reflect the serious nature of securities, pension, and accounting fraud and the need for aggressive and appropriate law enforcement action to prevent such offenses; (2) assure reasonable consistency with other relevant directives and with other guidelines; (3) account for any aggravating or mitigating circumstances that might justify exceptions, including circumstances for which the sentencing guidelines currently provide sentencing enhancements; . . . (6) make any necessary conforming changes to the sentencing guidelines; and (7) assure that the guidelines adequately meet the purposes of sentencing as set forth in section 3553 (a)(2) of title 18, United States Code.

Sarbanes-Oxley Act § 1104 (Amendment to Federal Sentencing Guidelines).

324. *See id.* § 1102 (to be codified at 18 U.S.C. § 1512(c)). This section makes it illegal for any person to (or attempt to) alter, destroy, mutilate, or conceal a record, document, or other object with the intent to impede an official proceeding or who "otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so." *Id.* Violators may incur a fine or be sentenced to no more than ten years in jail. *See id.*

security of" an issuer subject to the 1934 Act,[325] or "to obtain, by means of fraud or fraudulent pretences, representations, or promises, any money or property in connection with the purchase or sale of any security of" such an issuer.[326] In either case, the offender may be fined or imprisoned for not more than twenty-five years.[327]

Accountants, in particular, have come under increasing governmental regulation of accounting standards, and the internal regulation of the gatekeepers themselves. SOX has made significant changes to both the relationship between the SEC and the accounting profession, as well as within the accounting profession itself. The statute targeted not only the officers and inside directors of publicly traded companies, but auditors and auditing standards as well. SOX represents an acceleration of a process, now almost a century old, characterized by the transference of regulatory power from the accounting profession to the state.

Title I of SOX establishes a new agency, the Public Company Accounting Oversight Board (PCAOB) as an independent, non-federal, non-profit corporation.[328] It's primary purpose is to oversee the audit of public companies.[329] Specifically, the PCAOB is charged with the protection of "the interests of investors and [to] further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."[330]

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325. *Id.* § 807 (to be codified at 18 U.S.C. § 1348(1)).

326. *Id.* (to be codified at 18 U.S.C. § 1348(2)).

327. *See id.*

328. *See* Sarbanes-Oxley Act § 101(a) (to be codified at 15 U.S.C. § 7211(a)). The PCAOB is composed of five members. Appointment to the PCAOB is to be made from a pool of applicants drawn "from among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public." *Id.* § 101(e)(1) (to be codified at 15 U.S.C. § 7211(e)(1)). Of the five members, two must be or have been certified public accountants. *See id.* § 101(e)(2) (to be codified of 15 U.S.C. § 7211(e)(2)). CPA's who serve as PCAOB Chair may not have actively practiced for at least five years prior to appointment. *See id.* No member of the PCAOB may be employed by another person or engage in any other professional activity for the term of his or her appointment. *See id.* § 101(e)(3) (to be codified at 15 U.S.C. § 7211(e)(3)). Members serve a five year term, and may not serve more than two terms whether consecutive or otherwise. *See id.* § 101(e)(5) (to be codified at 15 U.S.C. § 7211(e)(5)). Members may be removed for good cause. *See* Sarbanes-Oxley Act § 101(e)(6) (to be codified at 15 U.S.C. § 7211(e)(6)).

329. *See id.* § 101(b) (to be codified at 15 U.S.C. § 7211(b)).

330. *Id.* § 101(a) (to be codified at 15 U.S.C. § 7211(a)). According to its website, the PCAOB mission is "to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports." PCAOB Mission Statement, *available at* http://www.pcaobus.org/default.asp (last visited June 3, 2004).

The PCAOB is designed to bring the regulation of the accounting profession, at least with respect to its relationship with corporations, under strong governmental control.[331] It should come as no surprise that the PCAOB has used its authority sparingly in its first few years of operation. [332] It may be that the PCAOB will show some reluctance to take regulatory power directly.[333] Of course, in this respect at least, it may follow the lead of the SEC.[334] However, its effects have already been felt.[335]

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331. The PCAOB is itself subject to SEC oversight. *See* Sarbanes-Oxley Act § 107(b)(5) (to be codified at 15 U.S.C. § 7217(b)(5)). The SEC can review, and modify disciplinary actions of the PCAOB. *See id.* § 107(c) (to be codified at 15 U.S.C. § 7217(c)). The SEC may also relive the PCAOB of its enforcement powers, censure the entire PCAOB or censure and remove from office any member of the PCAOB. *See id.* § 107(d)(2) (to be codified at 15 U.S.C. § 7217(d)(2)) (Such actions must be in the "public interest, for the protection of investors, or otherwise in furtherance of the purposes of this Act or the securities laws.").

332. For a description of some of the standards considered and adopted to date, see http://www.pcaobus.org/pcaob_standards.asp (last visited June 3, 2004).

333. In some respect this reluctance is mandated. For example, the PCAOB is required to establish ethical standards under section 103 of SOX. *See* Sarbanes-Oxley Act § 103 (to be codified at 15 U.S.C. § 7213). These standards are to be developed after consultation with professional accounting and advisory groups. *See id.* § 103 (to be codified at 15 U.S.C. § 7213(a)(1)). The groups likely to participate include organizations like FASB and AICPA. *See The Legislative History of the Sarbanes-Oxley Act of 2002: Accounting Reform and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Housing, & Urban Affairs*, vol. II, 107th Cong. 843, 896 (2003).

334. For example, a key issue in connection with these regulations has centered on the definition of "internal controls" for purposes of section 404 of SOX and with respect to disclosure and assessment pursuant to proposed Regulation S-K item 307. The Commission has proposed that the standard be tied to the codification of that term by the American Institute of Certified Public Accountants (AICPA). The Commission has stated a belief that:

> [T]he purpose of internal controls and procedures for financial reporting is to ensure that companies have processes designed to provide reasonable assurance that:
>
> - [t]he company's transactions are properly authorized;
> - [t]he company's assets are safeguarded against unauthorized or improper use; and
> - [t]he company's transactions are properly recorded and reported to permit the preparation of the registrant's financial statements in conformity with generally accepted accounting principles. We believe that these objectives are embodied in the definition of the term "internal controls" as the term is defined in AICPA's Codification of Statements on Auditing Standards (AU) section 319 and is consistent with section 103 of the Sarbanes-Oxley Act.

Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act, 67 Fed. Reg. 66,208, 662,20 (Oct. 30, 2002). As a consequence, the Commission's proposed definition would provide that:

> [T]he term "internal controls and procedures for financial reporting" means controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles as addressed by the Codification of Statements on Auditing Standards 319 or any

The statute divides the regulatory authority of the PCAOB into seven broad areas: (1) registration of public accounting firms that prepare audit reports for issuers subject to the reporting requirements of the 1934 Act;[336] (2) establishment or adoption of rules for auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for 1934 Act issuers;[337] (3) the conduct of inspections of registered public accounting firms for compliance with PCAOB rules, including accounting standards;[338] (4) the conduct of investigations and disciplinary procedures, and the imposition of sanctions against registered public accounting firms and associated persons subject to its authority;[339] (5) performance of such other duties as the PCAOB determines, or as otherwise ordered by the SEC, or otherwise;[340] (6) enforcement of SOX, the PCAOB's rules, professional standards, and the securities laws related to the preparation of audit reports by registered public accounting firms;[341] and (7) determination of the budget and management of the operations of the PCAOB.[342]

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superseding definition or other literature that is issued or adopted by the Public Company Accounting Oversight Board.

Id.

335. The work of the PCAOB and its regulatory activities have been well documented on its website: http://www.pcaobus.org (last visited June 3, 2004).

336. *See* Sarbanes-Oxley Act § 101(c)(1) (to be codified at 15 U.S.C. § 7211(c)(1)).

337. *See id.* § 101(c)(2) (to be codified at 15 U.S.C. § 7211(c)(2)).

338. *See id.* § 101(c)(3) (to be codified at 15 U.S.C. § 7211(c)(3)).

339. *See id.* § 101(c)(4) (to be codified at 15 U.S.C. § 7211(c)(4)).

340. *See id.* § 101(c)(5) (to be codified at 15 U.S.C. § 7211(c)(5)). Such additional duties should be for the purpose of implementing SOX and to promote the high professional standards and quality of auditing services offered by registered public accounting firms in order to protect investors and the public interest. *See id.*

341. *See* Sarbanes-Oxley Act § 101(c)(6) (to be codified at 15 U.S.C. § 7211(c)(6)).

342. *See id.* § 101(c)(7) (to be codified at 15 U.S.C. § 7211(c)(7)).

All public accounting firms are required to register with the PCAOB.[343] Accounting firms that are not registered with the PCAOB are prohibited from preparing or issuing audit reports on U.S. public companies and from participating in such audits.[344] Registration provides the PCAOB with a wealth of information useful in controlling and disciplining firms performing audits,

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343. *See id.* § 102(a) (to be codified at 15 U.S.C. § 7212(a)). The PCAOB provides a sample registration form on its website, http://www.pcaobus.org/Form1Sample.pdf. The PCAOB must act on the application within forty-five days of its receipt of a completed form. *See id.* § 102(c)(1) (to be codified at 15 U.S.C. § 7212(c)(1)). The PCAOB may assess fees for processing registration applications and annual reports. *See id.* § 102(f) (to be codified at 15 U.S.C. § 7212(f)). Fees for registration with the PCAOB can range from $250 for a registrant with no clients, to $390,000 for a registrant with more than one thousand clients. *See* Pub. Co. Accounting Oversight Bd., Announcement of Registration Application Fees, PCAOB Rel. 2003-010 (July 17, 2003), *available at* http://www.pcoabus.org/rules/Release2003-010.pdf (2003).

Applicants for registration must provide a significant amount of information, including: (1) the names of all issuers for which the registrant prepared or issued audit reports during the preceding year or current calendar year; (2) the annual fees received by the firm form each issuer for audit, accounting, and non-accounting services; (3) other current financial information that the PCAOB may request regarding the firm's most recently completed fiscal year (This includes disclosure of "fees received by the applicant during its most recently completed fiscal year for: audit services, other accounting services, tax services, and all other products and services, whether the fees were received from 'issuers' or from their other clients.") Pub. Co. Accounting Oversight Bd., Registration System for Public Accounting Firms, PCAOB Release No. 2003-007 A3-xviii (May 6, 2003), *available at* http://www.pcaobus.org/rules/release2003-007.pdf (2003) [hereinafter PCAOB Release No. 2003-007]); (4) a statement of the firm's quality control policies for its accounting and auditing practices; (5) a list of all accountants associated with the firm who participate or contribute to audit reports; (6) information related to any criminal, civil or administrative action, or disciplinary proceedings against the firm or its associates. The registration form itself requires "information about certain additional proceedings that may reflect on the applicant's fitness for registration, even though the proceedings may no longer be pending or do not relate to audit reports." *Id.* at A3-l; (7) copies of any periodic/annual disclosure filed by an issuer with the SEC during the preceding year which discloses any accounting disagreements between the issuer and the firm in connection with an audit report; and (8) any other information that the PCAOB or the SEC determines to be relevant to protect investors and the public interest. *See* Sarbanes-Oxley Act § 102(b)(2)(A)-(H) (to be codified at 15 U.S.C. § 7212(b)(2)(A)-(H)). The PCAOB has used this authority to require a limited amount of additional information. For example, section 102(b) of SOX does not expressly require that the Board obtain office locations and certain contact details concerning an applicant. The Board believes that such information is necessary, and has required it in Part I of Form 1.

344. *See id.* § 102(a) (to be codified at 15 U.S.C. § 7212(a)). Non-U.S. public accounting firms that prepare or furnish audit reports with respect to any U.S. public company are also subject to PCAOB rules to the same extent as a U.S. firm. *See id.* § 106(a) (to be codified at 15 U.S.C. § 7216(a)). The PCAOB may also compel non-U.S. public accounting firms that do not issue audit reports, but are substantially involved in the preparation of the audit reports, to register. *See id.*

as well as significant gatekeeping functions with respect to public corporations.[345] In addition, registered accounting firms must consent to cooperation and compliance with requests for testimony or production of documents made by the PCAOB.[346] Consent is made explicit—registered firms must provide a statement affirming the registrant's understanding that cooperation and compliance with the requirements of the PCAOB is a condition to the continuing effectiveness of the firm's registration.[347]

Auditor gatekeepers self-monitor to a large extent. However, the monitoring is subject to disclosure to the government and to discipline in the event the disclosure is false or the disclosure reveals a failure to comply with the standard for appropriate internal monitoring. For example, item 4.1 of the registration form requires the registrant to provide a narrative description of the firm's quality control policies. The final release explains:

> [T]he description should be in a clear, concise, and understandable format and should convey the scope and the key elements of the applicant's quality controls for its accounting and auditing practice. A description that addresses all of the elements of quality control covered by the professional quality control standards the firm is subject to will be sufficient. Technical descriptions and detailed explanations of procedures are not required. Absent unusual circumstances, the Board does not contemplate granting confidential treatment requests for this Item.[348]

Registered public accounting firms also must submit an annual report to the PCAOB and update the information provided in the registration.[349] Registration applications and annual report updates are public documents. However, the PCAOB may exempt from disclosure confidential or proprietary information.[350] As part of its responsibility for setting standards, the PCAOB must require registered accounting firms to conform to the following requirements: (1) to prepare and maintain work papers and other documents related to any audit for at least seven years; (2) to have all audit reports reviewed and approved by an independent auditor or by another partner within

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345. For the nineteen page sample registration form, see http://www.pcaobus.org/Form1Sample.pdf (last visited June 3, 2004).

346. *See* Sarbanes-Oxley Act § 102(b)(3)(A) (to be codified at 15 U.S.C. § 7212(b)(3)(A)).

347. *See id.* § 102(b)(3)(B) (to be codified at 15 U.S.C. § 7212(b)(3)(B)).

348. PCAOB Release No. 2003-007, *supra* note 343 at A3-xlix - l (citing AICPA Statement on Auditing Standards (SAS) No. 25; AU § 161; Statements on Quality Control Standards (SQCS) No. 2; AICPA SECPS Membership Requirements, Appendix K, SECPS sec. 1000.45).

349. *See* Sarbanes-Oxley Act § 102(d) (to be codified at 15 U.S.C. § 7212(d)).

350. *See id.* § 102(e) (to be codified at 15 U.S.C. § 7212(e)).

the firm who is not in charge of the preparation of the audit report; and (3) to describe the internal control review required under SOX section 404(b).[351]

As part of the quality control standards the PCAOB develops with respect to the issuance of audit reports, the PCAOB must include:

> [R]equirements for every registered public accounting firm relating to–(i) monitoring of professional ethics and independence from issuers on behalf of which the firm issues audit reports; (ii) consultation within such firm on accounting and auditing questions; (iii) supervision of audit work; (iv) hiring, professional development, and advancement of personnel; (v) the acceptance and continuation of engagements; (vi) internal inspection; and (vii) such other requirements as the Board may prescribe, subject to subsection (a)(1).[352]

Firms producing regular audits of more than one hundred issuers must be inspected annually by the PCAOB to assess compliance with SOX, SEC rules and professional standards.[353] The PCAOB may also conduct special inspections at its discretion or in response to an SEC request.[354] During inspections, the PCAOB must identify any act, practice, or omission that

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351. Section 404(b) of SOX provides:

> With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Id. § 404(b) (to be codified at 15 U.S.C. § 7262(b)). With respect to its review of an issuer's internal controls assessment, the accounting firm must describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b), and present in such report (or in a separate report):

> (I) the findings of the auditor from such testing;
> (II) an evaluation of whether such internal control structure and procedures—
> (aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
> (bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
> (III) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing.

Id. § 103(a)(2)(A)(iii) (to be codified at 15 U.S.C. § 7213(a)(2)(A)(iii)).

352. *Id.* § 103(a)(2)(B) (to be codified at 15 U.S.C. § 7213(a)(2)(B)).

353. *See id.* § 104(a); 104(b)(1)(A) (to be codified at 15 U.S.C. § 7214(a)-(b)). Firms producing reports for one hundred or fewer issuers are subject to PCAOB inspection once every three years. *See id.* at § 104(b)(1)(B) (to be codified at 15 U.S.C. § 7214(b)(1)(B)).

354. *See* Sarbanes-Oxley Act § 104(b)(2) (to be codified at 15 U.S.C. § 7214(b)(2)).

violates SOX, PCAOB rules, the accounting firm's own quality control policies, or professional standards.[355]

Regardless of the manner in which the PCAOB becomes aware of a violation, the PCAOB is authorized to conduct investigations (in addition to annual and special inspections) of registered public accounting firms for any act, practice, or omission that violates SOX, PCAOB rules, securities laws relating to audit reports, SEC rules issued under SOX, or professional standards.[356] Investigations may also cover the registered accounting firm's associated persons.[357] Such investigations must be conducted pursuant to rules of fair procedure.[358] When conducting an investigation, the PCAOB is authorized to require testimony it considers relevant or material from the registered accounting firm and its associates.[359] It may also seek testimony and the production of documents from any person (including any client of the accounting firm) upon notice to that person.[360] The PCAOB may ask the SEC to issue subpoenas to compel testimony or document production.[361] Firms who fail to cooperate may have their registrations suspended or revoked.[362] Though all testimony elicited and documents produced are to be treated as confidential, any such information may be disclosed to the SEC, the U.S. Attorney General, appropriate federal regulators, state attorneys general, and appropriate state regulatory authorities.[363]

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355. *See id.* § 104(c)(1) (to be codified at 15 U.S.C. § 7214(c)(1)). Violations or breaches must be reported to the SEC or appropriate state regulatory authorities. *See id.* § 104(c)(3) (to be codified at 15 U.S.C. § 7214(c)(3)).

356. *See id.* § 105(b)(1) (to be codified at 15 U.S.C. § 7215(b)(1)).

357. *See id.*

358. *See id.* § 105(a) (to be codified at 15 U.S.C. § 7215(a)). The PCAOB has published rules of fair procedure. Pubic Company Accounting Oversight Board, PCAOB Release No. 2003-015 (Sept. 29, 2003), *available at* http://www.pcaobus.org/rules/Release2003-015.pdf.

359. *See* Sarbanes-Oxley Act § 105(b)(2)(A) (to be codified at 15 U.S.C. § 7215(b)(2)A)). In addition, the PCAOB may require the production of material or relevant documents from the registered accounting firm and its associates no matter where such documents are held. *See id.* at § 105(b)(2)(B) (to be codified at 7215(b)(2)(B)).

360. *See id.* § 105(b)(2)(C) (to be codified at 15 U.S.C. § 7215(b)(2)(C)).

361. *See id.* § 105(b)(2)(D) (to be codified at 15 U.S.C. § 7215(b)(2)(D)).

362. *See id.* § 105(b)(3)(A) (to be codified at 15 U.S.C. § 7215(A)). Likewise, individuals may be suspended or barred from associating with a registered firm. *See id.*

363. *See id.* § 105(b)(5) (to be codified at 15 U.S.C. § 7215(b)(5)).

Upon completion of its investigation, the PCAOB may impose disciplinary or remedial sanctions on the parties investigated.[364] These sanctions may include: (1) "temporary suspension or permanent revocation of registration;"[365] (2) "temporary or permanent suspension or bar of a person from further association with any registered public accounting firm;"[366] (3) "temporary or permanent limitations on the activities, functions or operations of such firm or person (other than in connection with required additional professional education or training);"[367] (4) civil monetary penalty;[368] (5) censure;[369] (6) "required additional professional education or training;"[370] or (7) any other appropriate sanction provided for in the PCAOB's rules.[371]

The government also has broad disciplinary powers against auditors under section 10A of the 1934 Act. Though the SEC had not appeared to vigorously use these powers during the first several years after the enactment of section 10A, the SEC has begun a more aggressive litigation campaign against what it may deem to be model violations of the provision.

Gatekeepers, in addition to the growing array of disciplinary powers described above, also face exposure to liability as principals for securities

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364. *See* Sarbanes-Oxley Act § 105(c)(4) (to be codified at 15 U.S.C. § 7215(c)(4)). Accounting firms may also be sanctioned for failing to reasonably supervise its associated persons, where the associated person is found in breach. *See id.* at § 105(c)(6) (to be codified at 15 U.S.C. § 7215(c)(6)). The imposition of certain sanctions are reserved for instances where the sanctioned party is found to have engaged in intentional or knowing conduct or to have engaged in repeated acts of negligent conduct each of which results in a violation. *See id.* § 105(c)(5)(A)-(B) (to becodified at 15 U.S.C. § 7215(c)(5)(A)-(B)).

365. *Id.* § 105(c)(4)(A) (to be codified at 15 U.S.C. § 7215(c)(4)(A)). This sanction is limited to conduct found to be intentional, knowing, reckless or repeatedly negligent. *See id.*

366. *Id.* § 105(c)(4)(B) (to be codified at 15 U.S.C. § 7215(c)(4(B)). This sanction is limited to conduct found to be intentional, knowing, reckless or repeatedly negligent. *See* Sarbanes-Oxley Act § 105(c)(5)(A)-(B) (codified at 15 U.S.C. § 7215((c)(5)(A)-(B)).

367. *Id.* § 105(c)(4)(C) (to be codified at 15 U.S.C. § 7215(c)(5)(C)). This sanction is limited to conduct found to be intentional, knowing, reckless or repeatedly negligent. *See id.* § 105(c)(5)(A)-(B) (to be codified at 15 U.S.C. § 7215(c)(5)(A)-(B)).

368. *See id.* § 105(c)(4)(D) (to be codified at 15 U.S.C. § 7215(c)(4)(D)). Monetary penalties may not exceed $100,000 for a natural person or $2,000,000 for others. *See id.* § 105(c)(4)(D)(i) (to be codified at 15 U.S.C. § 7215(c)(4)(D)(i)). However, the penalties increase to a maximum of $750,000 for natural persons and $15,000,000 for others if the conduct is intentional, knowing, reckless or repeatedly negligent. *See id.* at § 105(c)(4)(D)(ii) (to be codified at 15 U.S.C. § 7215(c)(4)(D)(ii)).

369. *See* Sarbanes-Oxley Act § 105(c)(4)(E) (to be codified at 15 U.S.C. § 7215(c)(4)(E)).

370. *Id.* § 105(c)(4)(F) (to be codified at 15 U.S.C. § 7215(c)(4)(F)).

371. *See id.* § 105(c)(4)(G) (to be codified at 15 U.S.C. § 7215(c)(4)(G)).

fraud, along with the officers and directors of the issuer.[372] The detect and report rules under section 10A of the 1934 Act, and the Regulations under SOX section 307, make it more likely that gatekeepers who continue to work for issuers who refuse to change behavior or disclose after the gatekeeper reports material violations of law face an increased possibility that their continued employment can be characterized as a joining in the fraud.[373]

Taken together, it becomes easier to see the pattern of the weave. All corporate actors are enlisted in the process of monitoring, and information gathering. All corporate actors are responsible for monitoring each other and themselves. If they fail to detect, or detect and report, or detect, report and convince the appropriate authority to take appropriate action, they might become subject to liability. Thus, the body of the system is created. In order to operate the system needs a "soul"—an animating set of principles, the enforcement of which provides the object, the life purpose, of the system. It is to the uncovering of that normative spirit that I turn to next.

IV. SYSTEMS OF SURVEILLANCE NORMS

The prior section suggested the scope and nature of surveillance obligations. It provided a guide to the "guts" of the system. However, systems as such are not value-neutral. Systems themselves necessarily suggest, or carry with them, the normative structure they are meant to most efficiently advance.[374] The pieces recently added to the emerging American system of surveillance also betray a strong normative bias. In this case, the bias is toward a confessional system, where private intangible organizations may no longer remain opaque to governmental scrutiny.

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372. Gatekeepers cannot be held liable as aiders and abettors of the fraudulent activities of officers and directors. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994). However, gatekeepers can still be held liable for aiding and abetting securities fraud under in criminal actions under provisions of generally applicable federal criminal statutes.

373. For a discussion of this issue, see Backer, *supra* note 56.

374. One of the great contributions of critical race theory in the twentieth century has been the suggestion that systems of governance need not be and are often not "neutral," but that indeed, the system itself is constructed to maximize the efficient implementation of the norms and objectives of the community creating the system. *See, e.g.*, Tanya Kateri Hernández, *Multiracial Matrix: The Role of Race Ideology in the Enforcement of Antidiscrimination Laws, A United States-Latin America Comparison*, 87 CORNELL L. REV. 1093 (2002); Neil Gotanda, *Failure of the Color-Blind Vision: Race, Ethnicity, and the California Civil Rights Initiative*, 23 HASTINGS CONST. L.Q. 1135 (1996); Cornell West, *Foreword*, *in* CRITICAL RACE THEORY: THE KEY WRITINGS THAT FORMED THE MOVEMENT (Kimberlé Crenshaw et al. eds., 1995); Neil Gotanda, *A Critique of "Our Constitution is Color-Blind,"* 44 STAN. L. REV. 1 (1991).

Without actually examining disclosure in operation, it is difficult to get a sense of these systemic normative choices or of the ways in which these disclosure obligations actually create operational systems of disclosure, which trigger obligations to act, or in the case of the state, an opportunity to enforce. While the discipline of surveillance is new, the stage on which it is played out for the political body of the state is quite ancient. The courts, rather than the markets, provide the principle stage for the elaboration of the new model of corporate discipline. It is on this stage that the SEC has chosen to perform its dramatization of the new and improved disclosure regime at work. It is from the *pieces de theâtre* of judicial process that the shape of the new disclosure regime emerges. This stage is preferred not only by the state, but also by the participants in the market for enterprise. Out of the private litigation emerging from the collapse of Enron, other critical parts of the evolving disclosure regime also becomes clearer. American courts provide an efficient space for

> an interrogation without end, an investigation that would be extended without limit to a meticulous and ever more analytical observation, a judgement that would at the same time be the constitution of a file that was never closed, the calculated leniency of a penalty that would be interlaced with the ruthless curiosity of an examination.[375]

This section examines the litigation against Chancellor Corp.,[376] Solucorp Industries, Ltd.,[377] and Enron[378] as archetypal narratives from which a relatively coherent set of conduct norms can be extracted. The cases present, in archetypal form, the bases of conduct norms emerging in a world of perpetual surveillance. The narratives are then used to extract a series of behavior norms applicable to both observer and observed. These norms are the foundation of a system of standards ultimately derived from and beholden to the state.

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375. FOUCAULT, *supra* note 1, at 827.

376. *See Chancellor* Complaint, *supra* note 9.

377. *See* SEC v. Solucorp Indus. Ltd., 274 F. Supp. 2d 379 (S.D.N.Y. 2003) [hereinafter *Solucorp I*]; SEC v. Solucorp Indus. Ltd., 197 F. Supp. 2d 4 (S.D.N.Y. 2002) [hereinafter *Solucorp II*]; *In re* Solucorp Indus. Ltd. Sec. Liting. [2000-2001 Transfer Binder] Fed. Sec. L. Rep. 91,265 (S.D.N.Y., Nov 13, 2000).

378. *See In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

A. Bad Facts

1. Chancellor Corp.

In a civil action filed by the SEC in April 2003,[379] the SEC charged a number of officers, directors and gatekeepers with the creation of false corporate documents and fictitious accounting entries for the purpose of misrepresenting the financial condition of the Chancellor corporation.[380] The charges focused on two particular transactions.[381] The first involved the accounting for the acquisition of a subsidiary; the second involved the improper capitalization of fees.[382] The SEC alleged that on August 10, 1998, Chancellor entered into a letter of intent to acquire a Georgia company, MRB, Inc.[383] The transaction closed in January 1999, but Chancellor sought to consolidate the two companies' financial results as of the end of Chancellor's prior fiscal year end.[384] The reason was simple enough—an early consolidation added nineteen million dollars in revenue to Chancellor's financial statements.[385] When Chancellor's outside auditors questioned the timing of the consolidation, the auditors were presented with a Management Agreement, created in late 1998 but falsely backdated to August 1998.[386] In the face of continued skepticism by the auditors, Chancellor's Chairman and CEO, Brian Adley,[387] directed Chancellor's acting CFO, David Volpe, and Chancellor's COO, Franklyn Churchill, to create a document purporting to amend the Management Agreement.[388] The auditors were then fired and new auditors hired who eventually, and despite serious reservations, agreed to Chancellor's position respecting the timing of the consolidation. In addition, Adley sought to have Chancellor record a $3.3 million consulting fee payable to a company, Vestrex, owned by Adley.[389] To support this entry, Adley caused Chancellor's employees to "alter or completely fabricate numerous

379. *See Chancellor* Complaint, *supra* note 9.
380. *See id.*
381. *See id.*
382. *See id.* at ¶¶ 2-3.
383. *See id.*
384. *See id.* at ¶ 22.
385. *See Chancellor* Complaint, *supra* note 9 (last visited Apr. 5, 2004). Chancellor's revenues increased from $11 Million to $30 Million as a result.
386. *See id.* at ¶ 24.
387. For a description of the principals alleged by the SEC to be involved in this transaction, *see id.* at ¶¶ 13-19.
388. *See id.* at ¶ 26.
389. *See id.* at ¶ 33.

documents."[390] The SEC further alleges to Chancellor's independent directors either permitted Chancellor's officers to engage in these actions, or ignored "red flags" which should have given rise to an obligation to investigate.[391] The gatekeepers also failed to investigate with the required vigor and failed to present reasonable suspicions to the Chancellor Board of Directors or the SEC. The SEC alleged that the auditors' willfully violated section 10A of the Exchange Act, caused the violation of section 13(a) of the Exchange Act Rules 12b-20 and 13a-1, and engaged in improper professional conduct under Rule 102(e)(1) of the Commission's Rules of Practice. Some of the auditors settled on that basis.[392] Others remain parties subject to the civil suit filed in April.[393]

2. *SEC v. Solucorp Industries, Ltd.*[394]

Solucorp, an environmental remediation company,[395] was convicted of numerous securities violations for deceptive and fraudulent business practices.[396] The court found that company officers knowingly falsified books or were reckless in preparing and certifying them.[397] Solucorp improperly recognized revenue that had never been finalized and subject to material contingencies.[398] Officers regularly issued falsified press releases, shareholder reports, annual reports, and SEC filings to deceive investors into believing Solucorp was a lucrative venture.[399] To manipulate Solucorp stock, company officers issued press releases overstating the value of future contracts only to sell personal shares when prices increased.[400] During reviews of Solucorp's books, financial insiders and outside counsel alerted company officers of disputes about the presentation of financial information relating to the company's timing and reporting of fees requiring changes to financial statements with a material detrimental impact on the presentation of

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390. *See id.* at 34. *See also id.* at ¶¶ 35-38.

391. *See Chancellor* Complaint, *supra* note 9, at ¶¶ 29, 44, 48, 53, 59, 60.

392. *See In re* David Decker, Fed. Sec. L. Rep. (CCH) ¶ 75,422 (Apr. 24, 2003), *available at* http://www.sec.gov/litigation/admin/34-47731.htm (order instituting public Administrative and Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act).

393. These include BKR Metcalf Davis, who became Chancellor's auditors after the original auditors were fired for refusing to issue a clean opinion, and Gregory Davis, the Metcalf Davis engagement partner. *See Chancellor* Complaint, *supra* note 9.

394. 274 F. Supp. 2d 379 (S.D.N.Y. 2003).

395. *See Solucorp I*, 274 F. Supp. 2d at 381-82.

396. *See id.* at 418.

397. *See id.*

398. *See id.*

399. *See id.*

400. *See id.*

information to investors.[401] Solucorp chose not to change its accounting of those items; the auditors issued a clean audit report and did not report their concerns either to the board of directors or to the SEC.[402]

3. Enron

This apocrypha of bad conduct focuses on corporate outsiders with interests in or duties to the corporation. The corporation's outside counsel, Vinson and Elkins and Kirkland and Ellis, created elaborate partnerships with companies secretly run by Enron.[403] Both received enormous fees for their services.[404] At least one of the firms engaged in acts designed to hide the nature of the relationships they were creating and thereafter sought to mislead the market by participating in the creation of misleading reports.[405] The law firms provided the necessary documentation to certify the illicit partnerships' legitimacy through the creation and approval of press releases, SEC fillings, and shareholder reports, which the lawyers knew were misleading.[406] The corporation's auditor, Arthur Anderson, provided both external auditing and internal accounting.[407] Arthur Anderson participated in the creation and maintenance of misleading financial statements,[408] representing to the public that Enron was in sound financial condition.[409] Arthur Anderson was tied to

401. *See id.* at 401-14.

402. *In re* Glenn R. Ohlhauser, File No. 3-11018, *at* http://www.sec.gov/litigation/admin/34-47256.htm (last modified Jan. 27, 2003).

403. *See In re* Enron Corp. Secs., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 656-73 (S.D. Tex. 2002). Vinson and Elkins were one of Enron's principle outside counsel which assisted in the creation of fraudulent devices used to hide debt and defraud investors. Vinson and Elkins assisted in legitimizing to the world Enron's fraud by certifying documents, performing reviews of company procedures and helping to construct Fastow's infamous special purpose entities. Kirkland and Ellis served as outside counsel but only in a secondary capacity. It represented the unconsolidated entities.

404. *See In re Enron*, 235 F. Supp. 2d at 614.

405. *See id.* at 656-57.

406. *See id.*

407. *See id.* at 676-77.

408. *See id.* at 673-74.

409. *See id.* at 673-85.

Enron through the receipt of enormous fees.[410] Bankers for the corporation, including Barclays, Bank of America Corporation, CIBC, Citigroup, Credit Suisse First Boston, Deutsche Bank AG, JP Morgan, and Merrill Lynch, derived personal benefit at the expense of corporate shareholders by generating spectacular fees for sham transactions designed to maintain Enron's operations and conceal its debt.[411] The banks helped conceal large loans by treating them as sales transactions. The banks also misstated financial statements and mis-rated potential ventures to outside investors for the purpose, in part, of protecting their interests in Enron.[412]

B. From Bad Facts to Regulatory Morals

The cases described in this section provide a window into the moral/legal universe of the sort of conduct now demanded of gatekeepers and others within and without the corporate enterprise. The importance of the cases does not lie in the penalties extracted by the prosecutor or the court, but rather in the utility of the courts for naturalizing, memorializing and providing instruction in the mechanics of corporate discipline.

> And, although the universal juridicism of modern society seems to fix limits on the exercise of power, its universally widespread panopticism enables it to operate, on the underside of the law, a machinery that is both immense and minute, which supports, reinforces, multiplies the asymmetry of power and undermines the limits that are traced around the law.[413]

Indeed, the greatest value of the cases is the way they reveal both the circles of an endless observation and discipline now imposed on corporate actors, and the expectations of the governor of this panoptic enterprise. And there is irony here: the government has increasingly appropriated for itself that great traditional tool of private market discipline—litigation—to shape the form of the norms, it rather than private actors, would impose.

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410. In 2000, Arthur Anderson generated about $52 Million in fees from auditing services for Enron. The fees represented auditing work that might have put Arthur Anderson in a conflict of interest situation, since the auditing firm was responsible for both internal and external auditing services—in effect it was being hired to audit its own work. *See In re Enron*, 235 F. Supp. 2d at 678. Arthur Anderson anticipated potential future fees for its Enron work as potentially being worth about $100 Million. *See id.* at 679. Moreover the size of the fees gave Arthur Anderson a significant stake in Enron's continued appearance of solvency, and thus in ensuring that the financial irregularities remain hidden. *See id.* at 677. Thus, despite what was alleged to be a number of significant red flags raised by Enron's accounting practices, Arthur Anderson issued clean audit reports in 2000. *See id.*

411. *See id.* at 637-56.

412. *See id.*

413. FOUCAULT, *supra* note 1, at 223.

The behavior constructed by the government through its strategic litigation focuses on two sorts on conduct. The first relates to the nature and character of efforts required of gatekeepers and others with surveillance responsibilities, and the second relates to the substantive rules of behavior for corporate actors. The contours of these emerging norms can be teased out from the cases described above.

These norms translate into specific conduct requirements for corporate actors now burdened with surveillance obligations owing to the corporation, its stakeholders, and the state. For gatekeepers, the cases serve as a warning of sorts—gatekeeper duties are now increasingly understood by the government as active and positive obligations. For independent members of the board of directors, and principally for independent members of the board's audit committee, the obligations appear no less positive. Failure to take aggressive action may lead to liability—even where the independent director did not profit from the transaction. For officers, monitoring obligations are now more direct. For other employees, the government extends greater protections for detecting and reporting violation by officers, gatekeepers and board members.

For accountants, this may translate into duties of more aggressive inquiry. The specifics of appropriate accountant conduct are nicely exampled in the SEC's enforcement actions against the audit manager and concurring audit partner of Chancellor Corp.'s outside auditors. In *Chancellor*, the SEC asserted that David Decker, the audit manager of the outside auditors, and Theodore Fricke, the concurring audit partner, failed in their detect and report obligation in certain specific ways.[414] The SEC pointed to a number of things that Decker did wrong. First, with knowledge that the prior auditors had been dismissed for disagreeing with management's position on the acquisition date of Chancellor's acquisition of MRB,[415] a subsidiary of Chancellor:

> Decker never questioned [Brian A.] Adley [Chancellor's Board Chairman and CEO] or any other Chancellor representative about the authenticity of the First Amendment. Decker never confirmed the existence, date or terms of the First Amendment with the

414. *See In re* David Decker, 7 Fed. Sec. L. Rep. (CCH) ¶ 75,422 (Apr. 24, 2003), *available at* http://www.sec.gov/litigation/admin/34-47731.htm (last modified Apr. 25, 2003). Decker "had operational responsibility for ensuring that the way in which the audit was conducted complied with Metcalf Davis' [the outside auditor's] quality control policies and generally accepted auditing standards (GAAS)." *Decker*, 7 Fed. Sec. L. Rep. (CCH) at 63,039.

415. The SEC asserted that Decker knew of the dismissal of the prior auditors, that the prior auditors had determined that the early consolidation of the acquisition violated GAAP, and that the prior auditors had not referred in their papers to a document supporting management's assessment (that might have suggested that the document had not existed during the earlier engagement). *Id.* Moreover, Decker had telephoned the engagement partner of the dismissed auditing firm "who expressed skepticism about the date [this key document] was created." *Id.*

> shareholders of the acquired company, MRB. He never communicated any doubt about the authenticity of the document to Chancellor's audit committee.[416]

With respect to a large consulting fee paid to Vestrex Capital Corp.,[417] Decker was aware of the deficiencies in supporting documentation supporting the treatment of that transaction. He "raised the issue with Davis, the engagement partner, but took no further action when Davis did nothing. Decker . . . took no action to determine the correct accounting treatment [and] signed off as impartial review manager, indicating that the audit comported with GAAS."[418] The SEC faulted Decker for failing to comply with GAAS,[419] for failing to exercise due professional care or obtain sufficient competent evidence to support the audit report,[420] for failing to critically assess documents he suspected were inauthentic,[421] for unreasonably relying on management's unsupported oral representations,[422] and for failing to report his suspicions to the audit committee.[423]

Fricke's misconduct was related to that of Decker, but involved different types of bad conduct. Fricke conducted no "research on the auditing requirements or accounting rules relevant to the issues noted in the audit

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416. *Id.*

417. Vestrex was wholly owned by Chancellor's CEO, Adley. *See id.*

418. *Id.*

419. "GAAS requires that auditors conducting an audit exercise due professional care and maintain a proper level of professional skepticism. Auditing standards also require auditors to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion." *Decker*, 7 Fed. Sec. L. Rep. (CCH) at 63,041. Drawing on SAS No. 54, the SEC explained "[a]n auditor has a responsibility to perform an audit to obtain reasonable assurance that material misstatements in financial statements due to fraud are detected." *Id.* More important, the SEC was explicit in the conduct norm to be extracted from this duty: "If management does not provide satisfactory information that there has been no illegal act, GAAS requires additional audit steps to be performed." *Id.*

420. "He knew that management's insistence on a 1998 acquisition date resulted in a significant increase in reported revenues, so that heightened scrutiny of the date was needed. However, he failed to extend the audit procedures to confirm with the MRB shareholders the existence of control in 1998." *Id.*

421. "He did not even question anyone at Chancellor about the authenticity of the documents. In spite of his concern that the documents might have been fabricated by Chancellor's management, he relied on the documents as support for the 1998 acquisition date." *Id.*

422. "He knew that Chancellor's management had not responded to Davis' requests for documents evidencing the services for which the fees were charged." *Id.*

423. Decker, according to the SEC, failed to comply with GASAS "when he failed to report to Chancellor's audit committee the possibility that the company's senior management had fraudulently created the First Amendment." *Decker*, 7 Fed. Sec. L. Rep. (CCH) at 63,041.

workpapers."[424] Aware of the disagreements about the subsidiary acquisition date, "Fricke relied on the conclusions of Davis and Decker, although he either knew *or was reckless in not knowing* that audit procedures had not been extended to resolve the significant audit issues documented in the workpapers."[425] With respect to the accounting for the Vestrex fee, Fricke, knowing of a prior-year reversal of the accounting treatment of those fees, "simply asked Davis if there were any significant related-party issues that he needed to address and accepted assurance that there were none."[426] Compounding Fricke's derelictions was his decision not to question the decision to capitalize the Vestrex fee without doing research to determine whether capitalization in that context was consistent with GAAP.[427] As a result, Fricke failed "to make an objective independent review of material accounting, auditing or reporting issues to ensure conformance with GAAP and GAAS."[428] He was reckless in not uncovering through his review of the workpapers the problem regarding the subsidiary acquisition date,[429] and in failing to review related party transactions in a manner consistent with its identification as a high-risk audit area.[430] Fricke's conduct amounted to a failure to exercise due professional care.[431]

The SEC asserted that this wrongful conduct constituted willful violations of Section 10A(a)(1)[432] and Section 10A(b)(1).[433] In addition, their conduct, by causing the corporation to file materially misleading forms, constituted a violation of Section 13(a) of the 1934 Act and Rules 12b-20 and 13a-1 thereunder.[434] For their trouble, both men were subject to an order to

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424. *Id.* at 63,040.

425. *Id.* (emphasis added).

426. *Id.*

427. *See id.*

428. *Id.* at 63,041.

429. *See Decker*, 7 Fed. Sec. L. Rep. (CCH) at 63,041-42.

430. *See id.* at 63,042.

431. According to the SEC characterization:

> He [Fricke] failed to observe the standards of reporting. As concurring reviewer, Fricke knew or was reckless in not knowing that insufficient audit evidence had been obtained to support an unqualified opinion. He failed to maintain a proper level of professional skepticism; failed to obtain sufficient competent evidential matter through inspection, observation, inquiries and conformations to afford a reasonable basis for an opinion regarding the financial statements under audit; and failed to obtain sufficient evidence to understand the purpose, nature, extent and financial statement effect of related-party transactions.

Id.

432. This violation related to the failure to design appropriate audit procedures. *See id.*

433. This violation related to the failure to inform Chancellor's audit committee of suspected fraud by senior management. *See id.*

434. *See id.*

cease and desist, and denied the privilege of appearing and practicing before the SEC.[435]

The SEC sought to find liability against another set of auditors under Section 10A in litigation revolving around a questionable recognition of revenue.[436] Again, the assertion of liability was based on a charge that the audit partner, in this case Glenn Ohlhauser, failed to act aggressively enough in connection with a questionable accounting practice.[437] The case is particularly interesting because Ohlhauser did not ignore the issue by any means. During the course of an engagement for GAAP reconciliation, Ohlhauser reviewed documentation related to the recognition of certain license fees and concluded that recognition of revenue was inappropriate for the quarter desired by Solucorp.[438] Ohlhauser informed Solucorp's CFO, Victor Herman, of this conclusion by a memo dated December 18, 1997.[439] Despite further discussion about the timing of income recognition between Ohlhauser and Herman, Ohlhauser thought it necessary to send a copy of the memo to Solucorp's outside counsel.[440] At that point, Herman requested that MacKay cease all work with respect to the September 30, 1997 financials, with the exception of completing the reconciliation to United States GAAP.[441] When, shortly thereafter, Solucorp changed its fiscal year-end, it continued to insist on recognition of revenue items.[442] Ohlhauser wrote to Herman in February 1998 about his continuing concerns and requested copies of backup documentation.[443] After reviewing the documentation, Ohlhauser again wrote to Herman to express continuing concern about Solucorp's recognition of

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435. *See Decker*, 7 Fed. Sec. L. Rep. (CCH) at 63,042. Decker was permitted to seek reinstatement after three years, Fricke after two. *See id.*; *see also* 17 C.F.R. § 201.102(e) (2003).

436. *See* SEC v. Solucorp Indus. Ltd., 274 F. Supp. 2d 379 (S.D.N.Y. 2003) [hereinafter *Solucorp I*].

437. *See Solucorp I*, 274 F. Supp. 2d at 404. Ohlhauser, a Chartered Accountant licensed in British Columbia, was a partner in the accounting and auditing firm of MacKay and Partners LLP (MacKay) from late 1996 through 1999. *See id.* at 404. In addition, Ohlhauser was the partner in charge of auditing Solucorp's financial statements for several years. *See id.* Ohlhauser was hired by Solucorp "to reconcile [Solucorp's financial] statements with United States GAAP for inclusion in [an] SEC filing." SEC v. Solucorp Indus., Ltd., 197 F. Supp. 2d 4, 5 (S.D.N.Y. 2000) [hereinafter *Solucorp II*].

438. *See Solucorp I*, 274 F. Supp. 2d at 405.

439. *See id.*

440. *See id.* at 406. Ohlhauser reiterated his objections in a conference call between him, Herman, and outside counsel. *See id.*

441. *See id.*

442. *See id.* at 409.

443. *See id.*

income from that transaction,[444] and thereafter wrote a memorandum distilling his concerns.[445] In addition, Ohlhauser expressed significant concerns about the collectibility of the income recognized.[446] Despite these concerns, Ohlhauser expressed an unqualified audit opinion on Solucorp's financial statements for the six-month transition period.[447] The SEC alleged that this conduct, constituted a breach of Ohlhauser's duty under Section 10A(b)[448]—that is, he failed to report his concerns to the audit committee of Solucorp's board, or to the board of directors (and the SEC) in the face of Herman's failure to take appropriate remedial action.[449] Clearly, from the SEC's perspective, passivity and staying behind the scenes will no longer serve as a basis for avoiding liability to the government. The SEC requires more of an auditor than the customary sort of discrete detect and report

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444. Ohlhauser wrote to Herman in March 1998, explaining that the documents he was shown were not referred to in prior SEC filings and it appeared that the agreement "ha[d] been 'backdated' and I don't know exactly how you reconcile this with information contained in the first 10-KSB." *Solucorp I*, 274 F. Supp. 2d at 409.

445. *See id.* at 409. Ohlhauser explained:

> During the course of Dec/97 audit we were now presented with final Smart agreement which was dated September 15, 1997. Because we never saw it before, we suspect that this was actually backdated and more likely actually signed sometime after the 10-SB filing. . . . I don't think revenue can be recognized before agreement is signed, even if agreement supposedly started earlier.

The opinion noted that there was disagreement among the parties as to whether the memorandum was sent by Ohlhauser or received by the audit firm in the U.S. to which it was sent. *See id.* at 409.

446. "Ohlhauser received information from Smart on March 4, 1998 as to amounts paid and owed. . . . However, Herman refused Ohlhauser's request to obtain financial statements from Smart, statements that, if obtained, would have revealed that as of March 31, 1997, Smart was dormant and had only minimal assets." *Id.* at 411 (citation omitted). Ohlhauser stated that he had no information on the ability of Smart to pay amounts owing. *See id.*

447. *See id.* at 412.

448. Section 10A(b) essentially required Ohlhauser, in this case, to determine whether an illegal act had occurred, inform the appropriate level of management and the audit committee of the company with respect to the illegal act, and in the event that the accountant determined that an illegal act would have a material effect on the company's financial statements, senior management had failed to take appropriate remedial action, and the failure to take remedial action was reasonably expected to warrant a departure from a standard report or warrant resignation from the engagement. *See* 15 U.S.C. § 78j-1(b)(1)-(2) (2000).

449. As the court explained in denying Ohlhauser's motion to dismiss:

> [The] SEC contends that Ohlhauser violated § 10A(b)(1) because he was aware of information that Solucorp and Smart illegally backdated the License Agreement in order to improperly recognize revenue. They allege that, contrary to the strictures contained in § 10A(b)(1), he failed to adequately investigate whether an illegal act had occurred and failed to apprise management and assure that the audit committee was made aware of his concerns.

Solucorp II, 197 F. Supp. 2d at 11.

behavior so well described in *Solucorp*. Gently voicing suspicion to the CFO, accepting inaction on management's part, and then "going along" with management's position (with a file copy of any writing as a fetish to protect against liability) is insufficient. An auditor must more aggressively seek out illegal conduct, an auditor must more clearly report his findings to management and the board, and an auditor must report his suspicions to the state under certain circumstances (now more broadly interpreted to include more circumstances than it did before). Monitoring by auditor gatekeepers requires more than that now—and the obligation is owing to (in part) and enforceable by (in part) the state.

The sort of more aggressive stance now in accord with SEC conceptions of "good auditor conduct" is also suggested in recent cases. An excellent example is found in the SEC's allegations in Chancellor.[450] While Decker, Fricke and their auditing form provide a model for conduct leading to liability under the securities laws, Chancellor's original auditors, Reznick Fedder and Silverman serve as a model of appropriate auditor conduct.[451] In February 1999, Reznick Fedder informed Chancellor's management that it thought that an August 1998 consolidation of Chancellor and MRB's financial results was not in conformity with GAAP.[452] Reznick Fedder found the terms of a management agreement allegedly falsely backdated to August 1998, as insufficient to support an early consolidation. The auditing firm described its position in a memo to Chancellor's audit committee,[453] and at a meeting of the board of Chancellor thereafter.[454] When soon after these presentations Reznick Fedder was first presented with additional documentation that appears to meet its objections,[455] they "were skeptical about the document's authenticity and continued to insist that Chancellor account for the MRB acquisition as of January 1999."[456] They were fired when they continued to resist approval of an early consolidation.[457] Finally after Chancellor filed a misleading Form 8-K in which the corporation failed to disclose the disagreement with its now fired

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450. *See Chancellor* Complaint, *supra* note 9.

451. *See id.* at ¶¶ 22-30, 43.

452. *See id.* at ¶ 23.

453. *See id.* at ¶ 25.

454. *See id.* "To support its position, Reznick Fedder gave Adley and Volpe [the acting CFO] accounting literature that outlined the criteria that had to be satisfied in order for Chancellor to consolidate properly MRB's 1998 financial results with its own." *Id.*

455. The SEC alleged that this document, a First Amendment to the management agreement, was created by Volpe at the command of Adley. *See Chancellor* Complaint, *supra* note 9, at ¶ 26.

456. *See id.* at ¶ 28.

457. *See id.*

auditors over the consolidation date,[458] Reznick Fedder "filed a letter with the Commission reporting the firm's disagreement with Chancellor's accounting treatment of the MRB acquisition."[459]

The gatekeeper obligations of lawyers emerge more subtly from the cases. On the one hand, the SEC's new rules create a greater detect and report burden on lawyers, enforceable by the state.[460] There are no cases yet enforcing the SOX section 307 regulations, but there may be a hint of things to come in *Solucorp*.[461] Interestingly enough, in that case, the SEC chose to go after the auditors but not the lawyers. My sense is that had the facts of *Solucorp* occurred after the effective date of the SOX section 307 regulations, Solucorp's lawyers as well as its gatekeepers might have faced liability for failure to detect-and-report. [462]

On the other hand, the regulations may be more effective in their monitoring aspect by encouraging voluntary disclosure to heighten the likelihood that very risk-averse law firms will not be charged along with their clients for violation of the securities laws. The Enron litigation opens a small window on emerging SEC expectations in a case with admittedly extreme facts.[463] One of Enron's lawyers, Vinson and Elkins, might face liability as a principal.[464] Another of Enron's lawyers, Kirkland and Ellis, avoided potential liability on this ground.[465] The court rejected Vinson and Elkins argument that its role in Enron, a role traditionally adopted by corporate counsel to avoid characterization as a principal, could not shield it from liability in this case.

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458. *See id.* ¶ 41.

459. *Id.* at ¶ 43. To compound matters, Chancellor thereafter filed a Form 8-K/A that suggested that Reznick Fedder's position was merely preliminary and that "falsely stated that Reznick requested additional information pertinent to the consolidation date only after it was dismissed." *Id.*

460. For a more detailed discussion of the scope of those obligations, *see* Backer, *supra* note 56, at 939-50, 964-74.

461. *See Solucorp I*, 274 F. Supp. 2d 379.

462. Recall that in *Solucorp*, Ohlhauser had reported his concerns about the early recognition of revenue from the purported agreement both in writing and in a telephone call to Solucorp's outside counsel. *See id.* at 409. At that point, it is likely that the obligation to report up the ladder would have been triggered under the regulations. *See* 17. C.F.R. § 205.3(b). Outside counsel's failure to report to the general counsel, and then to audit committee or board of directors would have triggered a violation. Outside counsel's continued representation of Solucorp in the face of an inadequate response would have exposed outside counsel both to liability under the detect and report provisions of the SOX Section 307 regulations, and to liability as a principle in Solucorp's scheme to defraud stakeholders. *See infra* notes 394-402 and accompanying text.

463. *See In re* Enron Corp. Sec., Derivative and ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

464. *See In re Enron*, 235 F. Supp. 2d at 704-05.

465. *See id.* at 705-06.

Vinson and Elkins, like Ohlhauser in *Solucorp*, knew too much too early in the course of the corporate client's conduct to permit the law firm to continue to perform services for the client as if nothing was happening:

> Vinson & Elkins was necessarily privy to its client's confidences and intimately involved in and familiar with the creation and structure of its numerous businesses, and thus, as a law firm highly sophisticated in commercial matters, had to know of the alleged ongoing illicit and fraudulent conduct. Among the complaint's specific allegations of acts in furtherance of the scheme are that the firm's involvement in negotiation and structuring of the illicit partnerships and off-the-books SPE's, whose formation documentation it drafted, as well as that of the subsequent transactions of these entities. It advised making Kopper manager of Chewco so that Enron's involvement in and control of the SPE would not have to be disclosed, drafted "true sales" opinions that Lead Plaintiff asserts were essential to effect many of the allegedly fraudulent transactions. Vinson & Elkins was materially involved in the New Power IPO, and it structured and provided advice on the Mahonia trades, all actions constituting primary violations of § 10(b).[466]

Moreover, Vinson and Elkins' behind-the-scenes-advisor defense was undercut, according to the court, because Vinson & Elkins did not remain absolutely in the background and absolutely silent. Vinson and Elkins "deliberately or with severe recklessness" directed a number of public statements, alleged to be fraudulent, "to potential investors, credit agencies, and banks, . . . in order to influence those investors to purchase more securities, credit agencies to keep Enron's credit high, and banks to continue providing loans to keep the Ponzi scheme afloat."[467] In contrast, Kirkland and Ellis avoided primary liability because none of its statements or writings were "drafted for any public disclosure or shareholder solicitation."[468] Duty under the new SOX section 307 detect and report regulations, combined with obligations relating to any document distributed to the public or filed with the SEC, create in lawyers, very much like it created with auditors (under Section 10A of the 1934 Act), obligations to avoid sitting back and permitting management to have its way.

But these provisions require disclosure to the public, not necessarily to the state. SOX section 307 regulations, however, provide protection for

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466. *Id.* at 704.

467. *Id.* at 705.

468. *Id.* at 706. Kirkland and Ellis, though, might have acted with significant conflicts of interest, according to he court. Id. But those activities were between client and lawyer, rather than Kirkland and Ellis and others. *See id.*

voluntary disclosure to the state.[469] The fear of primary liability has likely provided a greater incentive for risk-averse lawyers to over-comply with SOX section 307's detect and report obligations than the mandatory provisions of the regulations. At the end of 2003, in what appears to be the first use of this voluntary disclosure provision by an American law firm, Akin Gump Strauss Hauer and Field reported to the board of directors its concerns about certain related party transactions within the corporate group and withdrew as counsel "to the company on a pending bond offering and [indicated] that it might notify the Securities and Exchange Commission of its withdrawal and the reasons for it."[470] The letter to the board apparently cited, among other things, SOX section 307.[471] In a sense, Akin Gump appears to be treating the voluntary disclosure provisions of the SOX section 307 regulations in the same way that the SEC now expects auditors to use the mandatory disclosure provisions of Section 10A of the 1934 Act. In either case, disclosure to the government is meant to forestall governmental charges that the gatekeeper either failed in its detect and report obligations, or, by continuing in the service of a management whose conduct might be subject to liability, to be open to treatment as a principal in management's unlawful activities. Where even the mere allegation that a law firm might be involved in the fraudulent schemes of its clients, or otherwise failed in its monitoring duties imposed by law, can

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469. 17 C.F.R. § 205.3(d)(2) provides that:

> An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary: (i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; (ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or (iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

Id. The detect-and-report to the government provision is reinforced with a protection against liability. "An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices." 17 C.F.R. § 205.6(c).

470. Patrick McGeehan, *Lawyers Take Suspicions on TV Azteca to Its Board*, N.Y. TIMES, Dec. 24, 2003, at C1. The article also noted that "[i]n his Dec. 12 letter, Mr. Scheinman said that 'we reserve the right to inform the S.E.C. of our withdrawal and the reasons therefore.' Those reasons were that Akin Gump had decided that the company had not told investors enough about" a series of related party transactions. *Id.* at C3.

471. *See id.*

have a substantial detrimental effect on the firm's reputation (and thus its business), law firms may tend to err on the side of disclosure rather than risk loss of reputation (and business).[472]

Inside the corporation, the independent director is increasingly assuming the role of internal gatekeeper. Independent members of the audit committee fare little better under the SEC's view as expressed in the *Chancellor* litigation. A case in point is the SEC's position with respect to Michael Marchese, an independent member of Chancellor's audit committee.[473] Again, the standard emerging is one of aggressive positive inquiry. The SEC took the position that Marchese failed to do enough.[474]

What did Marchese do? "Marchese did not seek re-election as a director in 1999. He ceased to be a director of Chancellor on June 25, 1999. In August 1999, Marchese wrote a letter to the Commission staff expressing concern about Chancellor's financial reporting."[475] Clearly, for the SEC, a director fails in his duty under federal securities laws (and consequently makes himself accountable to federal regulators) if he resigns and reports. Something more is needed.

What did Marchese do wrong; why was what he did insufficient to avoid liability, at least according to the SEC? First, Marchese participated in the firing by the board of directors of Chancellor's original auditors after the auditors advised Adley that the treatment of the acquisition of a subsidiary by Chancellor did not comport with GAAP.[476] He signed off on the replacement auditing firm's determination that a method of accounting for the acquisition,

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472.

> Outside counsel who participate in the creation and marketing of fraudulent devices, and outside counsel who discover evidence of potential fraud in the construction, marketing, explanation, or disclosure of corporate actions and fail to report such evidence to management, or fail to distance themselves from those schemes after reporting, face a heightened likelihood that their conduct could give rise to an inference of scienter necessary to maintain an action against them as primary violators.

Backer, *supra* note 56, at 991.

473. *See In re* Michael Marchese, 7 Fed. Sec. L. Rep. (CCH) ¶ 75,424 (Apr. 24, 2003), *available at* http://www.sec.gov/litigation/admin/34-47732.htm (last modified Apr. 25, 2003). Marchese was described by the SEC as an acquaintance of Adley, the Chancellor CEO. Marchese became an outside director of Chancellor in 1996 and served on the audit committee from 1996 to 1999. *See Marchese*, 7 Fed. Sec. L. Rep. (CCH).

474. According to the SEC: "Marchese failed to perform his duties as a director. He recklessly ignored signs pointing to improper accounting treatment, thereby allowing management's fraud to continue. He acted recklessly in signing Chancellor's Form 10-KSB for 1998, which contained materially misleading statements." *Id.* at 63,045.

475. *Id.* at 63,047.

476. *See id.* at 63,045-46.

disputed by the fired auditors, conformed to GAAP.[477] Lastly, he made no effort to question the inclusion of a particular accounting treatment of related party transactions where similar treatment in a prior year had been reversed.[478] Marchese violated Section 10(b) and Rule 10b-5, as well as Section 13(a) and Section 13(b)(2)(A) of the 1934 Act, according to the SEC, when he signed Chancellor's 1998 Form 10-KSB.[479] Marchese violated Section 13(b)(2)(B) by failing to determine the reasons for the accounting disputes and whether there were in place sufficient internal controls to ensure accurate financial reporting.[480] By the time Marchese left the Board of Directors and reported his misgivings to the SEC, it was too late.[481]

What should Marchese have done other than resigning and reporting? Marchese should have engaged in a substantially greater amount of due diligence before signing any report filed with the SEC. The SEC was

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477. *See id.* at 63,046.

478. *See id.* at 63,046-47.

479. At the time of his execution of that form, Marchese:

> knew that the Form 10-KSB reflected a 1998 MRB acquisition date. He also knew that Chancellor's original audit firm had been fired, with his approval, due in part to its disagreement with the 1998 date. Nevertheless, he recklessly failed to make any inquiry into the circumstances leading to the new audit firm's approval of a 1998 MRB acquisition date, or whether it was correct. In addition, Marchese knew that in the previous year Chancellor had written off $1.14 million in related-party fees to Adley entities. However, he recklessly failed to make any inquiry into the basis for the reported $3.3 million in fees payable to an entity owned by Chancellor's CEO which were included in Chancellor's 1998 Firm [sic] 10-KSB. Marchese failed to make any inquiry into the existence of documents substantiating the services for which the fees were purportedly due.

Marchese, 7 Fed. Sec. L. Rep. (CCH) at 63,047. In addition, and with specific reference to section 13(b)(2)(A) and Rules 12b-20 and 13a-1, Marchse was:

> [R]eckless in not knowing that Chancellor's Form 10-KSB for 1998 contained materially misleading statements. Further, he signed Chancellor's Form 10-KSB for 1998 without making inquiry into the basis for the reported fees payable to Adley's company or the basis for the new audit firm's approval of the 1998 MRB acquisition date.

Id. at 63,048.

480. As summarized by the SEC:

> He never attempted to determine the reason for Chancellor's varying accounting treatments of the MRB acquisition and related fees to Vestex, and whether these demonstrated a lack of internal controls to ensure accurate financial reporting and prevent improper transfers to related parties. Marchese never reviewed Chancellor's accounting procedures or determined whether in fact there were any internal controls.

Id.

481. As a result, and following the settlement offer submitted by Marchese, the SEC imposed a cease-and-desist sanction pursuant to Section 21C of the 1934 Act. *See id.*

especially critical of what, in the state law context, would sound like claims for breaches of a duty of care:

> Marchese's dereliction of his duty as an outside director is more broadly reflected in his complete failure ever to review Chancellor's accounting procedures or internal controls, or even to become aware that he was an audit committee member, and his total deference to CEO Adley. Marchese completely failed to exercise any oversight over Chancellor's financial reporting, *exercising no care* to ensure that the company had appropriate internal controls and that its financial records were accurate. He acquiesced in Adley's complete control of accounting decisions, including those relating to payments to Adley's own companies.[482]

This evaluation is striking for the way it mimics traditional state court discourse of a director's state law fiduciary duties—especially the duty to monitor.[483] The effect, perhaps, points to the consolidation by the SEC of a (new) law of federal fiduciary duty, tied not to satisfaction of the needs of shareholders, but instead, tied to compliance with the reporting requirements demanded by federal law.[484] Indeed, in the SEC's own press release about the commencement of the action against another independent director of

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482. *Id.* at 63,045-46 (emphasis added).

483. For the classic rendition, see *Francis v. United Jersey Bank*:

> In certain circumstances, the fulfillment of the duty of a director may call for more than mere objection and resignation. Sometimes a director may be required to seek the advice of counsel . . . concerning the propriety of his or her own conduct, the conduct of other officers and directors or the conduct of the corporation.

432 A.2d 814, 823 (N.J. 1981). Indeed, the SEC seems to have adopted as its own touchstone for liability the New Jersey court's admonition, in the context of state duty of care norms, that the "sentinel asleep at his post contributes nothing to the enterprise he is charged to protect." *Francis*, 432 A.2d at 822.

484. Indeed, in the Chancellor litigation against Rudolph Peselman, another outside director (1996-2001) and member of the Chancellor audit committee (1999-2001), the SEC made assertions that closely parallel the breach of (federal) fiduciary duty claims asserted against Marchese in the cease and desist proceedings. The SEC alleged that

> Peselman had completely neglected to fulfill his duties as a director and as an audit committee member. He failed to oversee Chancellor's financial reporting, exercising no care to ensure that the company had appropriate accounting procedures and internal controls and that its financial records were accurate. In fact, he acquiesced in Adley's complete control of accounting decisions, including those relating to payments to Adley's own company Vestex.

See Chancellor Complaint, *supra* note 9.

Chancellor, the SEC described the federal action as predicated in part on that director's breach of his fiduciary duty.[485]

The cases emphasize the extent to which officers and employees have become an object of a diffuse duty to monitor. Chancellor emphasizes the need for strict surveillance by gatekeepers and independent directors. In that case the CEO and Chairman of the Board of Directors was able to use his influence over other officers to engage in forgery and deceit to perpetuate financial fraud.[486] In *Solucorp*, auditor gatekeepers confronted a management desperate to recognize revenue from a questionable source. Unchecked, Solucorp's management would have continued to perpetuate its fraud on stakeholders. Lastly, Enron exemplified a corporation many of whose officers were out of control—and which relied, in the final analysis, on whistle-blowing by non-officer employees, to begin the process of disclosure that unraveled management's alleged financial misdeeds.[487] Each of these cases serves as a reminder of the need for surveillance, and the principal object of that surveillance.

In another sense, the cases amplify trends of the last decade, trends that have sought to impose more strictly a culture of surveillance within the workplace and for the benefit of stakeholders—and the state.[488] The incentives

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> According to the suit, Peselman, a member of the Board of Director's Audit Committee from June 1999 to October 2001, violated antifraud provisions of the securities laws by signing a number of false financial statements and, as an outside director with fiduciary responsibilities, by ignoring clear warning signs that financial improprieties were ongoing at the company. . . .

SEC v. Brian Adley, 7 Fed. Sec. L. Rep. (CCH) ¶ 75,423, *available at* http://www.sec.gov/litigation/litreleases/lr18104.htm (last modified June 3, 2004).

486. See discussion *supra*, 379-393.

487. Sherron Watkins, one of the principal whistle-blowers in the Enron story, was quite specific in laying blame:

> Sherrin [sic] Watkins, the Enron whistleblower that testified before the committee Thursday, said two top Enron executives in particular were accountable for Enron's collapse and for duping its CEO Kenneth Lay: former Enron chief executive Jeffrey Skilling and CFO Andrew Fastow. In addition, Watkins said other culprits included the company's auditor, U.S. firm Arthur Andersen, its lawyer, Vinson & Elkins, its chief accounting officer Richard Causey and treasurer Ben Glisan.

AICPA Chairman Calls for Reform, SMARTPROS (Feb. 15, 2002), *at* http://www.smartpros.com/x32989.xml. Ms. Watkins has produced her side of the story in book form. *See* MIMI SWARTZ & SHERRON WATKINS, POWER FAILURE: THE INSIDE STORY OF THE COLLAPSE OF ENRON (2003).

488. The position taken by the justice department is telling in this respect. *See* Memorandum from Larry D. Thompson, Depurty Attorney Gen., to U.S. Attorneys: Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm [hereinafter Thompson Memorandum].

are particularly well revealed in two of the general principles to be used to determine whether to charge a corporation. The first is "pervasiveness of wrongdoing within a corporation."[489] The second is "cooperation and voluntary disclosure."[490] Together, both can be effectively utilized by a corporation only if it has in place fairly pervasive systems of surveillance. "Compliance programs are established by corporate management to prevent and to detect misconduct and to ensure that corporate activities are conducted in accordance with all applicable criminal and civil laws, regulations, and rules. The Department encourages such corporate self-policing, including voluntary disclosures to the government of any problems that a corporation discovers on its own."[491] Indeed, whatever the legal requirements for monitoring in state law, a corporation is penalized for failure to create and

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489. *Id.* at II A.2. The principle provides:

> Charging a corporation for even minor misconduct may be appropriate where the wrongdoing was pervasive and was undertaken by a large number of employees or by all the employees in a particular role within the corporation, *e.g.*, salesmen or procurement officers, or was condoned by upper management. On the other hand, in certain limited circumstances, it may not be appropriate to impose liability upon a corporation, particularly one with a compliance program in place, under a strict *respondeat superior* theory for the single isolated act of a rogue employee. There is, of course, a wide spectrum between these two extremes, and a prosecutor should exercise sound discretion in evaluating the pervasiveness of wrongdoing within a corporation.

Id. at IV A. The comments suggest that "[o]f these factors, the most important is the role of management. . . . [A] corporation is directed by its management and management is responsible for a corporate culture in which criminal conduct is either discouraged or tacitly encouraged." *Id.* at IV B.

490. The principle provides:

> In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation may be relevant factors. In gauging the extent of the corporation's cooperation, the prosecutor may consider the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection.

Id. at IV A.

491. *Id.* at VII A.

> [T]he Department, in conjunction with regulatory agencies and other executive branch departments, encourages corporations, as part of their compliance programs, to conduct internal investigations and to disclose their findings to the appropriate authorities. Some agencies, such as the SEC . . . have formal voluntary disclosure programs in which self-reporting, coupled with remediation and additional criteria, may qualify the corporation for amnesty or reduced sanctions.

Thompson Memorandum, *supra* note 488, at IV B.

effectively manage a system of surveillance.[492] The Justice Department explained that:

> [T]he existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for criminal conduct undertaken by its officers, directors, employees, or agents. Indeed, the commission of such crimes in the face of a compliance program may suggest that the corporate management is not adequately enforcing its program.[493]

The character of the culture of surveillance has expanded beyond its narrow legal confines not only in the hands of the Justice Department, but with the SEC as well. A position recently threatened by the SEC appears to evidence a particularly interesting turn in that regard. The government appears to reject the notion that compliance with the formal requirements of the substantive standards need always provide a good defense to violation either of the disclosure rules or the "detect and report" rules.[494] This issue may be at the core of part of the litigation spawned by Enron. Richard Causey, Enron's Chief Accounting Officer was indicted in January 2004, on six counts of

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492. As the comments suggest:

> While the Department recognizes that no compliance program can ever prevent all criminal activity by a corporation's employees, the critical factors in evaluating any program are whether the program is adequately designed for maximum effectiveness in preventing and detecting wrongdoing by employees and whether corporate management is enforcing the program or is tacitly encouraging or pressuring employees to engage in misconduct to achieve business objectives.

Id. at VII B.

493. *Id.* at VII A.

494. As I explained elsewhere:

> Lawyers and accountants have tried to recast both the SOA section 307 regulations and the detect-and-report obligations under section 10A as species of re-articulations of understandings within already existing provisions. Compliance with some sort of very narrowly defined set of obligations under this view will ensure protection both from liability under the respective gatekeeper provision and from liability as principal wrongdoers. Thus reduced in scope and thrust, auditors and lawyers would appear to have nothing more than the obligation to report to management those fairly substantial items of evidence of wrongdoing that they might encounter by chance. Serendipity can thus reward sophisticated guile on the part of management, or at least provide lawyers and auditors with the defense of management guile whenever liability is asserted.

Backer, *supra* note 56 (citing Jeffrey W. Stempel, *The Sarbanes-Oxley Act: Lawyer Professional Responsibility, and a Heightened Role for Business Lawyers,* NEV. LAW., Mar. 2003, at 8). Accountants have sought to defend against action by the SEC on similar grounds. *See, e.g., Solucorp II*, 197 F. Supp. 2d at 10; *In re* Sunterra Corp. Sec. Litig., 199 F. Supp. 2d 1308, 1321 (M.D. Fla. 2002); *In re* Sunbeam Sec. Litig., 89 F. Supp. 2d 1326, 1337 (S.D. Fla.1999).

fraud.[495] Causey will posit a technical defense to the charges—"that he followed the GAAP rules. . . . Whatever Enron did was blessed by Andersen and its myriad lawyers."[496] The government appears to be ready to use the Causey case to litigate the issue of the sufficiency of bare GAAP compliance as a defense to a fraud action.[497]

Disclosure, thus, is not merely a system of observation and reporting. It is the tip of an iceberg of complex power interactions. Privatization shifts power to the state while shifting the obligations of power to the individuals deputized. Gatekeepers have to actively investigate and report suspected illegal activities, broadly defined. Independent directors may not rely on officers without independent verification. Always suspicious, directors must oversee a system of monitoring reasonably calculated to ferret out wrongdoing. Within this system, employees are encouraged to report any wrongful activity—and are protected from retaliation to some extent. Auditor gatekeepers are required to report to the government under certain circumstances and will be punished if they fail in their duty. Lawyers are required to report to independent directors and are encouraged to report to the government as well. Lawyers will be punished where they do neither. Lawyers who complain and do little else may find themselves lumped together with corporate officers as principles in schemes to commit financial fraud. And at the center of this web is the government.

> The SEC is sometimes referred to as Wall Street's "top cop." While this characterization may be accurate, it vastly oversimplifies the system of public and private enforcement that operates to protect our markets. The SEC is charged with the civil enforcement of laws and rules which are intended both to protect investors and promote the efficient formation of capital. But the Commission is just one piece of a larger mosaic. There's the Department of Justice, which has jurisdiction to bring criminal prosecutions of the federal securities laws; the self-regulatory organizations, such as the NASD and NYSE, which regulate the financial services community; state

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495. *See* Dan Ackman, *Causey May Put GAAP on Trial*, FORBES (Jan. 23, 2004), *at* http://www.forbes.com/work/2004/01/23/cx_da_0123topnewse.html. The actions against him center on the accounting for the off-the-book partnerships set up by Enron, partnerships which the government asserts were at the core of Enron's scheme to misstate its financial position and defraud investors.

496. *Id.* The technical issue will revolve around the validity of a judgment that, though the use of cross-investment by related off-the-books partnerships was morally or ethically suspect as it might lead people to misperceive the financial condition of Enron, the practice was technically permitted under GAAP.

497.

> But there has long been a broader view of accounting that even the technically legal can be fraudulent and illegal if the net effect is to defraud. . . . If the U.S. government were to use the Causy case to push that idea—and not just quibble about technicalities—that might give some real special purpose to the Enron affair.

Id.

> prosecutors and a variety of state agencies, which oversee compliance with comparable state securities laws; and finally, an active plaintiffs' securities bar. Even this array of watchdogs, however, might be hard pressed to stand at every street corner of our markets. There are more than 14,000 public companies, 7,900 broker-dealers, and 34,000 investment company portfolios. That's why, *through a network of statutes, regulations, and judicially imposed theories of liability, lawmakers and others have conspired to press another group of players into the service of protecting our markets*. These players are sometimes referred to as "gatekeepers"—gatekeepers who control the access of companies to our capital markets, and through them the hearts, minds, and pockets of investors. They include, among others, auditors, attorneys, analysts, and boards of directors.[498]

The connection between monitoring by private individuals and state power becomes clear.[499] The panopticism of disclosure "seem[s] to extend the general forms defined by law to the infinitesimal level of individual lives; or they appear as methods of training that enable individuals to become integrated into these general demands."[500] At the level of substantive conduct, disclosure works best as a system of confession. Confession produces punishment. At the level of procedural conduct, or gatekeeping, disclosure works as a system of self-discipline. Even the confessors confess for the benefit of their masters.

V. FROM THE CENTER OF THE PANOPTICON

We are now in a position to better draw insights about the future of corporate discipline and what that future reveals about the locus of power and power/policy relationships between the various participants in the corporate enterprise, the market, and the state. Panoptic systems of surveillance––grounded on spying and confession—produce transparency. But such systems produce more than "mere" transparency, understood as a passive ends of sorts. Instead, transparency serves as an instrument of power, registering "forms of behaviour, attitudes, possibilities, suspicions—a permanent account of individuals' behaviour."[501] It serves as a means of control. Such systems make it possible to adjust even the most minute forms of relationships between people, as well as the nature of obligatory systems of conduct.

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498. Stephen M. Cutler, Speech by SEC Staff: Remarks at the University of Michigan Law School (Nov. 1, 2002), *available at* http://www.sec.gov/news/speech/spch604.htm (emphasis added) (footnote omitted).

499. Scholars have begun to see the connection and suggest that the state action doctrine ought to be extended to cover individuals exercising delegated governmental power. *See* Gillian E. Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367 (2003).

500. FOUCAULT, *supra* note 1, at 222.

501. *Id.* at 214.

I have suggested that the ostensibly perfectly reasonable systems of surveillance, increasingly perfected in our age, may have effects other than those for the attainment of which the systems were installed. However, it is one thing to understand the nature of systems of surveillance, it is quite another to understand where the administrative power of surveillance has flowed. For that, too, has consequences. What emerges is a subtle shift of focus from markets to state and the deployment of mechanisms of market control in the new global war between organized political states and the emerging bands of sub-national (or anti-national) groups for global political power.

A. Shifting Power over Development of Normative Rules from Markets to the State

Financial scandals tend to bring regulation.[502] Well-documented examples have existed in the West since the 1700's.[503] Regulation tends to draw power away from systems of private or informal regulation and place them within formal and state-centered regulatory systems. What was true in the aftermath of the South Sea Bubble in England almost 300 years ago applied with equal force in the context of the great corporate reforms in Europe of the 19th century,[504] and the creation of the system of disclosure by the Americans during the 20th Century's Great Depression. SOX has a similar potential.

SOX and the actions of governmental regulators since its enactment have suggested a change in governance priorities. The mechanics of enforcement, so in evidence in SOX, may reflect the needs and priorities of constituencies other than market participants as much as it reflects a need to preserve the stability of investments in wealth producing markets. SOX makes it easier to see the contours of a regulatory environment in which the state sits as the ultimate board of directors of public companies. Fiduciary duties now seem to run to the state as much as they might run to corporate stakeholders. The

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502. For interesting discussion of this phenomenon, *see, e.g.*, Coates, *supra* note 42:

> When the finance sector moves into a sustained bear market or suffers from a sharp and confidence-impairing crash or break, federal elected officials have often felt pressure or seen an opportunity to propose new legislation to deal with whatever real or perceived problem caused the bear market or crash. Likewise, when financial fraud or scandal is uncovered by prosecutors or journalists, it attracts public attention, and politicians react by holding hearings and floating new bills.

Id. at 568.

503. *See, e.g.*, MALCOLM BALEN, A VERY ENGLISH DECEIT: THE SECRET HISTORY OF THE SOUTH SEA BUBBLE AND THE FIRST GREAT FINANCIAL SCANDAL (2002).

504. *See id.*

independent directors of Chancellor Corporation, charged with breach of federal securities fiduciary duties, might well be the tip of this iceberg.

Moreover, the notion of fiduciary duty itself, at least as it runs to the federal government, appears to be changing as well. It has grown from a set of shorthand rules for determining the contours of insider conduct, to a vehicle through which the great social contests over ethics can be naturalized within the economic sphere. Indeed, to a great extent, the substance of the changes has acquired a greater sense of ethical or moral urgency. Behavior rules for business are cloaked in more morally absolutist terms—more like the ethics of religion than the ethics of the marketplace. And in the construction of a quasi-religion of economic conduct, a priestly caste is needed. The bureaucratic state provides the modern apparatus of priesthood, combining the theology of democratic governance with a set of ethics and morals of behavior.[505] Transparency provides the means of a ceaseless confession; punishment provides the means for reinforcing a power hierarchy in which the state, and not the actors in the market, determine the moral/legal culpability of non-state actors. Punishment becomes a public affair—no longer merely a means to compensate private parties wronged. It now serves the disciplinary purposes of the state.

I do not mean to suggest that the changes are necessarily a bad thing. The best form of governance is that which best accords with the desires of the subject population. However, I do mean to suggest that it represents a continuing change from past practice and these changes can have any number of unintended consequences throughout the social and economic order. Among the greatest consequences is the shift of power possible through adoption of this new regime—from private actors to the state as the ultimate regulator.[506] It is not clear to me that the best solution to great problems of public policy ought necessarily rely first on a resort to state power. Equalizing power among the great private interests most affected by enterprise behavior—shareholders, labor, creditors—and letting them sort out the character of their relationships with capital and management, might appear to provide an alternative. However, that alternative limits the power of the state to interfere. Where the consequences of private sorting may be economic and political instability, it is more, rather then less, likely that the state will seek to

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505. In this sense, the bureaucracy mimics the judiciary. For a discussion of the nature of judicial authority within the United States and the European Union, see generally Larry Catá Backer, *Retaining Judicial Authority: A Preliminary Inquiry on the Dominion of Judges,* 12 WM. & MARY BILL RTS. J. 117 (2003).

506. Indeed, critics of the new Sarbanes-Oxley regime note the shift SOX produces from reliance on market strategies to "curing" the "failures" of Enron and the like, to state-centered strategies. *See, e.g.*, Ribstein, *supra* note 32, at 47-48.

intervene—and to control.[507] It is also most likely in that case to impose systems of behavior designed to limit instability—even if doing so might inhibit optimal economic behavior.

These changes have not gone unnoticed.[508] Perhaps it is not surprising that the greatest losers of the current round of regulation have begun to decry regulatory changes. At the 2004 gathering of high corporate executives at the World Economic Forum, executives decried the trend toward fusion of morals and law. Executives expressed their criticism in economic terms—the new fusion is inefficient.

> [E]xecutives at the annual gathering of political and business leaders in the Swiss ski resort of Davos said a higher sense of moral responsibility at the boardroom level would be more effective than a rules clampdown.
>
> "Checking boxes and signing things won't solve integrity problems," said Daniel Vasella, Chief Executive Officer of Swiss drugs firm Novartis. . . . James Schiro, chief executive officer of insurer Zurich Financial Services . . . said holding executives accountable to higher moral principles would do more good than new rules.
>
> "Bad people make bad decisions," he said. "Ethical behaviour cannot be regulated, it cannot be imposed by legislation."[509]

Of course, ethical behavior *can* be imposed by legislation. However, fusing ethical and legal behavior returns us to an earlier, more theocratic age, where power over the body and soul was consolidated. It is this consolidation of power, rather than the inefficiencies of legislating ethics, that may cause executives of large multinational economic enterprises some concern, and the concern is not about the ethics—it is about the power.

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507. From the perspective of government, pre-SOX economic regulation produced an "'environment in which fraud and malfeasance have destroyed jobs and assets while chief executive pay goes up year after year.'" Thomas Atkins, *DAVOS—Business Leaders Reject Tougher Governance Rules*, FORBES, Jan. 25, 2004, *at* http://www.forbes.com/personalfinance/retirement/newswire/2004/01/25/rtr1225934.html. (quoting William Parrett, chief executive officer of Deloitte & Touche Tohmatsu USA).

508. *See, e.g.*, Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress, in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 495 (Nancy B. Rapoport & Bala G. Dharan, eds., 2004). Professor Paredes expresses discomfort with the one-size-fits- all approach of the legislative reforms in the wake of the financial scandals, and suggests that capital markets themselves might have forced a reconstitution of corporate governance in a manner permitting an appropriate amount of flexibility as determined by stakeholders in particular enterprises. "I am concerned that these reforms will do more harm than good by requiring companies to adopt a corporate governance structure that does not fit their business or governance needs." *Id.* at 502. I have suggested that the reforms may be efficient from the nation-state's perspective precisely because the reforms meet the state's needs—the needs of the regulated entities assume a more secondary importance.

509. *Id.*

Many of the trends evident in SOX and its related provisions would be enhanced under proposed legislation. The SEC is seeking enhancements of its authority to reach the assets of corporate and gatekeeper "wrongdoers" and to substitute for private litigation the federal government as a major source of restitution for violation of securities laws norms. The proposed Securities Fraud Deterrence and Investor Restitution Act of 2003[510] would have made it harder for people to shelter assets from SEC levy by claiming homestead or other exemptions under the Bankruptcy Code, permitted the SEC to seek penalties in cease and desist proceedings, significantly increased the amount of civil penalties that could be assessed, obtain financial records without notice to the owners thereof, permitted lawyers to waive the attorney-client privilege in government investigations without waiving the privilege in private party actions, made it easier to obtain information from grand jury proceedings, provided for nationwide service of civil trial subpoenas, permitted privatization of debt collection, and expanded the Fair Funds provisions.[511]

The trends do not merely affect power balances between public and private sectors. Consolidation in the hands of government—an institution that has a far greater number and variety of stakeholders than a corporate firm—carries with it a number of other efficiency concerns.[512] The first is the problem of cross-subsidization. Much like the old (pre-1980s) telephone company would distort its pricing structure so that one aspect of its business would subsidize another,[513] so the state is likely to engage in cross-subsidization in furtherance of policy goals which may not produce optimal economic effects for the affected companies. For example, the protection of the integrity of the markets is not undertaken for the sake of the markets but as a matter of state policy requiring a certain amount of stability in capital and labor markets to forestall political instability. Market regulation may be instituted to further the goal of income redistribution—up or down. Markets

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510. H.R. 2179, 108th Cong. (2003).

511. *See id. See also* Stephen M. Cutler, Testimony Concerning The Securities Fraud Deterrence and Investor Restitution Act, H.R. 2179 (June 5, 2003), *available at* http://www.sec.gov/news/testimony/060503tssmc.htm.

512. These power balance concerns are hardly new. Nor are their effects. Nearly a generation ago we worried about the capture of the SEC by certain sectors of the market and by certain stakeholders and hoped for its liberation. *See, e.g.*, Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315 (discussing the SEC's use of "public interest" principle to maximize its political support among "special interests" in the securities industry).

513. Many of these ideas were argued in the litigation over the break up of the Bell system. *See* United States v. AT&T, 552 F. Supp. 131 (D.D.C. 1982), *aff'd sub nom.*, Maryland v. United States, 460 U.S. 1001 (1983). *See also* Glen O. Robinson, *The Titanic Remembered: AT&T and the Changing World of Telecommunications*, 5 YALE J. ON REG. 517 (1988) (book review).

assume a second order importance to the state, which values its own value maximization more highly.

B. SOX as Part of a Larger Scheme of Regulation

"By means of a wise police, the sovereign accustoms the people to order and obedience."[514] Privatization of the enforcement power through the deputization of corporate actors and agents reflects years of governmental efforts to delegate responsibility for monitoring and reporting obligations to various groups within the private sector. For example, the war on gang and drug activity produced anti-money-laundering statutes through which banks and other financial intermediaries received substantial monitoring and reporting obligations with respect to large cash transactions.[515] SOX ultimately cannot be understood in a vacuum. It forms an integral part of a system of legislation that rose to prominence after September 11, 2001. SOX, the Patriot Act,[516] and other recent legislation[517] are all directed at similar objects. First, these acts continue the policy of *centralizing* regulatory power within the state and its administrative apparatus. Second, these acts amplify the policy of *devolving* or *privatizing* enforcement. In a way, analogous to the

514. FOUCAULT, *supra* note 1, at 215.

515. *See* National Money Laundering and Related Financial Crimes Strategy Act of 1998, 31 U.S.C. §§ 5340-5342 (2000). The Act began a five year initiative for the government to combat money laundering and related financial crimes through both detection and prevention. *See id.* § 5341. Money laundering statutes and the obligations of banks and others is beyond the scope of this article. For more information on this subject see, for example, Fernando L. Aenlle-Rocha, *Correspondent Banking After September 11*, L.A. LAW., Sept. 2002, at 27; Eduardo Aninat et al., *Combating Money Laundering and the Financing of Terrorism*, FIN. & DEV., Sept. 2002, at 44; Raymond W. Baker, *The Biggest Loophole in the Free-Market System*, WASH. Q., Autumn 1999, at 29.

516. Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot Act) Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (codified in scattered sections of 50 U.S.C.).

517. For anti-terror legislation, see the Homeland Security Act of 2002, Pub. L. No. 107-296, 116 Stat. 2135 (procurements for defense against or recovery from terrorism or nuclear, biological, chemical, or radiological attack). For money laundering legislation, see Federal Deposit Insurance Corporation, 12 U.S.C. § 1181-1832 (regulations governing insured depository institutions); 12 U.S.C. § 3412 (use of information); 18 U.S.C. § 1956 (laundering of monetary instruments); and 31 U.S.C. § 5317 (search and forfeiture of monetary instruments).

operation of contemporary American federalism,[518] SOX and its related legislative cousins seek to draw absolute regulatory power to the highest echelons of state organization. Once firmly within the grasp of the national government, that entity can, as a privilege and subject to its whim, delegate some or all of the regulatory authority it has consumed back to subordinate governmental entities, individuals. Just as the state can absorb ultimate authority for economic well-being from the religious establishments, it can then delegate back to those bodies authority for the care of impoverished—but now subject to its ultimate control[519]—SOX and its anti-terror regulatory cousins, draw authority to regulate enterprises from the markets to itself—if only to appear to give administrative authority (but not control) back, in part, to the institutions from which power was divested.

The pattern of regulatory control and enforcement devolution so evident under SOX is also followed by various parts of the USA Patriot Act.[520] For example, the Patriot Act modified the Bank Secrecy Act of 1970[521] to broaden the scope of those businesses now obligated to implement anti-money-

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518. In another context, I have noted how the basis of contemporary American federalism is, to some extent, more gesture than reality:

> For many commentators in the United States, federalism has been transformed into a disposable concept almost entirely in the hands of the federal supreme court. Federalism is no longer deemed a fundamental *political* conception of the governmental organization of a society with common bonds. American orthodox federalism now appears essentially discretionary. The discretionary power is vested in the federal government, rather than in that of the constituent states. Federalism, in this sense, is merely code for the quantum of power the federal government will devolve to the states. For many Americans, then, states have become the appendage of the general government; federalism merely provides the means of resisting the reduction of states to mere administrative units. The decision to grant greater or less deference to the subsidiary units of governments rests largely in the hands of the general government. That was the essence of the "new federalism" under President's [sic] Nixon and Reagan; it is the essence of federalism in other federal states as well. Within this framework, enumerated powers are largely illusory.

Larry Catá Backer, *The Extra-National State: American Confederate Federalism and the European Union*, 7 COLUM. J. EUR. L. 173, 181 (2001) (citations omitted).

519. *See* Larry Catá Backer, *Welfare Reform at the Limit: The Futility of "Ending Welfare as We Know It,"* 30 HARV. C.R.-C.L. L. REV. 339 (1995).

520. *See* USA Patriot Act of 2001, 115 Stat. 272.

521. Pub. L. No. 91-508, 84 Stat. 1114 (codified as amended at 18 U.S.C. §§ 1956, 1957 & 1960).

laundering programs.[522] Each of these businesses now becomes part of the network of the state's eyes and ears.[523] Few complain but all understand the effects of enforcement privatization.[524] This pattern, into which SOX fits so comfortably and adds so much, is at least a generation old in the United States. Like SOX, it is tied to American state policy seeking to protect the integrity of the political and economic system against corruption and instability. "In an effort to fight the War on drugs, the U.S. government has recruited U.S. banks as agents to track down illicit funds. In 1970, the U.S. government enacted legislation that effectively imposed an immense burden on U.S. bankers to know their customers and to track suspicious transactions."[525]

The proposed "Domestic Security Enhancement Act of 2003", further continues this pattern of enforcement devolution.[526] The authority to obtain

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522. Businesses now included within the definition of "financial institution" for purposes of the Bank Secrecy Act include securities and commodities brokers, insurance companies, dealers in precious metals, travel agencies, casino operators, real estate brokers, and pawn brokers. *See* Financial Crimes Enforcement Network; Anti-Money Laundering Programs; Special Programs for Certain Foreign Accounts, 67 Fed. Reg. 48,348 (July 23, 2002) (to be codified at 31 C.F.R. pt. 103). For a discussion, *see* Nicole M. Healy & Judith A. Lee, *Ad Hoc Task Force on Professional Responsibilities Regarding Money Laundering: PATRIOT Act and Gatekeeper Update*, 37 INT'L LAW. 631 (2003); *see also* Christopher Boran, *Money Laundering,* 40 AM. CRIM. L. REV. 847 (2003); Daniel Mulligan, Comment, *Know Your Customer Regulations and the International Banking System: Towards a General Self-Regulatory Regime*, 22 FORDHAM INT'L L.J. 2324 (1999).

523. Among the other duties of businesses subject to the anti-money laundering acts, businesses are obligated to develop Customer Identification Programs for new accounts, and screening accounts through a governmental database provided by the Financial Crimes Enforcement Network (FinCen) and another organization, the Office of Foreign Asset Control. Federal Deposit Insurance Corporation, 68 Fed. Reg. 25,090 (May 9, 2003) (to be codified at 12 C.F.R. pt. 326). In addition, federal law enforcement agencies may seek information from these businesses. *See* USA Patriot Act § 314, 115 Stat. at 307.

524. Thomas Brom recently noted that:

> Risking charges of being unpatriotic, a few industries have raised polite objections. Catherine Whatley, president of the National Association of Realtors, wrote in an August [2003] letter to [the Financial Crimes Enforcement Network], "First, it is inappropriate to impose law enforcement responsibilities on an industry comprised of small businesses that are not trained in such matters, such as real estate brokerages. Second, it is questionable whether expanding Anti-Money Laundering coverage to real estate brokers, agents and others is a necessary step in the fight against money laundering and the financing of terrorism."

Thomas Brom, *Full Disclosure,* CALIF. LAW. MAG., Dec. 2003, at 31.

525. Mulligan, *supra* note 522, at 2324.

526. A "not for distribution" copy of the rumored "USA Patriot Act II" was leaked to a D.C. Advocacy group known as the Center for Public Integrity (CP) and aired on Bill Moyers PBS program Friday, January 9, 2003. Text can be located at http://www.PBS.org/now/politics/patriot2-hi.pdf (last visited June 3, 2004).

business records has been broadened.[527] Law enforcement agents may obtain credit reports upon a certification that the information will be used "in connection with their duties to enforce federal law."[528] Restrictions on surveillance and access to hard-drive contents have been lowered.[529] Furthermore, courts will be permitted to issue a simple subpoena to require a third party to turn over information about any individual, as long as the information is sought "with respect to an investigation" concerning domestic or international terrorism.[530] What makes this more effective is the simultaneous expansion of the definition of terrorism to include any violation of federal or state law committed with the intent of affecting government policy and that is potentially dangerous,[531] the government may essentially subpoena anybody. The net result is, on the one hand, to open business records to governmental investigators. In another, and perhaps more important sense, it also suggests the notion that records must be kept. It is not unlikely that government might some day argue for the imposition of a legal standard for the keeping of business records. Failure to maintain appropriate records (from which governmental investigations may be furthered) might be transformed into evidence of collusion with the object of the investigation—or on a Sarbanes-Oxley model, into evidence of a failure to comply with (now mandatory) record-keeping requirements.

Devolution is not limited to those participating in streams of commerce. Section 215 of the Patriot Act amends Title V of the Foreign Intelligence Surveillance Act of 1978[532] to permit certain officers of the Federal Bureau of Investigation to "make an application for an order requiring the production of any tangible things (including books, records, papers, documents, and other items) for an investigation . . . to protect against international terrorism or clandestine intelligence activities."[533] Those who are required to comply with the request are forbidden to "disclose to any other person (other than those persons necessary to produce the tangible things under this section) that the Federal Bureau of Investigation has sought or obtained tangible things under this section."[534] The provision essentially privatizes information gathering,

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527. *See* Domestic Security Enhanced Act of 2003 § 156 (draft, Jan. 9, 2003), *available at* http://www.PBS.org/now/politics/patriot2-hi.pdf.

528. *Id.* § 126.

529. *See id.* § 124.

530. *Id.* §§ 128, 129.

531. *See id.* § 122.

532. *See* USA Patriot Act § 215 (to be codified at 50 U.S.C. §§ 1801-1862).

533. *Id.* (to be codified at 50 U.S.C.A. § 1861). The only exception provided is for an "investigation of a United States person . . . conducted solely upon the basis of activities protected by the first amendment to the Constitution." *Id.*

534. *Id.* (to be codified at § 1861(d)).

relating to one aspect of criminal regulation. It will directly affect librarians, booksellers, and video store merchants. However, it is not clear whether the power to obtain information will lead to the creation of rules respecting the obligation to maintain certain business records. The history of SOX and related legislation makes that possibility likely.

Moreover, the culture of surveillance, of transparency for purposes of monitoring and control, is not limited to strictly federal initiatives. The federal government has begun funding initiatives under which states develop common information data bases on their citizens for use in "law enforcement." Among the more prominent recent additions is the Multi-State Anti-Terrorism Information Exchange (MATRIX). Sponsored by and funded in part by grants from the Office of Justice Programs of the U.S. Department of Justice as a pilot, proof-of-concept project, MATRIX was "initiated in response to the increased need for timely information sharing and exchange of terrorism-related . . . information among members of the law enforcement community."[535] The core of the information mined is currently limited to state records and "20 billion pieces of data held by a private company."[536] This

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535. Multistate Anti-Terrorism Information Exchange, *Frequently Asked Questions*, *at* http://www.matrix-at.org/faq.htm (last visited June 3, 2004). Currently, few states have actually joined the MATRIX. A few that have joined have since stopped participating citing concerns about privacy. But other states are contemplating becoming part of the MATRIX. *See* Brian Bergstein, *Privacy Issues Dog Anti-Terrorism Database Project,* PATRIOT NEWS (Harrisburg) Feb. 1, 2004, at A18 (the project is currently run by Florida state police and currently involves Connecticut, Florida, Pennsylvania, Ohio, New York and Michigan; Georgia and Utah dropped out and officials in Iowa, North Carolina, Arizona and Arkansas are considering joining). The Institute for Intergovernmental Research describes itself as "a Florida-based nonprofit research and training organization, [that] specializes in law enforcement, juvenile justice, and criminal justice issues. [It] provides local, state, and federal law enforcement agencies with assistance needed to implement changes that promote greater governmental effectiveness." Institute for Intergovernmental Research, *at* http://www.iir.com (last visited June 3, 2004).

536. Bergstein, *supra* note 535, at A18. The MATRIX project is "implementing factual data analysis from existing data sources [to integrate] disparate data from many types of Web-enabled storage systems . . . to identify, develop, and analyze terrorist activity and other crimes for investigative leads." Multistate Anti-Terrorism Information Exchange, *MATRIX Defined*, *at* http://www.matrix-at.org/matrix_defined.htm (last visited June 3, 2004). This capability will facilitate integration and exchange of information within the participating states, including "criminal history records, driver's license data, vehicle registration records, and incarceration/corrections records including digitized photographs, with significant amounts of public data records." *Id.*

informal, federally sponsored, program, is the tip of the iceberg.[537] The pattern has been set, it makes sense that the pattern will be in evidence not only with respect to 'traditional' areas of police work, but in connection with economic crimes as well. Indeed, disruptions of markets for securities, or threats to the stability of (large) public companies, are increasingly characterized as economic crimes of significance far beyond the relatively small group of stakeholders directly affected. As critical components of state security, economic stability, labor market stability, and wealth production, securities fraud will be treated more and more as important matters of state policy.

In the broader context, the architecture of "detect and report" so prominent in SOX easily fits into the sort of anti-corruption statutes that have risen to prominence in the last thirty years. The Foreign Corrupt Practices Act,[538] like the anti-money laundering statutes and the Patriot Act, are all cousins of SOX. All fit comfortably together to produce a globally integrated system of intelligence serving multiple purposes. The Attorney General for England and Wales recently reminded us that financial fraud in all its aspects damages the economy and, as such, is necessarily a matter of state policy; economic crime defrauds stakeholders and funds global criminal and terrorist networks; financial crime damages financial institutions in ways that impede globalization of economic activity; the punishment of financial crimes also has a social dimension—social stability requires punishment regimes that are equivalent across class and race lines.[539] Corporate lawyers and academics stay within the narrow confines of their self-described disciplines to their peril, or to the peril of irrelevance, when confronting the contextualized phenomenon which are SOX and its related statutes.

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537. Thus, for example, the Institute for Intergovernmental Research website provides links for a number of other similar initiatives, including the Center for Task Force Training, Global Intelligence Working Group, Project Development and Implementation Training, Criminal Intelligence Systems Operating Policies, Multi-state Anti-Terrorism Information Exchange, Regional Information Sharing Systems, Global Justice Information Sharing Initiative, National White Collar Crime Center State and Local Anti-Terrorism Training, and National Youth Gang Center. *See* Institute for Intergovernmental Research, *at* http://www.iir.com (last visited June 3, 2004).

538. 15 U.S.C. § 78dd (2000).

539. *See* Peter Henry Goldsmith, Opening Keynote Address at the Twenty-First Cambridge International Symposium on Economic Crimes Financial Crime, Terror & Subversion: The Control of Risk in a Destabilized World Economy, Cambridge, England (Sept. 8, 2003) (personal notes of address on file with author).

CONCLUSION: THE RISE OF SURVEILLANCE MERCANTILISM

"The public execution was the logical culmination of a procedure governed by the Inquisition. The practice of placing individuals under 'observation' is a natural extension of a justice imbued with disciplinary methods and examination procedures."[540] For some time now, the federal government has more and more openly embraced the logic of this postmodern insight. In a quest for the protection of free markets, the government has increasingly captured for itself the power to manage and direct that market. The borders of free enterprise are thus increasingly set not by stakeholders who—through their individual or aggregate behavior—develop and maintain conduct norms for the firm and its factors and discipline breaches, but by the state.

Among the most important changes was the addition of certification requirements for chief executive and chief financial officers in connection with the company's periodic reports required to be filed under the Exchange Act.[541] In addition, the Act requires the annual report to contain a report and evaluation of management's internal controls;[542] requires "real time" disclosure of material changes in the financial condition of the reporting company or results of operation;[543] changes the reporting rules for purposes of Section 16 of the Exchange Act;[544] amends Section 10A of the Exchange Act to require exchanges to adopt listing standards requiring every member of a company's audit committee to be independent and carry out a number of specific responsibilities;[545] requires every reporting company to disclose whether its audit committee has at least one financial expert and, if not, the reasons why

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540. FOUCAULT, *supra* note 1, at 227.

541. *See* Sarbanes Oxley Act of 2002, Pub. L. No. 107-204, § 906, 116 Stat. 745, 806 (to be codified at 18 U.S.C. § 1350). Section 906(a) of the Sarbanes-Oxley Act requires CEO and CFO certification of each periodic report that contains financial statements. Section 302 requires the company's principal officers to certify each annual and quarterly report with respect to their review of the report and certain internal controls now mandated by the Act. *See id.* § 302 (to be codified at 15 U.S.C. § 7241).

542. *See id.* § 404 (to be codified at 15 U.S.C. § 7262).

543. *See id.* § 409 (to be codified at 15 U.S.C. § 78m).

544. *See id.* § 403 (to be codified at 15 U.S.C. § 78p). The Act requires reports of changes in beneficial ownership within two days, rather than monthly as previously permitted through the use of Form 4 and Form 5.

545. *See id.* § 301 (codified at 15 U.S.C. § 78j-1(m)). These duties include the appointment and oversight of outside auditors, the determination of the compensation of outside auditors, and the resolution of conflicts between management and the auditors. In addition, Section 202 of the Act requires the SEC to adopt rules requiring the audit committee to pre-approve all auditing and non-auditing services. *See* Sarbanes-Oxley Act § 202 (to be codified at 15 U.S.C. § 78j-1(i)).

it doesn't;[546] requires public companies to disclose whether it has adopted a code of financial ethics or the reasons it has not;[547] prohibits public companies from extending or arranging loans to its directors and officers;[548] imposes certain blackout periods for trading shares acquired in connection with employment as an officer or director;[549] and imposes new ethical obligations on lawyers who practice before the SEC.[550]

The Sarbanes-Oxley Act provides another significant step toward an attempted "domestication" of both market and firm by the state. That domestication is motivated in part by the desire to harness the power of free enterprise to the interests of the state in economic stability, wealth diffusion and internal peace. More importantly, perhaps, broader state interests—elimination of threats to state power, whether domestic or foreign, war in modern form—motivate domestication. In a real sense, the thrust of modern economic regulation, thus broadly contextualized, suggests the development of a modern form of mercantilism[551] in the form of "necessary" market and governance regulation. "The sentiments of modern mercantilists could not be more apparent in the arena of world nations. Cyclical waves of internal and external regulation, protection, and political-bureaucratic provisions of all kinds continue to punctuate contemporary Western economies, just as they are features of third world developments."[552] Certainly without noting the irony, or the post-September 11, 2001 meaning his words might acquire, Henry Spiegel once described mercantilism as economic warfare for national gain.[553] In the 21st century, nation states deploy

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546. *See id.* § 407 (to be codified at 15 U.S.C. § 7265).

547. *See id.* § 406 (to be codified at 15 U.S.C. § 7264).

548. *See id.* § 402 (to be codified at 15 U.S.C. § 78m(k)) (amending section 13 of the 1934 Act by adding subsection k).

549. *See id.* § 306 (to be codified at 15 U.S.C. § 7244). These provisions will operate in an manner analogous to the short swing trading rules of Section 16 of the Exchange Act of 1934.

550. *See id.* § 307 (to be codified at 15 U.S.C. § 7245).

551. *See supra* note 13 and accompanying text.

552. ROBERT B. EKELUND JR. & ROBERT D. TOLLISON, POLITICIZED ECONOMIES: MONARCHY, MONOPOLY, AND MERCANTILISM ix (1997). Like these authors, I do not focus on mercantilism as a series of errors of economic theory focusing on 'money' or specie, but rather focus on mercantilism as a system of state regulation for the maximization of state power.

> The tradition established for the study of mercantilism by scholars in the German Historical School and by their English disciples has been given far less emphasis over the twentieth century. These writers argued that mercantilist policies and ideas were very sensible for a period in history during which the attainment of state power was the overriding goal of the policy.

Id. at 4.

553. *See* HENRY WILLIAM SPIEGEL, THE GROWTH OF ECONOMIC THOUGHT 93 (3d ed. 1991).

economics and economic policy as one weapon in complicated competitions for national gain.[554]

554. "Much of what is criticized as economic foolishness in trade policies may be explained as 'politically rational' for policy-makers who are less guided by economic rationality than by a desire to maximize political support and to minimize political opposition." ERNST-ULRICH PETERSMANN, CONSTITUTIONAL FUNCTIONS AND CONSTITUTIONAL PROBLEMS OF INTERNATIONAL ECONOMIC LAW 117 (1991)

> For instance: Since import restrictions cannot give net protection to the national economy as a whole but only redistribute income between different sectors of the domestic economy, trade policy-makers may prefer to use trade policy instruments other than tariffs (e.g. selective non-tariff barriers to trade) whose non-transparent character minimizes consumer opposition and whose redistributive effects may be difficult to choice among the various instruments of trade control may be influenced also by their different procedural characteristics and legal requirements.

Id. at 117-18.