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THE SECURITIES AND EXCHANGE COMMISSION'S  
PRE- AND POST-ENRON RESPONSES TO  
CORPORATE FINANCIAL FRAUD:  
AN ANALYSIS AND EVALUATION

*David S. Ruder*  
*Yuji Sun*  
*Areck Sycz\**

INTRODUCTION

In recognition of the seventieth anniversary of the United States Securities and Exchange Commission (the SEC or the Commission), this Article evaluates the SEC's responses to corporate financial frauds during the early years of the twenty-first century.<sup>1</sup> Early 2001 disclosures of fraudulent activities at Enron Corp.<sup>2</sup> and the mid-summer

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1 The Article was prepared in response to an invitation from the Notre Dame Law School to Professor Ruder to participate on September 23 and 24, 2004, as a panelist on the subject "The SEC at 70." The brochure advertising the conference stimulated the subject matter in this Article by its statement that "even some federal lawmakers who once championed securities deregulation have expressed concern of late that the SEC has not acted aggressively enough to protect the interests of small investors."

2 *In re Enron Corp. Sec., Derivative and ERISA Litig.*, 235 F. Supp. 2d 549, 613-37 (S.D. Tex. 2002) (recounting the facts according to the plaintiffs); *The Enron Collapse: Impact on Investors and Financial Markets, Hearings Before the House Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters. and the Subcomm. on Oversight Investigation of the House Comm. on Fin. Servs.*, 107th Cong. 107-51 (2001) (statement of Robert K. Herdman, Chief Accountant, Sec. and Exch. Comm'n); SPECIAL INVESTIGATIVE COMM. OF THE BD. OF DIRS. OF ENRON CORP., REPORT OF INVESTIGATION (2002) [hereinafter POWERS REPORT], available at <http://www.enron.com/corp/por/pdfs/PowersReport.pdf>;

2002 announcement by WorldCom, Inc., that it had disguised its true operating performance by using improper accounting<sup>3</sup> resulted in the adoption of the Sarbanes-Oxley Act<sup>4</sup> on July 30, 2002. Although this Article examines events that took place prior to the Enron disclosures, it concentrates on the SEC's reactions to the Enron era scandals, including its responses to the Sarbanes-Oxley legislation.

Part I of this Article will set forth the facts underlying the Enron collapse. Part II will describe the Commission's enforcement activities in the area of financial fraud, its corporate governance initiatives, and its role in the establishment of accounting oversight. Part III will discuss the Commission's rulemaking and other responses to the Enron collapse in the disclosure area. Part IV will discuss the SEC's resources. The Article will advance the conclusions that in many respects SEC initiatives guided the Congress in drafting the Sarbanes-Oxley Act and that the SEC's pre- and post-Enron activities evidenced an active and effective SEC role in regulating U.S. corporations.

## I. THE ENRON FACTS

Enron was an old-line energy company, owning electric power-production facilities and natural gas pipelines. In the 1990s, Enron repackaged itself as an energy trading company whose primary mode of business was to trade in various energy vehicles, including contracts to provide electric power in the future at pre-determined prices and similar contracts to deliver natural gas, water rights, wind power systems, broad band transmission systems, insurance, and other products.

The company pursued an accounting strategy of creating "special purpose entities" (SPEs), whose purpose was in part to shift debt from Enron's books and to hide credit risk. In addition to facilitating off-balance sheet borrowing, the special purpose entities had other advantages. Many of Enron's investments were in illiquid enterprises, some of which involved high risk. Enron was able to transfer these investments to SPEs either to produce an apparent immediate profit or to eliminate risky investments from its balance sheet. As a means of improving the effectiveness of these off-balance sheet transactions, some of Enron's special purpose entities were managed by its Chief

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see also John Emshwiller & Rebecca Smith, *Enron Jolt: Investments, Assets Generate Big Loss, Part of Charge Tied to 2 Partnerships Interests Wall Street*, WALL ST. J., Oct. 17, 2001, at C1.

3 SEC v. WorldCom, Inc., Litigation Release No. 17,558, 77 S.E.C. Dock. 3013 (June 27, 2002), available at <http://www.sec.gov/litigation/litreleases/lr17588.htm>.

4 Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

Financial Officer, Andrew Fastow, despite conflict of interest problems. Fastow-managed entities could more easily enter into complicated transactions and could do so in less time because Fastow was on both sides of the transactions.

In the early fall of 2001, Arthur Andersen, LLP (Andersen), Enron's auditor, reviewed one of the special purpose entities and decided that the accounting had been incorrect. On October 16, 2001, Enron announced it was taking a \$544 million after-tax charge against earnings relating to transactions with LJMZ Co. Investment, a partnership managed by Fastow. Enron also recognized that in prior transactions it had issued its shares in exchange for notes receivable and had improperly recorded these transactions as an increase to notes receivable of one billion dollars and an increase in shareholder equity of one billion dollars. Proper accounting would have been to show the notes receivable as a reduction in shareholder equity. As a result, shareholder equity was reduced by \$1.2 billion, including an additional \$200 million from 2001 transactions. Enron's stock collapsed and the company filed for bankruptcy in mid December 2001.

Following the Enron collapse a special committee of the Enron Board of Directors under the leadership of a new director, William C. Powers, Jr., the Dean of the University of Texas Law School, investigated transactions between Enron and the investment partnerships created and managed by Fastow.<sup>5</sup> The Powers Report concluded that Enron's publicly-filed disclosures "were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships."<sup>6</sup> It found that oversight of management by Enron's board and its audit committee was deficient.<sup>7</sup>

## II. SEC ENFORCEMENT, CORPORATE GOVERNANCE, AND ACCOUNTING OVERSIGHT

### A. *Enforcement*

The SEC's primary method of attacking corporate fraud is through use of its enforcement powers. It has power to investigate fraud and power to impose fines and other sanctions in administrative proceedings and in litigated cases in federal courts. Throughout the nineties, the SEC brought a large number of enforcement actions in-

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5 POWERS REPORT, *supra* note 2, at 1. Many of the facts described above were set forth in the *Powers Report*.

6 *Id.* at 17.

7 *See id.* at 9-10.

volving financial fraud.<sup>8</sup> Its active enforcement program has continued. In recent years, the Commission has initiated a growing number of enforcement actions. Such actions in each of its fiscal years grew from 477 in 1998 to 679 in 2003.<sup>9</sup> In the Commission's fiscal year 2002, ending on September 30, 2002, the Commission brought 598 enforcement actions.<sup>10</sup> During that year, the Commission brought 163 cases involving allegations of improper accounting, misleading disclosure, and other financial fraud.<sup>11</sup> Stephen Cutler, Director of the SEC's Division of Enforcement, described the activity:

But none of the numbers can convey the remarkable nature of our cases last year as vividly as a simple iteration of the names of some of the companies involved: Xerox, WorldCom, Rite Aid, Adelphia, Tyco, Enron, Waste Management, Dynegy, Edison Schools, Homestore, Microsoft, PNC Bank, Amazon.com.<sup>12</sup>

The Commission's increasing enforcement activities in the financial fraud area were extremely vigorous given the Commission's limited budget.<sup>13</sup> Not only were many financial fraud cases initiated, but the alleged frauds in most cases involved large sums of money. For instance:

- In *SEC v. Buntrock*, the Commission charged six officers of Waste Management with perpetrating a massive financial fraud lasting more than five years in which the company had misstated its pre-tax earnings by approximately \$1.7 billion.<sup>14</sup>

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8 Richard C. Sauer, *Financial Statement Fraud: The Boundaries of Liability Under the Federal Securities Laws*, 57 BUS. LAW. 955, 958 n.20 (2002).

9 1999 SEC. AND EXCH. COMM'N, ANNUAL REP.; 2000 *id.*; 2001 *id.*; 2002 *id.*; 2003 *id.* For each of those fiscal years the number of actions filed were: 1998- 477, 1999- 525, 2000- 503, 2001- 485, 2002- 598, and 2003- 679.

10 Linda Chatman Thomsen, Recent SEC Enforcement Cases Presented at the 23d Annual Ray Garrett, Jr. Corporate and Securities Institute (April 2003).

11 Stephen M. Cutler, Remarks Before the American Institute of Certified Public Accountants (Dec. 12, 2002), available at <http://www.sec.gov/news/speech/spch121202smc.htm>.

12 *Id.*

13 See discussion of Commission resources *infra* Part IV. The Commission has sought to leverage its enforcement resources in various ways. For instance, on October 23, 2001, the Commission released a *Report of Investigation Pursuant to Section 21(a)*, in which it set forth criteria which the Commission will consider "in determining whether, and how much, to credit self-policing, self-reporting, remediation and cooperation" in deciding whether to refrain from bringing enforcement actions, bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents. In re Matter of Gisela de Leon-Meredith, Exchange Act Release No. 44,970 (October 23, 2001), 76 S.E.C. Dock. 220 (Oct. 23, 2001).

14 Waste Management, Inc. Founder and Five Other Former Top Officers Sued for Massive Earnings Management Fraud, Litigation Release No. 17,435, 77 S.E.C. Dock. 695 (Mar. 26, 2002).

- In *SEC v. WorldCom*, the Commission charged WorldCom with a massive accounting fraud totaling more than \$3.8 billion.<sup>15</sup>
- In *SEC v. Adelphia Communications Corp.*, the Commission charged Adelphia Communications Corporation, its founder, his three sons, and two senior executives with “one of the most massive financial frauds ever to take place at a public company,” involving billions of dollars.<sup>16</sup>
- In *SEC v. Kozlowski*, the Commission charged three former top officials of Tyco International, Ltd. with failing to disclose to shareholders low interest loans, forgiveness of loans, and related party transactions in the millions of dollars.<sup>17</sup>
- In *SEC v. Dynegy, Inc.*, the Commission alleged improper accounting and misleading disclosures at Dynegy, Inc., regarding the use of special purpose entities and prearranged “wash” transactions involving large sums.<sup>18</sup>
- In *SEC v. Fastow*, the Commission brought one of many actions in the Enron Corp. investigation, charging Andrew Fastow, the company’s former Chief Financial Officer, with antifraud violations engaged in for the purpose of enriching himself and misleading investors about Enron’s true financial condition.<sup>19</sup>
- In *SEC v. Safety-Kleen Corp.*, the Commission charged Safety-Kleen Corp. and four of its former senior executives with a massive accounting fraud resulting in a restatement of earnings of \$534 million for a three-year period.<sup>20</sup>

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15 *SEC v. WorldCom, Inc.*, Litigation. Release No. 17,588, 77 S.E.C. Dock. 3013 (June 27, 2002). For a list of WorldCom related actions, see Sec. & Exch. Comm’n, *Spotlight on SEC v. WorldCom*, at <http://www.sec.gov/spotlight/worldcom.htm> (last modified July 29, 2004).

16 *SEC v. Adelphia Communications Corp.*, Litigation Release No. 17,627, 78 S.E.C. Dock. 326, 326 (July 24, 2002).

17 *TYCO Former Executives L. Dennis Kozlowski, Mark H. Swartz and Mark A. Belnick Sued for Fraud*, Litigation Release No. 17,722, 78 S.E.C. Dock. 1495 (Sept. 12, 2002).

18 *SEC Settles Securities Fraud Case with Dynegy Inc. Involving SPEs and Round-Trip Energy Trades*, Litigation Release No. 17,744, 78 S.E.C. Dock. 1493 (Sept. 25, 2002).

19 *SEC Charges Andrew S. Fastow, Former Chief Financial Officer of Enron, with Fraud*, Litigation Release No. 17,762 (Oct. 2, 2002), available at 2002 WL 31425946. For a list of SEC Enron-related enforcement actions, see Sec. & Exch. Comm’n, *Spotlight on Enron*, at <http://www.sec.gov/spotlight/enron.htm> (last modified Sept. 1, 2004).

20 *SEC Sues Former CEO, CFO and Other Top Executives of Safety-Kleen Corp. for Accounting Fraud; Company Consents to Permanent Injunction; Criminal Charges Filed Against Two Former Officers*, Litigation Release No. 17,891 (Dec. 12, 2002), available at 2002 WL 31770878.

This record of the Commission's enforcement activities in the financial fraud area shows an agency dealing effectively with an unusually large number of high profile financial frauds.

### B. Corporate Governance

The Commission's post-Enron agenda also included improving corporate governance as a means of protecting investors.<sup>21</sup> Although corporate governance has historically been a matter of state regulation,<sup>22</sup> and although the Commission "lacks the authority to promulgate rules or regulations directly affecting corporate governance,"<sup>23</sup> the Commission has accomplished corporate governance reform by urging the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASD), and other self-regulatory organizations (SROs) to adopt listing standards affecting corporate governance.<sup>24</sup> Following this pattern, on February 13, 2002, SEC Chairman Harvey L. Pitt wrote to the Chairman of the NYSE and the Chairman of the NASD urging the SROs to review corporate governance listing standards.<sup>25</sup>

In response, the NYSE appointed a "Corporate Accountability and Listing Standards Committee" to study corporate governance. The Committee issued its report on June 6, 2002,<sup>26</sup> and the NYSE issued its initial recommendations for comprehensive changes to the NYSE's corporate governance listing standards on August 16, 2002.<sup>27</sup> The NASD filed a rule change proposal containing substantive

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21 In a *Wall Street Journal* article published shortly after the Enron bankruptcy, Chairman Pitt promoted better corporate governance through "[m]ore meaningful investor protection by audit committees" as one approach to prevent future Enrons. Harvey L. Pitt, Op-ed, *How to Prevent Further Enrons*, WALL ST. J., Dec. 11, 2001, at A18, available at <http://www.sec.gov/news/speech/spch530.htm>.

22 See Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545, 546-48 (1984); see also MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION* (1976) (demonstrating the development of corporate law and the history of state regulations).

23 Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 783 (1994).

24 Schwartz, *supra* note 22, at 571 n.72.

25 Press Release, Securities and Exchange Commission, Pitt Seeks Review of Corporate Governance, Code of Conduct (Feb. 13, 2002), available at <http://www.sec.gov/news/press/2002-23.txt>.

26 N.Y. STOCK EXCH., CORPORATE ACCOUNTABILITY AND LISTING STANDARDS REPORT (2002), available at <http://www.nyse.com/press/NT00565884.html>.

27 N.Y. STOCK EXCH., CORPORATE GOVERNANCE RULE PROPOSALS REFLECTING RECOMMENDATIONS FROM THE NYSE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE AS APPROVED BY THE NYSE BOARD OF DIRECTORS AUGUST 1, 2002 (2002), available at [http://www.nyse.com/pdfs/corp\\_gov\\_pro\\_b.pdf](http://www.nyse.com/pdfs/corp_gov_pro_b.pdf).

changes to its listing standards on October 9, 2002.<sup>28</sup> After several amendments,<sup>29</sup> NYSE and NASD rules were approved by the SEC on November 4, 2003.<sup>30</sup> In adopting the new corporate governance listing standards, both the NYSE and the NASD have acknowledged that independent directors can effectively perform crucial monitoring functions. They both recognize that corporations need to have independent boards that can exercise their own judgment in overseeing management.<sup>31</sup> The new listing standards of both SROs require boards with a majority of independent directors<sup>32</sup> and independent audit, compensation, and nomination committees.<sup>33</sup> With respect to the definition of "independence," both SROs adopted requirements to disqualify directors who had strong business or social relationships with the company.<sup>34</sup>

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28 Self-Regulatory Organizations, National Association of Securities Dealers, Exchange Act Release No. 47,516, 68 Fed. Reg. 14,451-01 (March 25, 2003).

29 N.Y. STOCK EXCH., PROPOSAL RELATING TO DIRECTOR INDEPENDENCE STANDARDS (2003), *available at* <http://www.nyse.com>; NAT'L ASS'N OF SEC. DEALERS, AMENDMENT 1 TO RULES 4200 AND 4350 REGARDING BOARD INDEPENDENCE AND INDEPENDENT COMMITTEES (2003), *available at* [www.nasdaq.com](http://www.nasdaq.com).

30 Order Approving Proposed Changes, Self-Regulatory Organizations, Nat'l Ass'n of Sec. Dealers, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154 (Nov. 12, 2003). The final Nasdaq listing standards are available at <http://www.nasdaq.com/about/recentrulechanges.stm> (last visited Nov. 18, 2004).

31 On March 31, 2003, a Task Force of the American Bar Association on Corporate Responsibility issued a report containing a series of recommendations regarding corporate governance, including the suggestions that the boards of directors should include a substantial majority of independent directors. AM. BAR ASS'N, THE REPORT OF THE AMERICAN BAR ASSOCIATION TASK FORCE ON CORPORATE RESPONSIBILITY (2003), *available at* [http://www.abanet.org/buslaw/corporateresponsibility/final\\_report.pdf](http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf); *see also* AM. BAR ASS'N, PRELIMINARY REPORT OF THE AMERICAN BAR ASSOCIATION TASK FORCE ON CORPORATE RESPONSIBILITY (2002), *available at* <http://www.ethicsandlawyering.com/Issues/files/ABAPrelimReport.pdf>.

32 N.Y. STOCK EXCH. LISTED COMPANY MANUAL R. 303A.01 (2004), *available at* <http://www.nyse.com/Frameset.html?displayPage=/about/listed/1022221393251.html>; NAT'L ASS'N SEC. DEALERS MANUAL R. 4200(a)(15) (2004).

33 *See* N.Y. STOCK EXCH., *supra* note 26, at 912.

34 The NYSE relies on a very general concept: independent directors are those who have "no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company)." N.Y. STOCK EXCH. LISTED COMPANY MANUAL R. 303A.02(a) (2004), *available at* <http://www.nyse.com/Frameset.html?displayPage=/about/listed/1022221393251.html>. The NASD requires that an independent director have no relationship with the company that would interfere with the exercise of independent judgments. The NASD proposal contains more specific disqualifying relationships. NAT'L ASS'N SEC. DEALERS MANUAL R. 4200(a)(15) (2004), *available at* [http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record\\_id=1159001510](http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159001510).



The Sarbanes-Oxley Act followed the SEC in seeking better corporate governance. The Act also deals with board independence, but mandates reforms only with respect to the audit committee. Section 301 of the Act establishes a new independence standard for audit committee members by adding subsection (m) to section 10A of the Exchange Act,<sup>35</sup> mandating the Commission to direct the SROs by rule to prohibit the listing of an issuer that is not in compliance with provisions of that section.<sup>36</sup> Under this new standard, an audit committee member must be an independent director of the issuer and must also meet two extra criteria: an audit committee member may not “(i) accept any consulting, advisory or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.”<sup>37</sup>

On April 9, 2003, the SEC implemented listed company audit committee standards provided by the Sarbanes-Oxley Act by adopting a new Rule 10A-(3) under the Exchange Act.<sup>38</sup> The SEC audit committee rules prohibit the listing of any security of an issuer that is not in compliance with the standards regarding issuer audit committees enumerated under new § 10A(m) of the Exchange Act.<sup>39</sup>

### C. Accounting Oversight

The Enron debacle also highlighted the failure of the accounting profession to protect investors when auditing public companies' financial statements. In January 2002, Chairman Pitt described a new system for “private regulation of the accounting profession with vigor-

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35 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775-76 (codified at 15 U.S.C.A. § 7211 (West Supp. 2004)).

36 Section 2(7) of the Sarbanes-Oxley Act defines “issuer” as a body whose securities are registered under section 12 of the Securities and Exchange Act or who files or has filed a registration statement that has not yet become effective under the Act. *See* Sarbanes-Oxley Act § 2(7), 15 U.S.C.A. § 7201 (West Supp. 2004); Securities and Exchange Act of 1934 § 3(8), 15 U.S.C. § 78c (2000).

37 Sarbanes-Oxley Act of 2002 § 301(m)(3)(b), 15 U.S.C.A. § 78j-1(m)(3)(B)(i)(ii).

38 Standards Relating to Listed Companies Audit Committees, Securities Act Release No. 8220, Exchange Act Release No. 47,654, 68 Fed. Reg. 18,788 (Apr. 16, 2003); *see also* Standards Relating to Listed Companies Audit Committees, Securities Act Release No. 8173, Exchange Act Release No. 47,137, 68 Fed. Reg. 2638 (proposed Jan. 17, 2003).

39 Rules and Regulations Under the Securities and Exchange Act of 1934, Reports Under Section 10A, 17 C.F.R. § 240.10A-3(a)(1)-(2) (2003). This Article does not discuss the definition of other SEC rules or corporate governance rules mandated by the Sarbanes-Oxley Act, such as hiring and firing outside auditors, and audit committee financial expert and “whistleblower” protections.

ous SEC oversight,” but not self-regulation by the accounting profession.<sup>40</sup> He proposed establishing a new “Public Accountability Board” (PAB) to assume “auditor and accountant discipline and quality control,” with the majority of its members unaffiliated with the accounting profession.<sup>41</sup> He proposed that independent funding for the new board be created by imposing “involuntary assessments” on public companies. He urged vesting the oversight body with “vigorous enforcement and investigative powers” to supplement the power of the SEC.<sup>42</sup> On March 21, 2002, he presented the integrated PAB proposal to Congress during his testimony before the Senate Committee on Banking, Housing and Urban Affairs.<sup>43</sup> On June 26, 2002, a month before the Sarbanes-Oxley enactment, the Commission proposed rules to create a PAB with the characteristics suggested by Chairman Pitt.<sup>44</sup>

The Sarbanes-Oxley legislation codified the substance of the Commission’s PAB proposal by establishing the Public Company Accounting Oversight Board (PCAOB), giving it the power to regulate the audit function of the accounting profession, including power to register auditing firms, power to establish auditing standards, power to set quality controls for auditing firms, and power to inspect and discipline accounting firms.<sup>45</sup> Section 101(b) of the Act specifies that the PCAOB “shall not be an agency or establishment of the United States Government” and establishes its status as a nonprofit private regulatory body.<sup>46</sup> Section 101(e)(2) of the Act states that “[t]wo members, and only 2 members” of the five-member PCAOB “shall be or have been certified public accountants.”<sup>47</sup> Codifying the Commission’s suggestion that fees be levied against public companies to fund the PCAOB, section 109 grants the PCAOB the power to establish “an-

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40 Harvey L. Pitt, Remarks at the Twenty-Ninth Annual Securities Regulation Institute (Jan. 23, 2002), available at <http://www.sec.gov/news/speech/spch536.htm>.

41 *Id.*

42 *Id.*

43 *Public Company Accounting Reform and Investor Protection Act of 2002: Hearing on S. 2673 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. 1103 (2002) [hereinafter *Hearing*] (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n), available at <http://www.sec.gov/news/testimony/032102tshlp.htm>.

44 Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process, Securities Act Release No. 8109, Exchange Act Release No. 46,102, 67 Fed. Reg. 44,964–45,001 (June 26, 2002) (codified as amended in 17 C.F.R. §§ 210, 229).

45 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101(a), 116 Stat. 745, 775–76 (2002) (codified at 15 U.S.C.A. § 7211 (West Supp. 2004)).

46 *Id.* § 101(b), 15 U.S.C.A. § 7211(b) (West Supp. 2004).

47 *Id.* § 101(e)(2), 15 U.S.C.A. § 7211(e)(2).

nual accounting support" fees which "shall be allocated among and payable by each issuer."<sup>48</sup> Section 107(a) of the Act makes clear that "[t]he Commission shall have oversight and enforcement authority over the Board."<sup>49</sup> All rules of the PCAOB must be approved by the Commission and all disciplinary actions taken by the PCAOB are subject to the Commission's review.<sup>50</sup> The Act further provides that other important aspects of PCAOB operation, including member appointments and its budget, must be approved by the Commission.<sup>51</sup>

The above summary discussion of the Commission's Enron-related activities in enforcement and corporate governance, as well as its suggestion that an independent accounting oversight board be established, present an SEC that has been forceful and effective in meeting problems demonstrated by corporate frauds. As the remainder of this paper demonstrates, its activities centering on improving the corporate disclosure system were also forceful and effective.

### III. THE SEC'S DISCLOSURE PROGRAM PRIOR TO AND AFTER ENRON

#### A. *The SEC Disclosure System*

The Sarbanes-Oxley reforms are the most far-reaching reforms in the securities laws regulating corporations since the enactments of the Securities Act of 1933 (the Securities Act)<sup>52</sup> and the Securities and Exchange Act of 1934 (the Exchange Act).<sup>53</sup> Evaluation of reforms in the area of disclosures should be made in the context of the comprehensive and extensive disclosure system established and enforced by the Commission since the enactment of the 1930s legislation.

Under the Exchange Act, publicly held companies in the United States are required to comply with regulations requiring them to disclose extensive information about their businesses and finances annually on Form 10-K,<sup>54</sup> quarterly on Form 10-Q,<sup>55</sup> and, when important events occur, on Form 8-K.<sup>56</sup> Under the Commission's integrated disclosure concept,<sup>57</sup> this disclosure system forms the basis for disclo-

48 *Id.* § 109(d)(1), 15 U.S.C.A. § 7219(d)(1), (g).

49 *Id.* § 107(a), 15 U.S.C.A. § 7217(a).

50 *Id.* § 107(b)-(c), 15 U.S.C.A. § 7217(b)-(c).

51 *Id.* §§ 101(e)(4), 109(b), 15 U.S.C.A. §§ 7211(e)(4), 7219(b).

52 Securities Act of 1933, 15 U.S.C. § 77a-77aa (2000).

53 Securities and Exchange Act of 1934, *id.* §§ 78a-78t (2000).

54 Forms, Securities and Exchange Act of 1934, 17 C.F.R. § 249.310 (1981).

55 *Id.* § 249.308a.

56 *Id.* § 249.308.

57 *See* Revision to System for Registration of Securities Offerings, Exchange Act. Release No. 18,007, 46 Fed. Reg. 41,902, 41,904 (Aug. 18, 1981) (describing the Commission's integrated disclosure system); Adoption of the Integrated Disclosure Sys-

tures made by seasoned corporations when they file registration statements under the Securities Act in connection with the sale of their securities. The Commission has facilitated this disclosure system in Regulation S-K by creating uniform disclosure provisions for both periodic reports and registration statements.<sup>58</sup>

As discussed throughout this paper, most of the post-Enron securities laws reforms have been accomplished through joint efforts by the Commission and Congress. In many instances, the chosen path for cooperation between the Commission and Congress involved Commission policy suggestions to Congress followed by congressional adoption of those policies and direction to the Commission to implement those policies.

### *B. The SEC's Disclosure Agenda Prior to the Sarbanes-Oxley Legislation*

The SEC's disclosure requirements have long been considered to be the most comprehensive in the world, and the Commission has constantly sought to improve the disclosure system. An assessment of the SEC's disclosure responses to the Enron scandal and other scandals can initially be made by reviewing the Commission's agenda beginning in the summer of 2001.

In an August 31, 2001, memorandum, prepared just as the Enron scandal was emerging, the Commission's Division of Corporation Finance announced a regulatory agenda including auditor independence, revenue recognition guidance, materiality definitions, restructuring, valuation and loss accruals, segment disclosure, accounting for derivatives, market risk disclosures, pro forma financial statements, intangible assets, and research and development expenses.<sup>59</sup> This list of Commission concerns demonstrated a long-held determination to attack current disclosure issues with new rulemaking and guidance.<sup>60</sup>

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tem, Exchange Act Release No. 18,524, 47 Fed. Reg. 11,380 (Mar. 16, 1982) (adopting integrated disclosure); Integrated Disclosure: Proposed Implementing Amendments Exchange Act Release No. 18,014, 46 Fed. Reg. 42,042 (Aug. 18, 1981) (proposing revision of schedule and form regime for integrated disclosure system).

58 Standard Instructions for Filing Forms Under the Securities Act of 1933, the Securities Exchange Act of 1934 and the Policy Conservation Act of 1975, 17 C.F.R. § 229.10 (2003). Regulation S-K covers securities, business, management, registration statement and prospectus provisions, and other disclosure items.

59 Div. of Corp. Fin., Sec. & Exch. Comm'n, *Current Accounting and Disclosure Issues*, Division of Corporation Finance, at <http://www.sec.gov/divisions/corpfin/acct-disc.htm> (last updated Aug. 31, 2001).

60 In addition to requiring corporate disclosures, the Commission also reviews registration statements, periodic reports, and other disclosure documents filed with

Further indication of Commission initiatives during this period can be gained from speeches, writings, and testimony of Harvey L. Pitt, who was sworn in as SEC Chairman on August 3, 2001, nearly two months prior to Enron's restatement announcement on October 16, 2001.<sup>61</sup> Early in his tenure, Chairman Pitt set an SEC agenda for reform of the disclosure system, primarily through a series of speeches.<sup>62</sup> On October 22, 2001, he observed that even though the U.S. disclosure system "is acknowledged to be the best in the world," it "can, and must, be strengthened and made relevant to our new global world of rapid communication."<sup>63</sup>

Shortly after taking office, Chairman Pitt expressed the need for improvement in the Exchange Act periodic reporting system.<sup>64</sup> In his view, disclosure by reporting companies in periodic intervals on a quarterly and annual basis inevitably made the information disclosed to the investor "static." He observed that the companies would "wait until the end of a quarter to disclose significant information" and the information, when it finally reached the investors, would often be stale.<sup>65</sup> Addressing this systemic problem, Chairman Pitt suggested as a solution supplementing the existing periodic disclosure regime with

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the Commission for the purpose of assessing the accuracy of disclosures. Since approximately 14,000 companies file registration statements with the Commission, the SEC is unable to review all of the documents filed with it. Instead, it has developed a "selective review" program through which it screens filings and decides whether to engage in a full or partial review, or no review at all. Even if a review is undertaken, that review will not be able to identify misrepresentations, inaccurate accounting, and other problems not discernable from the filed documents. See discussion of Commission resources *infra* note 267, app. A.

61 See Emshwiller & Smith, *supra* note 2.

62 A full list of Chairman Pitt's public remarks, including speeches and *Wall Street Journal* articles, are available at <http://www.sec.gov>; Chairman Pitt seemed to be following the example of his predecessor, Arthur Levitt, who made a series of important policy pronouncements in speeches. Seasoned SEC observers are aware that speeches by SEC chairmen are reviewed, edited, and sometimes written by SEC staff members. The Chairman's speeches, as well as speeches by staff members, are widely seen as indicators of forthcoming SEC policies.

63 Harvey L. Pitt, Remarks Before the American Institute of Certified Public Accountants (AICPA) Governing Council (Oct. 22, 2001), available at <http://www.sec.gov/news/speech/spch516.htm>.

64 The SEC's vision of an improved disclosure system was obscured in part by press reaction to another portion of the AICPA speech in which Chairman Pitt was criticized for appearing to be too friendly toward the accounting profession. His statement that the accounting "profession is comprised of individuals who are committed to our disclosure system, and who are critical partners with us in making financial disclosures meaningful," *id.*, can be interpreted as an effort to secure progress in regulating the accounting profession through cooperation rather than acrimony.

65 *Id.*

a new concept of “current” disclosure.<sup>66</sup> He suggested that reporting companies should be required to “disclose unquestionably material information when it arises and becomes available” rather than waiting for a periodic report filing deadline.<sup>67</sup> To achieve this goal, he suggested new utilization of technology, particularly the Internet, which he observed had the capability of “disseminating critical information quickly” and was “inherently customized: users can find as much or as little information as they want.”<sup>68</sup> In other speeches in the fall of 2001, Chairman Pitt further explained his vision of a more current disclosure system.<sup>69</sup> He believed that the SEC should encourage companies to disclose “trend information to give investors the same kind of view as is available to the managers of those companies.”<sup>70</sup>

In addition to suggesting a current disclosure system, Chairman Pitt discussed other disclosure reforms. He urged public companies to “consider simplifying financial disclosures to make accounting statements useful to, and utilizable by, ordinary investors.”<sup>71</sup> Regarding “pro forma” financial information that does not comply with Generally Accepted Financial Principles (GAAP), Chairman Pitt observed that unstructured pro forma financial disclosures were not comparable among different companies and even among different periods of the same company,<sup>72</sup> and that as a result “there is a strong need for companies to reconcile ‘pro forma’ disclosures with mandated GAAP financial statements.”<sup>73</sup>

Enron filed its bankruptcy petition on December 2, 2001. In a December 11, 2001, *Wall Street Journal* article, Chairman Pitt reiterated his plan to improve “current disclosure” as one way to restore investor

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66 *Id.*

67 *Id.*

68 *Id.*

69 See Harvey L. Pitt, Remarks at the Consumer Federation of America Financial Services Conference (Nov. 29, 2001) [hereinafter Pitt, Consumer Federation of America Remarks], available at <http://www.sec.gov/news/spch525.htm>; Harvey L. Pitt, Remarks at the Fall Meeting of the American Bar Association Committee on Federal Regulation of Securities (Nov. 16, 2001), available at <http://www.sec.gov/news/spch524.htm>; Harvey L. Pitt, Remarks at the Practicing Law Institute Thirty-Third Annual Institute on Securities Regulation (Nov. 8, 2001) [hereinafter Pitt, Practicing Law Institute Remarks], available at <http://www.sec.gov/news/spch520.htm>; Harvey L. Pitt, Remarks at the SEC Historical Society Major Issues Conference (Nov. 14, 2001), available at <http://www.sec.gov/news/spch523.htm>.

70 Pitt, Practicing Law Institute Remarks, *supra* note 69.

71 Pitt, *supra* note 63.

72 Pitt, Consumer Federation of America Remarks, *supra* note 69.

73 Pitt, *supra* note 21.

confidence.<sup>74</sup> He linked the Enron failure to the need for better financial disclosure and identified the “lack of clear and transparent financial statements” as one of the “system flaws” that must be repaired.<sup>75</sup> In a January 2002 speech, he also urged companies to disclose the “three, four or five most critical accounting principles upon which a company’s financial status depends, and which involve the most complex, subjective or ambiguous decisions or assessments.”<sup>76</sup>

Chairman Pitt also discussed Commission initiatives in written testimony given on March 21, 2002, before the Committee on Banking, Housing and Urban Affairs of the Senate.<sup>77</sup> In that testimony, he described plans to achieve needed improvements in three areas: informative and timely public disclosure, oversight of accountants and the accounting profession, and improvements in corporate governance.<sup>78</sup> He described several SEC initiatives for improving management discussion and analysis presentation<sup>79</sup> in three areas: critical accounting policies,<sup>80</sup> off-balance sheet obligations,<sup>81</sup> and trend information.<sup>82</sup> He also suggested requiring greater clarity in disclosure,<sup>83</sup> more timely disclosure,<sup>84</sup> accelerated disclosure of corporate insider trading reports,<sup>85</sup> and more current disclosure through expanded 8-K filings.<sup>86</sup>

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74 *Id.*

75 *Id.*

76 Harvey L. Pitt, Remarks at the Twenty-Ninth Annual Securities Regulation Institute (Jan. 29, 2002), *available at* <http://www.sec.gov/news/speech/spch536.htm>.

77 *Hearing, supra* note 43, at 1103 (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n).

78 *Id.* at 1105–06 (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n).

79 *Id.* at 1109 (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n).

80 *Id.* at 1109–10 (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n).

81 *Id.* at 1110 (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n).

82 *Id.* (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n).

83 *Id.* at 1110–11 (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n).

84 *Id.* at 1111 (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n).

85 *Id.* at 1112 (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n).

86 *Id.* at 1112–13 (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n). In his testimony, Chairman Pitt also suggested corporate governance reform, *id.* at 1113 (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm’n), and asked for legislation permitting increased SEC ability to bar officers and directors from service at public companies, *id.* at 1114–16 (written testimony of

C. *The SEC's Activities Improving the Timeliness of Disclosure*

Section 409 of the Sarbanes-Oxley Act introduced "Real Time Issuer Disclosure" by amending section 13 of the Exchange Act to require reporting companies to "disclose to the public on a rapid and current basis" information which "the Commission, through its rules, determines necessary."<sup>87</sup> This timely disclosure approach is consistent with the SEC's approach to disclosure in the period prior to passage of the Sarbanes-Oxley Act. The Commission's subsequent actions in adopting measures to improve the timeliness of disclosure confirmed its adherence to that approach.

In a February 13, 2002, press release, the SEC announced its intent to propose changes in corporate disclosure rules as "the first in a series of steps to improve the financial reporting and disclosure system."<sup>88</sup> The Commission's action plan included five items: (1) to provide acceleration of reporting of transactions by company insiders in company securities, including transactions with the company; (2) to accelerate deadlines for annual and quarterly reports; (3) to expand the list of events triggering an 8-K reporting obligation; (4) to require public companies to post their 1934 Exchange Act reports on their web sites; and (5) to require disclosure of critical accounting policies in Management's Discussion and Analysis in annual reports.<sup>89</sup>

On April 23, 2002, as part of its response to section 409, the SEC released its proposals for accelerated periodic disclosure filing dates and website access to reports.<sup>90</sup> Its final rule, "Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports," was adopted on September 5, 2002.<sup>91</sup>

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Harvey L. Pitt, Chairman, Sec. & Exch. Comm'n). As noted below, he also outlined Commission proposals for a Public Accountability Board to regulate the accounting profession and proposed other accounting related reforms, *id.* at 1116-24 (written testimony of Harvey L. Pitt, Chairman, Sec. & Exch. Comm'n).

<sup>87</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 409, 116 Stat. 745, 791 (amending Securities and Exchange Act of 1934 § 13, 15 U.S.C.A. § 78m (1997 & West Supp. 2004)).

<sup>88</sup> SEC to Propose New Corporate Disclosure Rules, SEC News DIG. (Sec. & Exch. Comm'n, Washington, D.C.), Feb. 12, 2002, available at <http://www.sec.gov/news/digest/02-13.txt>.

<sup>89</sup> *Id.*

<sup>90</sup> Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Securities Act Release No. 8089, 67 Fed. Reg. 19,896 (proposed Apr. 23, 2002) [hereinafter Acceleration Proposing Release].

<sup>91</sup> Acceleration of Periodic Report Filing Dates and Disclosures Concerning Website Access to Reports, Securities Act Release No. 8128, Exchange Act Release No. 46,464, 67 Fed. Reg. 58,480 (Sept. 16, 2002) (to be codified in scattered sections of 17 C.F.R.) [hereinafter Acceleration Adopting Release]. In April 2003, the Commission



## 1. Acceleration of Periodic Report Deadlines

Regarding acceleration, the Commission noted that the filing deadlines for periodic reports had not been changed since they were established in 1970<sup>92</sup> and observed that many “large seasoned reporting companies capture and evaluate information and announce their quarterly and annual financial results well before they file their formal reports with the Commission.”<sup>93</sup>

The Commission sought to bring these spontaneously developed disclosure practices into its regulatory framework by accelerating the 10-K and 10-Q reporting requirements. Recognizing the burdens of meeting accelerated schedules, the Commission applied the requirement to a relatively narrow group of large companies. It applied the accelerated filing deadlines to the group of “accelerated filers,”<sup>94</sup> companies that are current in fulfilling their filing requirements<sup>95</sup> and have a “public float<sup>96</sup> of \$75 million or more.”<sup>97</sup>

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issued a correcting release: Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports; Correction, Securities Act Release No. 8128A, 67 Fed. Reg. 17,880 (Apr. 14, 2003).

92 Acceleration Proposing Release, 67 Fed. Reg. at 19,897.

93 *Id.* In a 1998 release, the Commission noted that “hundreds of public companies issue press releases to announce quarterly and annual results well before they file their reports” with the SEC. *Id.* at 19,897–98; *see also* Regulation of Securities Offerings, Securities Act Release No. 7606A, Exchange Act Release No. 40,632A, 63 Fed. Reg. 67,174 (Dec. 4, 1998) (showing the SEC soliciting comments on whether the filing deadlines should be shortened for periodic reports under the Securities Exchange Act). The SEC commented that, according to research conducted by its Office of Economic Analysis during the preceding decade, “registrants on average issued their year-end earnings announcements approximately 43 days after fiscal year end” and “their quarterly earnings announcements approximately 27 days after period end.” Acceleration Proposing Release, 67 Fed. Reg. at 19,898 n.27.

94 Acceleration Adopting Release, 67 Fed. Reg. at 58,487–91. The definition of “accelerated filer” is contained in 17 C.F.R. § 240.12b.2 (2003).

95 A company must have been “subject to the reporting requirements of Section 13(a) [15 U.S.C. § 78m(a)] or 15(d) [15 U.S.C. § 78o(d)] of the Exchange Act for a period of at least 12 calendar months preceding the filing of the report” and must have “filed at least one annual report pursuant to Section 13(a) or 15(d).” Acceleration Proposing Release, 67 Fed. Reg. at 19,899.

96 The Commission defines “float” as “the aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer.” *Id.* at 19,911. The Commission recognized that the definition of “accelerated filer” would not apply to large foreign reporting companies. The Commission requested comment on whether it would be advisable to accelerate the reporting deadlines for foreign reporting companies. *Id.* at 19,904.

97 As of the date within no more than sixty and no less than thirty days before the end of the company’s last fiscal year. Acceleration Adopting Release, 67 Fed. Reg. at 58,487–88.

In order to ease the apprehensions of large reporting companies, the SEC introduced a three-year phase-in period for the accelerated deadlines. The deadlines for periodic reports did not change for fiscal years ending in 2002. For fiscal years ending on December 15, 2003, or later, the 10-K deadlines were reduced to seventy-five days while the 10-Q deadline remained intact. For fiscal years ending on December 15, 2004, or after, the deadline for the 10-K and 10-Q reports were accelerated to sixty days and forty days respectively. The 10-Q report filing deadline for fiscal years ending on December 15, 2005, was set at thirty-five days.<sup>98</sup> The different pace of acceleration of deadlines for annual and quarterly reports reflected an opinion expressed by the majority of commenters that "it would be more difficult to accelerate filing of the quarterly report than the annual report."<sup>99</sup>

Recently, recognizing difficulties for companies attempting to comply with rules implementing section 404 of the Sarbanes-Oxley Act relating to internal controls, the Commission has postponed the deadlines for accelerated filing by one year.<sup>100</sup>

## 2. Website Access

As an additional response to section 409's "Real Time Disclosure" objectives, the Commission adopted an amendment to Item 101 of Regulation S-K,<sup>101</sup> requiring "accelerated filers" in their annual reports on Form 10-K: (1) to disclose "that the public may read and copy any material . . . file[d] with the SEC at the SEC's Public Reference Room;"<sup>102</sup> (2) to disclose the address of the company's website;<sup>103</sup> and (3) to disclose whether the company makes its annual, quarterly, and Form 8-K reports available on its website, free of charge, "as soon as reasonably practicable, and in any event on the same day as" the company filed such reports with the Commission.<sup>104</sup>

The Commission's reasoning for the website access proposal was very similar to its reasoning regarding accelerated deadlines. It explained that the proposal would promote widespread and timely access to corporate information enabling investors to make their investment decisions on an informed basis, thereby advancing effi-

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98 *Id.* at 58,482.

99 *Id.*

100 Temporary Postponement of the Final Phase-In Period for Acceleration of Periodic Reporting Filing Dates, Securities Act Release No. 8477, Exchange Act Release No. 50,254, 69 Fed. Reg. 53,550 (Sept. 1, 2004).

101 Regulation S-K, 17 C.F.R. § 229.101(e) (2004).

102 Acceleration Adopting Release, 67 Fed. Reg. at 58,505.

103 *Id.*

104 *Id.*

cient functioning of the securities market.<sup>105</sup> It stated that by posting reports on-line “accelerated filers” will help to “democratize the capital markets by enabling many small investors to access corporate information just as readily as large institutional investors.”<sup>106</sup>

#### D. *Form 8-K Reform*

The SEC’s next step on the path toward real-time disclosure was to implement two proposals made prior to the adoption of Sarbanes-Oxley, shortening the reporting time periods for the Form 8-K, which requires prompt disclosure of certain triggering events, and adding new and revised 8-K disclosure requirements.

On June 25, 2002, more than a month before the Sarbanes-Oxley Act was signed into law, the Commission proposed adding new disclosure requirements to Form 8-K and accelerating its filing deadlines.<sup>107</sup> Its final rule was adopted on March 25, 2004.<sup>108</sup> The first five sections of the amended Form 8-K, under the revised numbering system, contain eight newly added disclosure items, two expanded existing items, two items transferred in part from periodic reports, and nine retained items.<sup>109</sup> The items are organized under five headings:

- Section 1: Registrant’s Business and Operation: new Item 1.01, entry into a material agreement not made in the ordinary course of company’s business;<sup>110</sup> new Item 1.02, termination of a material definitive agreement;<sup>111</sup> and retained Item 1.03, bankruptcy or receivership.<sup>112</sup>
- Section 2: Financial Information: retained Item 2.01, completion of acquisition or disposition of assets;<sup>113</sup> retained Item 2.02, results of operations and financial condition;<sup>114</sup> new Item 2.03,

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105 Acceleration Proposing Release, Securities Act Release No. 8089, 67 Fed. Reg. 19,896, 19,902 (proposed Apr. 23, 2002).

106 *Id.*

107 Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 8106, 67 Fed. Reg. 42,914 (proposed June 25, 2002).

108 Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Exchange Act Release No. 49,424, 69 Fed. Reg. 15,594 (Mar. 25, 2004).

109 *See id.*

110 *Id.* at 15,596.

111 *Id.* at 15,597.

112 *Id.* at 15,598.

113 *Id.*

114 *Id.* This item was adopted by the Commission in January 2003 in a final rule addressing pro forma financial measures. *See* Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 8176, Exchange Act Release No. 47,226, 68 Fed. Reg. 4820 (Jan. 30, 2003) (to be codified in scattered sections of 17 C.F.R.). The SEC issued the proposing release on November 13, 2002. *See* Conditions for Use of

creation of a direct financial obligation that is material to the company;<sup>115</sup> new Item 2.04, events triggering a direct financial obligation or an obligation under an off-balance sheet arrangement that is material to the registrant;<sup>116</sup> new Item 2.05, costs associated with exit or disposal activities resulting in material changes;<sup>117</sup> and new Item 2.06, material impairments to one or more company assets under GAAP.<sup>118</sup>

- Section 3: Securities and Trading Markets: new Item 3.01, notice from an exchange or a quotation system about failure to satisfy a listing standard or about delisting of a class of company's securities, and actions taken by the company resulting in termination of a listing or a transfer of a listing to another exchange or quotation system;<sup>119</sup> transferred and modified Item 3.02, unregistered sales of equity securities;<sup>120</sup> and transferred and modified Item 3.03, material modification to the rights of security holders.<sup>121</sup>
- Section 4: Matters Related to Accountants and Financial Statements: retained Item 4.01, changes in registrant's certifying accountant;<sup>122</sup> and new Item 4.02, non-reliance on previously issued financial statements, reports, or reviews.<sup>123</sup>
- Section 5: Corporate Governance and Management: retained Item 5.01, changes in control of registrant;<sup>124</sup> retained and expanded Item 5.02, departure of directors or principal officers, election of directors, and appointment of principal officers;<sup>125</sup> new Item 5.03, relating to amendments to articles or bylaws not

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Non-GAAP Financial Measures, Securities Act Release No. 8145, 67 Fed. Reg. 68,790 (proposed Nov. 13, 2002). This item requires reporting companies "to furnish to the Commission all releases or announcements disclosing material non-public financial information." Conditions for Use of Non-GAAP Financial Measures, 68 Fed. Reg. at 4825. This release and the proposing release are discussed here only to the extent of their effect on the Form 8-K reporting mechanism. The next section of this Part, "Enhanced Financial Disclosure," discusses the releases in depth. See *infra* Part III.E.

115 Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 69 Fed. Reg. at 15,595.

116 *Id.*

117 *Id.*

118 *Id.*

119 *Id.*

120 *Id.*

121 *Id.*

122 *Id.*

123 *Id.* at 15,604. If they incorporated or relied-on financial statements covering one or more years for which the company was required to provide audited financial statements pursuant to requirements of Regulation S-X or Regulation S-B. *Id.*

124 *Id.* at 15,605.

125 *Id.* at 15,605-06.

proposed in prior statements;<sup>126</sup> retained Item 5.04, temporary suspension of trading under registrant's employee benefit plans;<sup>127</sup> and retained Item 5.05, amendments to the registrant's code of ethics.<sup>128</sup>

In addition to adding new disclosure items, the Commission has amended the Form 8-K filing dates, requiring companies to file reports on Form 8-K within four business days of a triggering event,<sup>129</sup> instead of five or fifteen days.

The new Form 8-K disclosure system is a strong part of the corporate governance and disclosure reform begun by the Commission prior to the adoption of the Sarbanes-Oxley Act and later mandated by the Act. It enhances various components of the reform by forcing public companies to disclose on a real-time basis major unusual events and irregularities. In this way, Form 8-K requirements serve as an early-warning system for investors, highlighting public companies' unusual major contracts, material financial exposures (whether such exposures are imminent or potential, definite or contingent), violations of listing standards, and major changes within the board or senior management. These reforms of the disclosure system by the Commission under Form 8-K are very positive.

Regarding the acceleration of 10-K and 10-Q reporting dates, the Commission has not moved to the continuous reporting system envisaged by Chairman Pitt shortly after he assumed office, but instead has relied on the existing structure to accelerate the deadlines for periodic reports in a graduated fashion. This gradual acceleration focuses on two important elements. First, the accelerated deadlines will initially apply only to large, seasoned companies. The Commission believes that those companies to a large extent have voluntarily adopted measures allowing them to communicate with investors in a more timely fashion. Second, the acceleration is substantial. News about corporate developments occurring during the preceding year or quarter will become available to investors in shorter time frames: in sixty days rather than ninety days for 10-K reports and in thirty-five days rather than forty days for 10-Q reports.

The changes to Form 8-K reporting are more dramatic steps towards achieving real-time issues disclosure, since they both accelerate

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126 *Id.* at 15,606.

127 *Id.* at 15,595, 15,606.

128 *Id.* at 15,595. The items in sections 7, 8, and 9 are treated by the Commission as retained and renumbered items. *Id.*

129 Expanded from the two days proposed in the Proposing 8-K Release. Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 8106, 67 Fed. Reg. 42,914, 42,914 (proposed June 25, 2002).

the deadlines for Form 8-K reports and substantially expand the number of events triggering the reporting obligation. By reducing the time span between the occurrence of a triggering event and the deadline to submit a mandatory report from fifteen days to four days, the Commission has greatly improved the role of Form 8-K as a tool of current disclosure. By increasing the number of events important enough to warrant prompt disclosure, the Commission created a better timely disclosure system with positive public results.

#### *E. Enhanced Financial Disclosure*

In 1998, SEC Chairman Arthur Levitt asserted that due to constant pressure to meet or exceed market expectations, publicly traded companies were too often reporting financial results that were the products of improper or misleading accounting practices.<sup>130</sup> Since then, earnings and balance sheet misstatements have been a special focus of the SEC.<sup>131</sup>

#### *F. MD&A Statements*

The Management's Discussion and Analysis (MD&A), contained in Forms 10-K and 10-Q, is a critical part of every public company's financial disclosure.<sup>132</sup> MD&A constitutes the narrative analysis and evaluation portion of a registrant's financial disclosure, providing the investors "an opportunity to see the company through the eyes of management."<sup>133</sup> Concerned that historical financial data does not indicate future operating results or future financial conditions, the Commission has for many years required registrants to discuss known trends or uncertainties in the MD&A. The increasing number of corporate financial reporting scandals caused the SEC to focus on various enhancements to MD&A as a means of enhancing the public company financial reporting process.

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130 See Arthur Levitt, The "Numbers Game": Remarks at the New York University Business and Law Center Annual Securities Conference (Sept. 28, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>.

131 Lynn Turner, Revenue Recognition: Remarks at USC SEC and Financial Reporting Institute (May 31, 2001), available at <http://www.sec.gov/news/speech/spch495.htm>.

132 For a detailed discussion of the MD&A requirements, see Linda Quinn & Ottilie L. Jarmel, *MD&A 2002: Linchpin of SEC Post-Enron Disclosure Reform*, in PRACTISING LAW INST., THE NEW DISCLOSURE & CORPORATE GOVERNANCE REGIME: WHAT EVERY CORPORATE AND SECURITIES LAWYER MUST KNOW 781 (2003).

133 Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 6711, 52 Fed. Reg. 13,715, 13,717 (Apr. 23, 1987).

On January 25, 2002, the Commission issued its Statement About Management's Discussion and Analysis of Financial Condition and Resulting of Operations (MD&A Financial Condition Statement),<sup>134</sup> addressing three areas: liquidity and capital resources including, off-balance sheet arrangements; certain trading activities that include non-exchange traded contracts accounted for at fair value; and effects of transactions with related and certain other parties.<sup>135</sup> These three areas were particularly relevant to the Enron collapse.

The SEC first asked companies to consider describing in detail their material sources of liquidity and financing, a request consistent with Item 303 of Regulation S-K, which requires registrants in their MD&A to "identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way."<sup>136</sup> In the context of liquidity and capital resources disclosure, the Commission also gave special emphasis to disclosure of off-balance sheet arrangements, a direct response to the Enron situation.<sup>137</sup> As investigations have revealed, Enron disclosed the existence

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134 Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operation, Securities Act Release No. 8056, Exchange Act Release No. 45,321, 67 Fed. Reg. 3746 (Jan. 25, 2002) [hereinafter MD&A Financial Condition Statement]. This statement, like the Commission's Critical Accounting Policy Advice, is not a Commission rule, but nevertheless carries substantial weight. The statement was made in response to a petition by major accounting firms asking the SEC to issue an interpretive release to provide guidance for public companies in preparing disclosures for inclusion in annual reports on Form 10-K and other reports on January 22, 2002. Arthur Andersen LLP et al., Petition to U.S. Securities and Exchange Commission for Issuance of Interpretive Release (Dec. 31, 2001), *available at* <http://www.sec.gov/rules/petitions/petndiscl-12312001.htm>.

135 MD&A Financial Condition Statement, 67 Fed. Reg. at 3746.

136 Regulation S-K, 17 C.F.R. § 229.303(a)(1) (2004). In the MD&A Financial Condition Statement, the SEC asked companies to be more specific and avoid boilerplate regarding liquidity. Companies were also reminded that they must identify known trends and circumstances that could materially affect liquidity if they are "reasonably likely to occur." MD&A Financial Condition Statement, 67 Fed. Reg. at 3748. Referring back to its 1989 MD&A release, the SEC reminded the registrants that the "reasonably likely" standard is a lower disclosure threshold than a "more likely than not" standard. *Id.* As to the issue of how to identify "known trends," the Commission reiterated its "probability and magnitude" test requiring disclosure unless the registrant affirmatively determines that the matter is not likely to come to fruition or is not material. *Id.* It also provided a detailed list of particular matters for the management to consider. *Id.*

137 Regulation S-K, 17 C.F.R. § 229.303(a)(ii). Previously, off-balance sheet arrangements were only briefly mentioned by Regulation S-K in the context of disclosing capital costs. Under Item 303(a)(ii) of Regulation S-K, the issuer was required to "indicate any material changes in the mix and relative cost of such resources," and in

of at least some of its SPEs, but “did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the [SPEs].”<sup>138</sup> In response to this lack of disclosure, the Commission has encouraged registrants to disclose the extent of their reliance on off-balance sheet arrangements where third parties provide financing, liquidity, or market or credit risk support.

The MD&A Financial Condition Statement also addressed disclosure about effects of transactions with related parties, another point of contention in the Enron collapse. The SEC advised companies that their MD&A disclosure should contain detailed discussions of material related-party transactions to the extent needed to provide investors with an understanding of their current and prospective financial positions and operating results.<sup>139</sup>

The Commission has also broadened the scope of “related parties.” Under the MD&A Financial Condition Statement, registrants are encouraged to disclose in the MD&A all material transactions not only with “related parties” in a traditional sense, but also with certain other parties “with whom the registrant or its related parties have a relationship that enables the parties to negotiate transaction terms that may not be available from clearly independent parties on an arm’s length basis.”<sup>140</sup> In the expanded definition of “related parties,” the nature, purpose and economic substance of, and risks associated with transactions with unconsolidated SPEs are subject to MD&A disclosure. Expanding the scope of “related parties” hopefully will discourage abuse of unconsolidated entity relationships.

Although the SEC declared that the MD&A Financial Condition Statement “does not create new legal requirements, nor does it modify existing requirements,”<sup>141</sup> the statement actually set out a compre-

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its discussion to consider changes between equity, debt, and any off-balance sheet financing arrangements.

138 See POWERS REPORT, *supra* note 2, at 17.

139 Previously, related-party transactions were required to be disclosed in financial statements (as footnotes) and in other specific contexts, but were not specifically required under the MD&A. For example, with respect to certain merger transactions, Regulation S-X indicates that related-party transactions should be identified and the transaction amounts stated on the face of the balance sheet, income statement, or statement of cash flows. Other requirements include, e.g., Item 13 of Form 10-K, Item 404 of Regulation S-K, and Item 7B of Form 20-F. See Philip J. Boeckman & John C. Cocchiarella, *Nuts and Bolts of the New SEC Disclosure Regime: Pro Forma Earnings, Critical Accounting Policies and MD&A*, in PRACTISING LAW INST., PLI’S SECOND ANNUAL INSTITUTE ON SECURITIES REGULATION IN EUROPE 33 (2002).

140 MD&A Financial Condition Statement, 67 Fed. Reg. at 3751.

141 *Id.* at 3747.



hensive and ambitious plan for reforming MD&A disclosure. In a departure from previous policy, which had preserved management flexibility in MD&A disclosure, the Commission has expanded the scope and detailed standards for MD&A disclosure. This more detailed approach to MD&A should produce better disclosure.

*G. The May 2002 SEC Proposals Concerning Critical Accounting Policies*

On December 17, 2001, while the collapse of Enron was still under investigation, the SEC began its attempts to improve public company financial disclosure by issuing a Cautionary Advice Regarding Disclosure about Critical Accounting Policies.<sup>142</sup> Under this cautionary advice, the Commission encouraged public companies to include in their MD&A full explanations of their "critical accounting policies." According to the SEC, these policies are both "important to the portrayal of a company's financial condition and results" and involve management's subjective judgments and estimations that are "inherently uncertain."<sup>143</sup>

In May 2002, the SEC continued its attention to discussion of critical accounting policies in MD&A by proposing to expand the disclosure about the application of critical accounting policies (the Critical Accounting Policies Release).<sup>144</sup> Even though the proposed rule has not been adopted, it provides guidance for registrants. The proposed rule would amend Item 303 of Regulation S-K and would create a new section in the MD&A. Specifically, the MD&A would include two new areas: identification and comprehensive description of critical accounting estimates used in preparing the financial statements, and identification and comprehensive description of the initial adoption of an accounting policy that has a material impact on the financial presentation.<sup>145</sup>

Under the proposal, the disclosure regarding estimates would be triggered under a difficult "highly uncertain" test, and the proposal

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142 Securities Act Release No. 8040, Exchange Act Release No. 45,149, 66 Fed. Reg. 65,013 (Dec. 17, 2001), *available at* <http://www.sec.gov/rules/other/33-8040.htm>. Note that this advice is not part of a rulemaking procedure, but an indication of how the Commission expects to interpret its rules, including Regulation S-K. The statement carries substantial weight.

143 *Id.* at 65,013.

144 Proposed Rule: Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies, Securities Act Release No. 8098, Exchange Act Release No. 45,907, 67 Fed. Reg. 35,620 (May 20, 2002).

145 *Id.* at 35,626.

would require comprehensive and complex disclosure.<sup>146</sup> Although the failure to adopt the proposal may indicate the SEC's acceptance of arguments that the proposal is too complicated, it seems likely that the SEC will continue to make MD&A the central item for disclosure of material subjective judgments made by management in the preparation of financial statements.

#### *H. Requirements Under Section 401 of the Sarbanes-Oxley Act*

Section 401(a) of the Sarbanes-Oxley Act added a new section 13(j) to the Exchange Act requiring the SEC to adopt rules requiring disclosure of off-balance sheet arrangements in periodic reports. According to Congress, new Section 13(j) of the Exchange Act dealing with off-balance sheet arrangements was adopted to address "the problems of Enron and its special purpose entities."<sup>147</sup> Specifically, this section required the SEC to issue final rules by January 26, 2003, providing that each annual and quarterly report required to be filed disclose

all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.<sup>148</sup>

The language of new Section 13(j) indicates that the drafters of this section were influenced by the SEC's expressions of concern regarding off-balance sheet arrangements, including its January 2002 MD&A Financial Condition Statement.<sup>149</sup>

Although Section 13(j) deals with specific aspects of financial disclosure, it uses general and broad terms, such as "other relationships," "other persons," and "may" that require explanation for the rule to operate. The Act did not specify where and how the required new

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146 For a discussion of the potential burden that may be imposed by the critical accounting estimates disclosure, see John J. Huber & Thomas J. Kim, *The Response to Enron: The Sarbanes-Oxley Act of 2002 and Commission Rulemaking*, in PRACTISING LAW INST. 34TH ANNUAL INSTITUTE ON SECURITIES REGULATION 61,154-55 (2002).

147 S. REP. NO. 107-205, at 28 (July 3, 2002).

148 Sarbanes-Oxley Act of 2002 § 401(a)(j), 15 U.S.C.A. § 78m(j) (West Supp. 2004).

149 Securities Act Release No. 8056, Exchange Act Release No. 45,321, 67 Fed. Reg. 3746 (Jan. 25, 2002).

disclosures should be made and delegated the power to the Commission to carry out the purposes of the section.<sup>150</sup>

On January 27, 2003, the SEC implemented section 401 of the Act by adopting amendments to MD&A in Item 303 of Regulation S-K.<sup>151</sup> The final rules define the term “off-balance sheet arrangement” as any transaction, agreement, or other contractual arrangement to which an entity that is not consolidated with the issuer is a party, under which the issuer has

1. any obligation under certain guarantee contracts;<sup>152</sup>
2. a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets;
3. any obligation under certain derivative instruments;<sup>153</sup> or

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150 On November 4, 2002, the SEC began implementing that section by proposing a series of amendments to Item 303 of Regulation S-K. The SEC also used this opportunity to codify certain portions of the MD&A Statement regarding off-balance sheet arrangements and contractual obligations. The proposal would have required registrants to provide, in a separate MD&A section, a comprehensive discussion of off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships with unconsolidated entities or other persons that have, or may have, a material effect on financial condition, changes in financial condition, revenues and expenses, results of operations, liquidity, capital expenditures, or capital resources. The proposals would also have required that registrants provide an overview of their aggregate contractual obligations and contingent liabilities in a tabular format. *See* Disclosure in Management’s Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Securities Act Release No. 8144, Exchange Act Release No. 46,767, 67 Fed. Reg. 68,054 (Nov. 8, 2002) [hereinafter *Off-Balance Sheet Arrangements Final Release*].

151 Disclosure in Management’s Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations and Contingent Liabilities and Commitments, Securities Act Release No. 8182, Exchange Act Release No. 47,264, 68 Fed. Reg. 5982 (Feb. 5, 2003) (to be codified in scattered sections of 17 C.F.R.) [hereinafter *Off-Balance Sheet Arrangements*].

152 The SEC notes that the “guarantee contracts” that fall under the scope of disclosure are the contracts that have characteristics identified in paragraph 3 of FASB Interpretation No. 45. FIN. ACCOUNTING STANDARDS BD., FASB INTERPRETATION NO. 45, GUARANTOR’S ACCOUNTING AND DISCLOSURE REQUIREMENTS FOR GUARANTEES, INCLUDING INDIRECT GUARANTEES OF INDEBTEDNESS OF OTHERS 7 (2002), *available at* <http://www.fasb.org/pdf/fin%2045.pdf>.

153 The SEC notes that the “obligation” covers any obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument, except that it is both indexed to the issuer’s own stock and classified in stockholders’ equity in the issuer’s statement of financial position, and therefore excluded from the scope of FASB Statement of Financial Accounting Standards No. 133.

4. any obligation (including contingent obligations) arising out of a variable interest in an unconsolidated entity that is held by and material to the issuer, where the unconsolidated entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the issuer.<sup>154</sup>

This final definition clearly indicates that the focus of the rule is off-balance sheet arrangements that are used by the registrant to provide financing, liquidity, market risk or credit risk support, or to engage in leasing, hedging, or research and development services.<sup>155</sup>

Under the final rules, the disclosure of off-balance sheet arrangements is triggered when the arrangements “have or are reasonably likely to have” a current or future effect on the issuer’s financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources that is material to investors.<sup>156</sup>

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See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FIN. ACCOUNTING STANDARDS NO. 133, ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES (1998).

154 Off-Balance Sheet Arrangements, 68 Fed. Reg. at 5987–88.

155 Some commentators were particularly concerned that the SEC’s proposed definition would not serve the purpose of providing more understandable financial information to the investors. See, e.g., Letter from Committee on Federal Regulation of Securities, American Bar Association, to the Securities and Exchange Commission (Dec. 31, 2002) [hereinafter ABA Comment Letter], available at <http://www.sec.gov/rules/proposed/s74202/skeller1.htm>. The final definition is narrower and is restricted to the arrangements that serve financing, liquidity and risk support functions. See, e.g., Letter from KPMG, LLP, to the Securities and Exchange Commission (Dec. 9, 2002), available at <http://www.sec.gov/rules/proposed/s74202/kpmg1.htm>.

156 Off-Balance Sheet Arrangements, 68 Fed. Reg. at 5990. This “reasonably likely” disclosure threshold is consistent with the existing disclosure threshold in Item 303 under which information that could have a material effect on financial condition, changes in financial condition, or results of operations must be included in the MD&A, SEC’s 1989 Interpretive Release on MD&A Disclosure, Securities Act Release No. 6835, Exchange Act Release No. 26,831, 54 Fed. Reg. 22,427 (May 18, 1989), and is also consistent with the threshold under the MD&A Financial Condition Statement, Securities Act Release No. 8056, Exchange Act Release No. 45,321, 67 Fed. Reg. 3746, 3748 (Jan. 25, 2002). The proposed rules would have introduced a very different “not remote” threshold. In the proposing release, the SEC seemed to have concluded that the term “may” in Section 13(j) indicated that Congress contemplated a standard for disclosure of off-balance sheet items more stringent than the existing “reasonably likely” standard. The SEC seems to have been convinced by many commentators that such a stringent standard is not required by the Act. See, e.g., ABA Comment Letter, *supra* note 155. The SEC adopting release provides guidance concerning application of this disclosure threshold. Management must assess the likelihood of the occurrence of any known trend, demand, commitment, event, or uncertainty that could affect an off-balance sheet arrangement. According to the final rule release, the proper test for such assessment is the traditional “probability and magnitude” test, as

Once the applicable off-balance sheet arrangements are identified, the rules require registrants to make comprehensive disclosures, including (1) the nature and business purposes of these arrangements, (2) the importance of these arrangements to the financial condition of the registrant, (3) the magnitude and material impact of these arrangements as well as circumstances that may trigger obligations under these arrangements, and (4) risks of termination of benefits from the arrangements.<sup>157</sup>

It is important to note that disclosure of information under these categories is not necessarily mandatory, because disclosure is required only "to the extent necessary for an understanding of the applicable transactions and their effects."<sup>158</sup> The proposed rules, which followed the policy of the MD&A Financial Condition Statement, would have mandated these specific disclosures.<sup>159</sup> The Commission did not adopt the mandatory standard, and instead continues to place on management the burden of deciding what disclosures should be made in MD&A.<sup>160</sup> Nevertheless, the new definitions of "off-balance sheet arrangement" should result in new, detailed, and informative disclosure regarding such arrangements.

The final rule also requires disclosure of aggregate contractual obligations and contingent liabilities.<sup>161</sup> Although the Sarbanes-Oxley Act does not mandate such disclosure, the SEC's 401(a) implementation rules seized the opportunity to codify proposals regarding contractual obligations and contingent liabilities initiated by the MD&A Financial Condition Statement.<sup>162</sup> The rules require companies to

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previously adopted by the 1989 MD&A release and reiterated under the MD&A statement. See MD&A Financial Condition Statement, 68 Fed. Reg. at 3748-49.

157 Regulation S-K, 17 C.F.R. § 229.303(a)(4)(i)(A)-(D) (2004).

158 *Id.* § 229.303(a)(4)(i).

159 Some commentators pointed out that such detailed disclosure requirements were both unnecessarily complex and overly prescriptive. See, e.g., Letter from Cleary, Gottlieb, Steen & Hamilton, to the Securities and Exchange Commission (Dec. 9, 2002), available at <http://www.sec.gov/rules/proposed/s74202/clearygottl.htm>. To address this concern, the Commission's final rules take a more "principles-based" approach with respect to these specific disclosure requirements. The SEC acknowledged in the adopting release that "the amendments contain a principles-based requirement." Off-Balance Sheet Arrangements, 68 Fed. Reg. at 5989.

160 The SEC stated that "[c]onsistent with traditional MD&A disclosure, management has the responsibility to identify and address the key variables and other qualitative and quantitative factors that are peculiar to, and necessary for, an understanding and evaluation of the company." Off-Balance Sheet Arrangements, 68 Fed. Reg. at 5985.

161 Regulation S-K, 17 C.F.R. § 229.303(a)(4)(ii).

162 MD&A Financial Condition Statement, Securities Act Release No. 8056, Exchange Act Release No. 45,321, 67 Fed. Reg. 3746, 3749 (Jan. 25, 2002).

provide a tabular presentation of known contractual obligations, referring to the following categories of obligations: (i) long-term debt, (ii) capital lease obligations, (iii) operating leases, (iv) purchase obligations, and (v) other long-term liabilities reflected in the issuer's balance sheet under GAAP. The table must disclose the aggregate amounts of such obligations that will become due within less than one year, within one to three years, within three to five years, and after five years as of the end of latest fiscal year.<sup>163</sup> Currently, the GAAP standard requires, throughout the registrants' financial statement, disclosure of contractual obligations to make future payments under the categories (i), (ii), and (iii) listed above.<sup>164</sup> The purpose of this disclosure is not to repeat the GAAP required disclosures, but to put "aggregated information about contractual obligations and contingent liabilities and commitments in a single location."<sup>165</sup> Compared to the traditional narrative discussion of MD&A, this tabular disclosure format is more visual, making it easier for readers to compare relevant information among periods.<sup>166</sup>

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163 Regulation S-K, 17 C.F.R. § 229.303(a)(5)(i).

164 See, e.g., Off-Balance Sheet Arrangements, 68 Fed. Reg. at 5994; FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FIN. ACCOUNTING STANDARDS NO. 13, ACCOUNTING FOR LEASES (1976); FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FIN. ACCOUNTING STANDARDS NO. 47, DISCLOSURE OF LONG TERM OBLIGATIONS (1981); FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FIN. ACCOUNTING STANDARDS NO. 129, DISCLOSURE OF INFORMATION ABOUT CAPITAL STRUCTURE (1997).

165 Off-Balance Sheet Arrangements Final Release, Securities Act Release No. 8144, Exchange Act Release No. 46,767, 67 Fed. Reg. 68,054, 68,062 (Nov. 8, 2002).

166 The final rules require disclosure of information that the registrant believes is necessary for an understanding of the "specified material effects" of its off-balance sheet arrangements. Regulation S-K, 17 C.F.R. § 229.303(a)(4)(i). Registrants may find that, under certain circumstances, they must make projections in order to explain the future effects of applicable off-balance sheet arrangements. Consistent with its approach in the Critical Accounting Policies Release, the Commission recognized in its Off-Balance Sheet Arrangements Final Release that "some of the disclosure required by the rules on off-balance sheet transactions and contractual obligations would require disclosure of forward-looking information." Off-Balance Sheet Arrangements Final Release, 67 Fed. Reg. at 68,065. The result is that this forward-looking information is mandated by the SEC. In order to make clear that the forward-looking disclosure is mandated, the SEC has eliminated a portion of the instructions in the MD&A rules that state that registrants are not required to provide forward-looking information. See, e.g., Regulation S-K, 17 C.F.R. § 229.303 (Instruction 7). To ease the burden attached to forward-looking statements, the instructions to Item 303 specifically state that the safe harbor for forward-looking information provided by the Private Securities Litigation Reform Act of 1995 (the Reform Act) will apply to forward-looking information that is required to be disclosed by the rules. Instruction (c) to paragraph (b) of Item 303 states that the safe harbor provisions of Section 27A of the Securities Act and Section 21E of the Exchange Act will apply to

The final rules establish concrete requirements and guidance for the MD&A discussion with respect to off-balance sheet arrangements and material contractual obligations. The requirements direct companies to present a complete and meaningful picture of transactions between the company and its unconsolidated affiliates. Focusing on the true purpose and impact of these transactions, the rules are designed to discourage the abuse of unconsolidated special purpose entities. Investors should benefit from the improved MD&A presentation, including the more understandable tabular formula for aggregated contractual obligations.

### 1. The SEC's Rulemaking Regarding Pro Forma Financial Information

Pro forma earnings statements present a company's earnings in a different, and usually more favorable, light than permitted by U.S. GAAP. Pro forma earnings frequently exclude a wide range of expenses, such as interest, taxes, or amortization, and sometimes include unusual gains in income in a manner that would not be allowed under GAAP.

During the 1990s companies increasingly began using pro forma earnings in their press releases and in SEC filings.<sup>167</sup> Since there was no uniform standard for pro forma reporting and since in many cases GAAP results did not accompany the pro forma figures, it was particularly difficult for investors to evaluate and compare the performance of companies based on pro forma information.

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forward-looking statements provided pursuant to paragraph (c) of Item 303. The safe harbor protection available to the MD&A disclosures are improved over the statutory safe harbor in the Reform Act because the "meaningful cautionary statement 'requirement' will be satisfied if a registrant satisfies all of its off-balance sheet arrangements disclosure requirements." *Off-Balance Sheet Arrangements*, 68 Fed. Reg. at 5993. All information provided in response to the rules, except for historical facts, will be deemed to constitute forward-looking statements within the meaning of the safe harbor.

167 In 1973, the Commission issued Accounting Series Release No. 142, warning of possible investor confusion from the use of financial measures outside of GAAP: "[T]he unilateral development and presentation on an unaudited basis of various measures of performance by different companies which constitute departures from the generally understood accounting model has led to conflicting results and confusion for investors." *Reporting Cash Flow and Other Related Data*, Securities Act Release No. 5377, Exchange Act Release No. 10041, 38 Fed. Reg. 9158 (Apr. 11, 1973). Nevertheless, SEC rules only regulated the use of pro forma information in the narrow context of certain merger transactions. Regulation S-X, 17 C.F.R. § 210 (2004).

## 2. The SEC Cautionary Advice Regarding Pro Forma Financial Information

In an effort to address the concerns raised by the use of pro forma earnings, the SEC issued its Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases (Pro Forma Advice) on December 10, 2001.<sup>168</sup> The Pro Forma Advice described pro forma financial information as earnings and results of operations presented "on the basis of methodologies other than Generally Accepted Accounting Principles."<sup>169</sup> The Commission warned reporting companies using non-GAAP measures that antifraud provisions applied to companies providing pro forma financial information in a misleading fashion. It reminded companies that the omission of material information may be misleading, despite the fact that a company's financial results may be literally true.<sup>170</sup>

Although the Pro Forma Advice contained warnings, the SEC acknowledged that non-GAAP information may serve a useful purpose, indicating that interpretations to GAAP results and summaries of GAAP financial statements are not prohibited.<sup>171</sup> Nevertheless, it indicated that pro forma information must be presented in a way that is not misleading and allows meaningful comparisons with GAAP and prior non-GAAP presentations. On January 16, 2002, the Commission demonstrated its seriousness about pro forma earnings when it announced the settlement of an enforcement action against Trump Ho-

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168 Securities Act Release No. 8039, Exchange Act Release No. 45,124, 66 Fed. Reg. 63,731 (Dec. 10, 2001), *available at* <http://www.sec.gov/rules/other/33-8039.htm>.

169 *Id.* at 63,732.

170 The SEC for the first time attempted to provide practical guidance regarding use of pro forma financial information. The SEC encouraged public companies to "consider" the earnings press releases guidelines jointly developed by Financial Executives International (FEI) and the National Investor Relations Institute (NIRI). The FEI/NIRI guidelines suggested, among other things, that companies provide, in tabular format, a reconciliation of any pro forma results to GAAP. *Id.* The FEI/NIRI guidance provides:

It is important to provide the pro forma results in context of their GAAP framework. The order in which reported or pro forma results are presented in the release is not as important as their context. Pro forma results should always be accompanied by clearly described reconciliation to GAAP results; this reconciliation is often provided in tabular form.

NAT'L INVESTOR RELATIONS INST., THE FEI/NIRI EARNINGS PRESS RELEASE GUIDELINES (2001), *available at* <http://www.niri.org/publications/alerts/EA120401.cfm>.

171 Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases, 66 Fed. Reg. at 63,732.



tels & Casinos Resort, Inc., in which it found pro forma earnings to be presented in a misleading fashion.<sup>172</sup>

### 3. Relevant Provisions under the Sarbanes-Oxley Act

Section 401(b) of the Sarbanes-Oxley Act required the SEC, not later than 180 days after enactment of the Sarbanes-Oxley Act (i.e., by January 26, 2003), to issue final rules providing that any pro forma financial information included in a periodic report or in any other public disclosure must be presented in a manner that (1) does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the pro forma financial information, in light of the circumstances under which it is presented, not misleading (the antifraud provision);<sup>173</sup> and (2) reconciles that information with comparable financial information prepared under GAAP.<sup>174</sup> The antifraud and comparable information requirements under this section are consistent with the Commission's prior Pro Forma Advice, and clearly reflect SEC influence on the legislative process.

### 4. The SEC's Rules Implementing Section 401(b) of the Act

On January 22, 2003, the SEC adopted rules implementing section 401(b) of the Sarbanes-Oxley Act.<sup>175</sup> The SEC regulation, Regulation G, requires public companies that disclose or release any applicable "non-GAAP financial measures" to provide a presentation of the most comparable GAAP financial measure and to reconcile the

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172 The cease and desist proceedings against Trump Hotels & Casinos Resorts, Inc., was based upon Trump's release of pro forma earnings without revealing that results were attributable to an unusual one-time gain rather than to operations. *In re* Trump Hotel & Casino Resorts, Inc., Accounting and Auditing Release No. 1499, [2001-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 75,014, at 63,251 (Jan. 16, 2002), available at <http://www.sec.gov/litigation/admin/34-45287.htm>. The Commission's press release announcing the action emphasized that the action was the first brought by the Commission based upon pro forma earnings financial reporting. Press Release, Securities & Exchange Commission, SEC Brings First Pro Forma Financial Reporting Case (Jan. 16, 2002), available at <http://www.sec.gov/news/press/2002-6.txt>.

173 This language is similar to SEC Rule 10b-5(b), 17 C.F.R. § 240.10b-5 (2004), the Commission's primary antifraud rule.

174 Sarbanes-Oxley Act of 2002 § 401(b), 15 U.S.C.A. § 78m (West Supp. 2004).

175 See Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 8145, Exchange Act Release No. 46,788, 68 Fed. Reg. 4820 (Jan. 30, 2003); see also Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 8145, Exchange Act Release No. 46,788, 67 Fed. Reg. 68,790 (proposed Nov. 13, 2002).

non-GAAP financial measure to the most comparable GAAP financial measure. The SEC also amended Item 10 of Regulation S-K to provide additional guidance to those registrants that include non-GAAP financial measures in SEC filings.<sup>176</sup>

Regulation G defines a “non-GAAP financial measure” as a numerical measure of an issuer’s historical or future financial performance, financial position, or cash flow that

- Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the issuer; or
- Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented.<sup>177</sup>

Regulation G applies whenever a registrant publicly discloses material information that includes a non-GAAP financial measure.<sup>178</sup> As part of such disclosure the registrant must (1) present the most directly comparable financial measure calculated and presented in accordance with GAAP and (2) reconcile the differences between the non-GAAP financial measure and the most directly comparable financial measure presented in accordance with GAAP.<sup>179</sup>

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176 As noted earlier, under the new Form 8-K registrants must file earnings releases or similar announcements on Form 8-K, with those filings subject to the guidance in amended Item 10 of Regulation S-K. See discussion *supra* at Part III.D.

177 Conditions for Use of Non-GAAP Financial Measures, 68 Fed. Reg. at 4821. In the release adopting Regulation G, the Commission made efforts to clarify the definition by adding both inclusive and restrictive instructions with specific examples. *Id.* at 4823. The inclusive instructions indicate that non-GAAP measures include all presentations that describe either a measure of performance that is different from GAAP calculation (such as income or loss before tax, or net income or loss), or a measure of liquidity that is different from cash flow or cash flow from operations according to GAAP. Examples include EBIT (earnings before interest and taxes) and EBITDA (earnings before interest, taxes, depreciation and amortization). *Id.*

178 Regulation G does not apply to a registrant’s SEC filings, which are covered by amendments to Item 10 of Regulation S-K, discussed *infra* notes 182–86 and accompanying text.

179 Conditions for Use of Non-GAAP Financial Measures, 68 Fed. Reg. at 4824. If the issuer discloses or releases publicly any material information that includes a forward-looking non-GAAP financial measure, the issuer must provide reconciliation to the comparable financial measure calculated and presented in accordance with GAAP unless doing so would require unreasonable efforts. If a registrant releases an applicable non-GAAP financial measure orally, by telephone, by webcast, or by broadcast or similar means, Regulation G allows the required accompanying information to be provided on the company’s website. *Id.* at 4826.

Serving the antifraud goal contained in the first clause of section 401(b), Regulation G does not provide a safe harbor to registrants who comply with it. Regulation G expressly states that a person's compliance or non-compliance with the requirements of Regulation G does not affect that person's liability under section 10(b) or Rule 10b-5.<sup>180</sup>

The SEC also amended Item 10 of Regulation S-K, providing similar but more stringent disclosure requirements regarding the use of non-GAAP financial measures.<sup>181</sup> The amended Item 10 applies to the same categories of non-GAAP financial measures covered by Regulation G, but only in SEC filings.

Similar to Regulation G, the new Item 10(e) of Regulation S-K requires all SEC filings containing a non-GAAP financial measure to include

(A) A presentation, with equal or greater prominence, of the most directly comparable financial measure or means calculated and presented in accordance with Generally Accepted Accounting Principles (GAAP);

(B) A reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historical non-GAAP measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP . . . .<sup>182</sup>

Additionally, Item 10(e) contains two provisions not in Regulation G, requiring

(C) A statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP financial measures provides useful information to investors regarding the registrant's financial condition and results of operations; and

(D) To the extent material, a statement disclosing the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measure[s] . . . .<sup>183</sup>

180 Regulation G, 17 C.F.R. § 244.102 (2004).

181 Conditions for Use of Non-GAAP Financial Measures, 68 Fed. Reg. at 4820.

182 Regulation S-K, 17 C.F.R. § 229.10(e)(1)(i)(A)-(B); Conditions for Use of Non-GAAP Financial Measures, 68 Fed. Reg. at 4831.

183 Regulation S-K, 17 C.F.R. § 229.10(e)(1)(i)(C)-(D); Conditions for Use of Non-GAAP Financial Measures, 68 Fed. Reg. at 4831.

These more stringent Item 10(e) additional requirements focus on disclosure of the reasons justifying the use of non-GAAP measures. The Commission indicated that "the justification for the use of the measure must be substantive," and the fact that the non-GAAP financial measure is used by or useful to analysts cannot itself justify the use of the non-GAAP financial measure.<sup>184</sup> It is reasonable to predict that these additional requirements will discourage massive use of non-GAAP measures, thus effectively forcing registrants to provide only the most valuable non-GAAP measures in their SEC filings.<sup>185</sup>

In summary, the SEC rules implementing section 401(b) establish comprehensive and detailed disclosure standards for using non-GAAP financial measures, while preserving antifraud remedies. The rules are consistent with the SEC's concerns and positions expressed before the adoption of the Sarbanes-Oxley Act.

### *I. Introduction to Management Certification*

As discussed above, the Exchange Act requires public companies to make information available to investors on a regular basis through a series of periodic reports. The annual report on Form 10-K and quarterly reports on Form 10-Q are heavily relied on by investors to make their investment decisions. If these periodic reports convey false information, investors will be injured and capital markets will be impaired. Under SEC rules, management is directly responsible for making disclosures to the public. Since 1980, a reporting company's principal executive officers, principal financial officers, and principal accounting officers, together with the majority of the board of directors, have been required to sign the annual report on Form 10-K on behalf of the company.<sup>186</sup> Principal financial officers and principal accounting officers have also been required to sign Form 10-Q, but

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<sup>184</sup> Conditions for Use of Non-GAAP Financial Measures, 68 Fed. Reg. at 4824 n.44.

<sup>185</sup> In addition to the mandated disclosure requirements, amended Item 10 of Regulation S-K prohibits the use of certain kinds of non-GAAP financials. 17 C.F.R. § 229.10(e)(1)(ii). For example, registrants cannot use non-GAAP liquidity measures that exclude charges or liabilities that require cash settlement absent an ability to settle in another manner. *Id.* § 229.10(e)(1)(ii)(A). However, EBIT and EBITDA measures are expressly carved out from this prohibition. The release adopting the rule indicates that the exception from this prohibition for EBIT and EBITDA was adopted in light of the wide and recognized existing use of these measures. Conditions for Use of Non-GAAP Financial Measures, 68 Fed. Reg. at 4824.

<sup>186</sup> This requirement was adopted by the SEC in 1980. See Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides; Integration of Securities Act Disclosure Systems, Exchange Act Release No. 17,114, 45 Fed. Reg. 63,630 (Sept. 25, 1980).

principal executive officers have not been required to sign the 10-Q.<sup>187</sup>

The Sarbanes-Oxley Act contains three provisions requiring corporate executives to certify the accuracy of reports filed with the Securities and Exchange Commission. Section 302 mandates the SEC to require by rule that the CEO and CFO provide certifications regarding the accuracy of financial information and the design and maintenance of internal controls.<sup>188</sup> Section 404 mandates the SEC to require by rule that management provide an internal control report.<sup>189</sup> Section 906 requires the CEO and CFO of each reporting company to certify that the company's periodic reports fairly present the financial condition and results of operations of the company, and provides criminal penalties for false certifications.<sup>190</sup> The three overlapping certification requirements clearly reflect congressional reactions to prior SEC proposals for executive certifications.

In fulfilling its congressional rulemaking mandates, the SEC has combined the sections 302 and 404 certification requirements into Rule 13a-15, which requires reporting companies to maintain, and their managements to evaluate, "disclosure controls and procedures" and "internal control over financial reporting."<sup>191</sup> Under Rule 13a-14 each certification must be included in the Form 10-K and 10-Q reports (and the section 906 certification must be furnished).<sup>192</sup>

In 1998, the SEC proposed requiring officers and directors to certify that periodic reports were accurate. The SEC renewed that proposal on June 17, 2002.<sup>193</sup> On June 25, 2002, it ordered the CEOs and CFOs of the nation's largest public companies to certify that their companies' most recent annual financial statements were accurate and complete.<sup>194</sup> The sections 302 and 404 rule requirements and the section 906 criminal provisions were adopted against the background of these SEC actions.

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187 Prior to the Sarbanes-Oxley Act, Form 10-Q was required to be signed on the registrant's behalf by a duly authorized representative and by the principal financial officer or the principal accounting officer of the registrant. The CEO might or might not have signed the 10-Q form as a duly authorized representative.

188 Sarbanes-Oxley Act of 2002, § 302, 15 U.S.C.A. § 7241 (West Supp. 2004).

189 *Id.* § 404, 15 U.S.C.A. § 7262.

190 *Id.* § 906, 18 U.S.C.A. § 1350 (West Supp. 2004).

191 Controls and Procedures, 17 C.F.R. § 240.13a-15 (2004).

192 Certification of Disclosure in Annual and Quarterly Reports, *id.* §§ 240.13a-14(a).

193 Regulation of Securities Offerings, Exchange Act Release No. 40,632A, 63 Fed. Reg. 67,174 (Dec. 4, 1998).

194 Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 46,079, 67 Fed. Reg. 41,877 (June 20, 2002).

*J. The SEC's Executive Certification Proposal of June 2002*

In 1998, as part of its "Aircraft Carrier" proposals, the SEC proposed expanding the number of persons required to sign the Form 10-Q to include executive officers of the registrant, including the CEO.<sup>195</sup> The SEC proposal also would have required officers who sign Forms 10-K and 10-Q to certify that they had read those reports and that to their knowledge the reports contained no material misstatements or omissions. The SEC hoped that the certification requirement would improve the quality of Exchange Act reporting by increasing the involvement of top executives.<sup>196</sup> The Aircraft Carrier proposals, although later abandoned, were an SEC attempt to enhance senior management's responsibility in periodic reports by using attestation requirements.

The Enron financial reporting scandal raised serious public concerns about whether senior executives were paying sufficient attention to the periodic reporting process. On June 17, 2002, the SEC renewed its Aircraft Carrier CEO attestation proposal by publishing a new proposal named "Certification of Disclosure in Companies' Quarterly and Annual Reports."<sup>197</sup> Under this proposal, each CEO and CFO would have been required to certify in annual and quarterly reports that

- He or she has read the report;
- To his or her knowledge, the information in the report is true in all important respects as of the end of the period covered by the report; and
- The report contains all information about the company of which he or she is aware that he or she believes is important to a reasonable investor as of the end of the period covered by the report.<sup>198</sup>

According to the SEC, senior management "should be involved" in reviewing their companies' periodic reports and investors should be able to view the certification as evidence of such management involvement.<sup>199</sup> The Commission clearly was dissatisfied with the passive role played by senior management at some reporting companies. By proposing the affirmative certification requirements on top of the ex-

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195 Regulation of Securities Offerings, 63 Fed. Reg. at 67,174.

196 In the Aircraft Carrier Release, the SEC stated that "the disclosures made in Exchange Act reports tend to be of a lesser quality than the disclosures made in Securities Act filings." *Id.* at 67,245.

197 67 Fed. Reg. 41,877.

198 *Id.* at 41,879.

199 *Id.* at 41,880.

isting signature requirements, the SEC sought to force top executives to review companies' periodic reports more carefully and to participate in the reporting process more extensively.

The 1998 SEC Aircraft Carrier certification proposal had been criticized as being unnecessary because signatories of periodic reports were already subject to the antifraud law framework.<sup>200</sup> However, according to the SEC the goal of the 2002 proposal was not "to affect . . . existing bases of liability" for CEOs and CFOs, but to reinforce the responsibility of CEOs and CFOs regarding periodic reports and to promote their more active and direct involvement.<sup>201</sup>

The June 17, 2002, proposal would have required reporting companies to maintain sufficient procedures to provide reasonable assurances that the company was able to collect, process, and disclose the information required to be disclosed in its periodic and current reports filed under the Exchange Act.<sup>202</sup> Reporting companies would also have been required to evaluate the effectiveness of these procedures and communicate the results to management. This responsibility was consistent with the books and records provisions of Exchange Act section 13(b)(2), which requires reporting companies to maintain internal accounting control procedures.<sup>203</sup> The Commission's June

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200 In its comment letter to the SEC, the Committee on the Federal Regulation of Securities of the Section of Business Law of the ABA wrote: "The Committee believes that the substance of the statement proposed to be certified is already implied by the signature on the report, and that the liability standard already inherent in executing the filing is sufficient." See Letter from Committee on the Federal Regulation of Securities, American Bar Association, to the Securities and Exchange Commission Regarding the Regulation of Securities Offerings (File No. 57-30-98) 96 (Sept. 28, 1999) [hereinafter ABA Committee on the Federal Regulation of Securities Letter], *available at* <http://www.sec.gov/rules/proposed/573098/Keller1.htm>.

201 Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. at 41,879.

202 *Id.*

203 The purpose of section 13(b)(2) is to maintain the integrity of a company's internal records and controls. It was added to the Exchange Act in the Foreign Corrupt Practices Act in 1977. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, § 102, 91 Stat. 1494, 1494 (codified at 15 U.S.C. § 78m (2000)). Section 13(b)(2)(A) requires companies to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the issuer's assets. 15 U.S.C. § 78m(b)(2)(A) (2000). Under section 13(b)(2)(B), companies must devise and maintain systems of internal accounting controls sufficient to provide reasonable assurances that (a) transactions are executed in accordance with management's authorization; (b) transactions are recorded as necessary (i) to permit preparation of financial statements in conformity with generally accepted accounting principles or other applicable criteria, and (ii) to maintain accountability for a company's assets; (c) access to assets is permitted only in accordance with management's authorization; and (d) the recorded accountability for assets is compared with ex-

17, 2002, certification proposal and its actions described below seem to have stimulated the adoption of sections 302, 404, and 906 of the Sarbanes-Oxley Act.

#### K. SEC Order 4-460: Certification for 947 Public Companies

On June 25, 2002, eight days after the SEC made its executive certification proposal, WorldCom announced that it was restating its 2000 and 2001 financial reports due to accounting errors.<sup>204</sup>

On June 27, 2002, the SEC published Order 4-460 requiring the CEOs and CFOs of the 947 largest public companies to certify that their company's most recent Form 10-K, and any Form 10-Q or Form 8-K filed since the most recent Form 10-K, were accurate and complete.<sup>205</sup> The scope of the applicable reports was broader than the SEC's June 17 proposal, including not only periodic reports on Forms 10-K and 10-Q, but also current reports on Form 8-K.

By August 15, 2002, the deadline set by the order, CEOs and CFOs of the vast majority of the companies subject to the order filed certifications according to the order.<sup>206</sup>

#### L. Criminal Penalties for False Certifications

Congress dramatically increased the criminal punishment attached to false and misleading periodic reports. In section 906 of the Sarbanes-Oxley Act, it created a separate executive certification requirement subject to substantial criminal penalties. Under section 906, the CEO and CFO of each reporting company must certify that every periodic report fully complies with the reporting requirements of the Exchange Act, and fairly presents, in all material respects, the financial condition and results of operation of the company.<sup>207</sup> If an executive certifies a report knowing that the certification is false, he or she may be fined not more than \$1,000,000 or imprisoned not more than ten years. If an executive willfully certifies a report knowing that the certification is false, he or she may be fined not more than

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isting assets at reasonable intervals and appropriate action is taken with respect to any differences. *Id.* § 78m(b)(2)(B).

204 On June 26, 2002, Chairman Pitt announced that the SEC would require public company certification of their most recent financial statements. Harvey L. Pitt, Remarks Before the Economic Club of New York (June 26, 2002), *available at* <http://www.sec.gov/news/speech/spch573.htm>.

205 SEC Order No. 4-460 (June 27, 2002), *available at* <http://www.sec.gov/rules/other/4-460.htm>.

206 The filing time and the certifications under Order 4-460 are available at <http://www.sec.gov/rules/extra/ceocfo.htm>.

207 Sarbanes-Oxley Act of 2002, § 906(a), 18 U.S.C.A. § 1350 (West Supp. 2004).



\$5,000,000 or imprisoned not more than twenty years.<sup>208</sup> Section 906 was effective immediately upon enactment and did not require SEC rulemaking.

*M. Management Certification Under Section 302 of  
the Sarbanes-Oxley Act*

Congress also became concerned about the reliability of corporate financial statements.<sup>209</sup> Section 302 of the Act, adopted under the title of "Corporate Responsibility for Financial Reports," required the SEC, within thirty days of enactment, to issue final rules requiring the principal executive officer and the principal financial officer of each company filing periodic reports under section 13(a) or 15(d) of the Exchange Act to provide extensive certifications in the issuer's annual and quarterly reports.<sup>210</sup> Section 302 incorporated the compo-

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208 *Id.*

209 See S. REP. NO. 107-205, at 25-26 (2002).

210 Sarbanes-Oxley Act of 2002 § 302(a), 15 U.S.C.A. § 7241 (West Supp. 2004).  
The Commission was required to adopt rules requiring the officers to verify 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;
- (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

nents of the SEC's June 17, 2002, proposal requiring certifying officers to state that they have reviewed the reports and that the reports are not materially misleading. The section went a step further by instructing executives to certify their affirmative participation in various aspects of their companies' "internal controls," without providing a clear definition for the latter term.

#### *N. Certification Under Section 302 of the Sarbanes-Oxley Act*

Since the Commission had published its executive certification proposal on June 17, 2002, it was able to meet the thirty-day deadline established by the July 31 enactment of Sarbanes-Oxley by publishing its final rules implementing section 302 on August 29, 2002.<sup>211</sup> It adopted new Exchange Act Rules 13a-14 and 15d-14, requiring all periodic reports filed on forms 10-K and 10-Q under Exchange Act sections 13(a) and 15(d) to be certified by CEOs and CFOs of the filing companies.<sup>212</sup> Rules 13a-14(b) and 15d-14(b), as adopted in August 2002, closely followed the language of section 302 and set out the terms of the executive certification to be included in the applicable reports. However, on June 5, 2003, when the Commission adopted final rules implementing section 404 of the Act, it also amended the rules implementing section 302.<sup>213</sup> The June 2003 amendments removed the text of section 302 executive certification from Rules 13a-

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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 corrective actions with regard to significant deficiencies and material weaknesses.

*Id.*

211 Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 46,427, 67 Fed. Reg. 57,276 (Sept. 9, 2002).

212 *Id.* at 57,277.

213 Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 47,986, 68 Fed. Reg. 36,636 (June 18, 2003) [hereinafter Final 404 Rule Release]. This release contains final rules implementing section 404 of the Act as well as amendments to final rules implementing section 302 of the Act.

14(b) and 15d-14(b) and placed the certification language in a new exhibit (31) to Item 601(b) of Regulation S-K.<sup>214</sup>

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214 17 C.F.R. § 229.601(b)(31) (2004). The content of the certification is set forth as follows:

1. I have reviewed this [specify report] of [identify registrant];
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure control and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are rea-

Section 302 of the Act requires that certifications be made “in each annual or quarterly report” filed or submitted under the Exchange Act.<sup>215</sup> In the final section 302 rules, the Commission confirmed that these certification requirements apply only to annual reports on Form 10-K and quarterly reports on Form 10-Q, not to reports on Forms 6-K and 8-K, which are event-driven and not required to be filed on an annual or quarterly basis.<sup>216</sup> The amended Rule 13a-14(b) requires the executive certification to be filed as an exhibit to the applicable periodic report.<sup>217</sup>

Subsection 3 of the required certification focuses on the financial information disclosed in companies’ periodic reports. As mandated by section 302, these financial disclosures must “fairly represent” the disclosing company’s financial condition. In the adopting release, the SEC emphasized its position that “fairly represent” is a higher standard than “fairly represent in accordance with GAAP.”<sup>218</sup> It stated that, “[p]resenting financial information in conformity with generally accepted accounting principles may not necessarily satisfy obligations under the antifraud provisions of the federal securities laws.”<sup>219</sup> It added that the financial information disclosed in a report must be “viewed in its entirety” and must meet a standard of overall material accuracy and completeness that is broader than financial reporting requirements under GAAP.<sup>220</sup>

In subsection 2 of the certification, the Commission used “based on my knowledge” to reflect the language “based on the officer’s knowledge” contained in section 302(a)(2).<sup>221</sup> The term “knowledge”

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sonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and

- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

*Id.*

215 Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C.A. § 7241.

216 Certification of Disclosure in Companies’ Quarterly and Annual Reports, 67 Fed. Reg. at 57,280.

217 Certification of Disclosure in Annual and Quarterly Reports, 17 C.F.R. § 240.13a-14(b).

218 See Certification of Disclosure in Companies’ Quarterly and Annual Reports, 67 Fed. Reg. at 57,279 & n.55 (citing *In re Caterpillar, Inc.*, Exchange Act Release No. 30,532, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,830, at 63,055 (Mar. 31, 1992); *In re Edison Schools, Inc.*, Exchange Act Release No. 45,925, [2001-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 75,070, at 63,367 (May 14, 1992)).

219 *Id.* at 57,279 n.55.

220 *Id.* at 57,279.

221 Sarbanes-Oxley Act of 2002 § 302(a)(2), 15 U.S.C.A § 7241 (West Supp. 2004).

is not defined in section 302 of the Act or in the Rule. Since the required certification is subjective in nature, some commenters had urged that the certifying officers should be allowed to certify information to the extent of their “actual knowledge” and belief.<sup>222</sup> To address this concern, the adopting release stated that the certification statements are “to be made based on the knowledge of the certifying officer,” and the rules are not intended “to change the current obligations of corporate officers in connection with the discharge of their duties.”<sup>223</sup>

With respect to the term “disclosure controls and procedures,” the rules adopted in August 2002 and repeated in June 2003 defined the phrase as

controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Act (15 U.S.C. 78a et seq.) is recorded, processed, summarized and reported, within the time periods specified in the Commission’s rules and forms.<sup>224</sup>

Significantly, the phrase “disclosure controls and procedures” describes a broad internal control system that facilitates the flow of both financial and non-financial information to “the issuer’s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.”<sup>225</sup> Therefore, effective disclosure controls and procedures must serve two important functions. First, the procedures must capture, on a comprehensive basis, all information that may be subject to disclosure under the Exchange Act filings that the issuer is required to file.<sup>226</sup> Second, the procedures must be designed to ensure that the relevant information is communicated to the issuer’s top executives in a timely manner. These procedures are fundamental to the SEC’s efforts to improve the overall quality of Exchange Act reports.

Significantly, although only periodic reports are subject to executive certification, disclosure controls and procedures are required to

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222 See, e.g., Letter from Committee on Securities Regulation, Association of the Bar of the City of New York, to the Securities and Exchange Commission, Regarding File No. S7-21-02; Release Nos. 34-46,079 and 34-46,300 (Aug. 19, 2002), available at <http://www.sec.gov/rules/proposed/s72102/cmnathan1.htm>.

223 Certification of Disclosure in Companies’ Quarterly and Annual Reports, 67 Fed. Reg. at 57,279.

224 Controls and Procedures, 17 C.F.R. § 240.13a-15(e) (2004).

225 *Id.*

226 Note that the definition of “disclosure controls and procedures” refers to “reports” to be filed under the Exchange Act, not just “periodic reports.”

be designed to ensure full and timely disclosure in current reports as well as in periodic reports. These procedures should help to facilitate the real-time disclosure scheme that section 409 of the Act requires the SEC to establish.<sup>227</sup>

The Commission's June 2003 amendments did not change the substance of the rules regarding "disclosure controls and procedure" as established in August 2002. First, by referring to the certification requirements specified under new Item 306(b)(31), Rules 13a-14 and 15d-14 effectively impose on top executives the duty to establish and evaluate their companies' disclosure controls and procedures.<sup>228</sup> The Commission also revised Rules 13a-15 and 15d-15 to require executives to evaluate the effectiveness of the issuer's disclosure control and procedures at the end of each fiscal quarter and fiscal year.<sup>229</sup> Second, according to the SEC, the reporting company should "assist" the executives in making these procedures operate.<sup>230</sup> To this end, the SEC has adopted rules 13a-15(a) and 15d-15(a), requiring each issuer to maintain disclosure control and procedures (as defined in Rules 13a-14(e) and 15d-14(e) respectively).<sup>231</sup> Third, to streamline management's obligation and the issuers' obligations regarding disclosure controls and procedures, the SEC added a new Item 307 to Regulation S-K, directing the issuer to disclose, as a new line item in 10-K and 10-Q, the conclusion and evaluation of its top executives regarding the effectiveness of the issuer's disclosure and control procedures.<sup>232</sup> The rules do not mandate any particular evaluation process. Instead, the Commission indicates that each issuer should "develop a process that is consistent with its business and internal management and supervisory practices."<sup>233</sup>

Although the definition of "disclosure controls and procedures" and its operating rules seemed clear, the SEC's August 2002 approach to the concept of "internal controls" caused some confusion. Sarbanes-Oxley section 302(a)(5) and (6) required the certifying officers to disclose deficiencies in the design or operation of "internal

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227 See the discussion of current disclosure and SEC rulemaking activities regarding section 409, *supra* notes 87-106 and accompanying text.

228 See Certification of Disclosure in Annual and Quarterly Reports, 17 C.F.R. § 240.13a-14; Certification of Disclosure in Annual and Quarterly Reports, *id.* § 240.15d-14.

229 *Id.* § 240.13a-15(b), (c); Controls and Procedures, *id.* § 240.15d-15.

230 Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 46,427, 67 Fed. Reg. 57,276, 57,280 (Sept. 9, 2002).

231 17 C.F.R. § 240.13a-15(a); *id.* § 240.15d-15(a).

232 Regulation S-K, *id.* § 229.307.

233 Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. at 57,281.

controls” to the issuer’s auditors and the audit committee. In the section 302 rules adopted in 2001, the Commission did not provide its own definition of “internal controls,” but instead directed companies to a “pre-existing” definition contained in Statement of Auditing Standards (AU) sections 319.06–.09.<sup>234</sup>

In the June 2003 amendments to rules implementing section 302, the Commission admitted that there had been confusion over the concept and the scope of “internal controls.”<sup>235</sup> It dropped “internal controls” from the certifications and relevant rules mandated by section 302 of the Act, avoiding the difficulty of defining this term.<sup>236</sup> The final rules adopted on June 5, 2003, revised the existing section 302 certification by replacing the term “internal controls” with the new term “internal control over financial reporting,” which was created by the Commission to implement section 404.<sup>237</sup>

Section 302 and its implementing rules have significant practical impact. To be able to make the required certification, top executives must carefully review the disclosure reports and actively involve themselves in the process of preparing the disclosure reports. They cannot

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234 *Id.* at 57,277 n.36; see AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, CONSIDERATION OF INTERNAL CONTROL IN A FINANCIAL STATEMENT AUDIT § 319 (2001).

235 See Final 404 Rule Release, Exchange Act Release No. 47,986, 68 Fed. Reg. 36,636, 36,638–39 (June 18, 2003). This release contains final rules implementing section 404 of the Act as well as amendments to the final rule implementing section 302 of the Act.

236 *Id.* at 36,640.

237 The Commission further revised a series of pre-existing rules and created new rules to define and operate the concept of “internal control over financial reporting” in the context of fulfilling section 302 requirements. First, new Rule 13a-15(f) sets forth the definition of “internal control over financial reporting.” Controls and Procedures, 17 C.F.R. § 240.13a-15(f). Second, new Rules 13a-15(d) and 15d-15(d) specify executives’ affirmative obligations to evaluate any material changes in the issuer’s internal controls over financial reporting during the applicable reporting period. *Id.* § 240.13a-15(d); Controls and Procedures, *id.* § 240.15d-15(d). Third, to establish issuers’ responsibilities with respect to this new concept, Rule 13a-15(a) is amended to require that registrants maintain not only “disclosure controls and procedures,” but also “internal control over financial reporting.” *Id.* § 240.13a-15(a). Finally, new Item 308 of Regulation S-K requires the issuer to disclose in a new line item in 10-K and 10-Q the conclusions of its top executives regarding any material changes in the issuer’s internal controls over financial reporting during the previous reporting period. Internal Control Over Financial Reporting, *id.* § 229.308(c). Integrated into the pre-existing rules regarding “disclosure controls and procedures,” the new rules effectively eased the confusion and harmonized the operation of rules implementing section 302 of the Act.

delegate these duties to the subordinate officers and merely sign a blank signature page of the disclosure form.<sup>238</sup>

### 1. Certification Under Section 404 of the Sarbanes-Oxley Act

The Sarbanes-Oxley Act section 302 certification requirement indicates that, in the view of Congress, senior management's responsibility must include the process of preparing periodic reports. Section 404 of the Act, adopted under the title "Management Assessment of Internal Controls," addresses this policy.<sup>239</sup> Section 404 directs the Commission to adopt rules requiring each annual report to contain an "internal control report" (1) stating management's responsibilities "for establishing and maintaining an adequate internal control structure and procedures for financial reporting" and (2) containing an assessment of the effectiveness of the company's "internal control structure and procedures" for financial reporting.<sup>240</sup> The section further requires auditor attestation regarding management's assessment.

The Commission proposed rules to implement section 404 of the Act<sup>241</sup> on October 22, 2002, and finalized them on June 5, 2003.<sup>242</sup>

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238 For a detailed discussion of various practical issues regarding executive certification requirements, see John Huber, *The Sarbanes-Oxley Act of 2002 and the Commission Rule Making: Remarks at the 23d Annual Ray Garrett Jr. Corporate and Securities Law Institute* (Apr. 10-11, 2003).

239 Section 404 contains the following language:

- (a) **RULES REQUIRED.**- The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall-
- (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
  - (2) 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.
- (b) **INTERNAL CONTROL EVALUATION AND REPORTING.**- 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.

Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C.A. § 7262 (West Supp. 2004).

240 *Id.*

241 Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 46,701, 67 Fed. Reg. 66,208 (Oct. 30, 2002).



The final rules place all disclosure requirements mandated by section 404 of the Act in a newly created Item 308 of Regulation S-K.

Under the new Item 308, an issuer's annual report must contain an internal control report from management that includes

- (1) A statement of management's responsibility for establishing and maintaining adequate internal controls over financial reporting for the registrant;
- (2) A statement identifying the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting . . . ;
- (3) Management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective . . . ; and
- (4) A statement that the registered public accounting firm that audited the financial statements included in the annual report . . . has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.<sup>243</sup>

Item 308 also directs issuers to include an auditor's attestation report on management's assessment in the applicable annual report.<sup>244</sup>

Section 404 provides no guidance for the term "internal control structure and procedures for financial reporting."<sup>245</sup> The final rule substitutes the phrase "internal control over financial reporting," defined as a process designed "to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles."<sup>246</sup> The rule states that the process must address the following three elements:

- (1) The maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;

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242 Final 404 Rule Release, Exchange Act Release No. 47,986, 68 Fed. Reg. 36,636 (June 18, 2003).

243 Regulation S-K, 17 C.F.R. § 229.308(a)(1)-(4) (2004).

244 *Id.* § 229.308(b). Although the auditors' attestation reports are extremely important, this Article concentrates on corporate disclosure obligations. SEC rules and PCAOB rules and standards implementing the audit attestation requirements under section 404 of the Act are not discussed.

245 Final 404 Rule Release, Fed. Reg. at 36,640. Section II.A.2 of the Final 404 Rule Release contains a detailed discussion of the history behind "internal controls." *Id.* at 36,639.

246 *Id.*

(2) 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 registrant are being made only in accordance with authorizations of management and directors of the registrant; and

(3) Reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.<sup>247</sup>

Compared with the section 404 rule proposal, this final definition provides more certainty because the scope of the underlying process does not depend on standards set up by an authority other than the SEC.<sup>248</sup> The three components specified by the definition effectively narrow the scope of the internal control certification to those relevant only to financial reporting.

Although section 404 requires only annual evaluation, the SEC believes that quarterly evaluation will create "symmetry" between management's duty to evaluate both "internal controls and procedures for financial reporting" and "disclosure controls and procedures." The final rules require quarterly evaluation of "internal control over financial reporting," but not as extensive as the annual evaluation mandated by section 404 of the Act. According to the final rules, the scope of management's quarterly evaluation is limited to changes that materially affect, or are likely to materially affect, the internal controls over financial reporting.<sup>249</sup>

The October 2002 proposal did not specify the exact content of the management report because according to the SEC doing so would

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247 *Id.*

248 *Id.* The proposed section 404 rules would have defined the term "internal controls and procedures over financial reporting" as

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

Disclosure Required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 46,701, 67 Fed. Reg. 66,208, 66,220 (Oct. 30, 2002). By referring to Auditing Standards section 319, the proposed definition would have included elements of controls with respect to the effectiveness of companies' operation and companies' compliance with laws not applicable to financial reporting. *See* discussion *supra* text accompanying note 234.

249 Final 404 Rule Release, 68 Fed. Reg. at 36,644.

likely result in “boilerplate responses of little value.”<sup>250</sup> Since the report will contain judgments made by management that will form the basis of the outside auditor’s attestation, some commentators believed that the SEC should provide guidance to the content of the management report.<sup>251</sup> In response, the Commission revised Rule 13a-15(c) to provide that management’s evaluation must be based on a “suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.”<sup>252</sup> The final rule release identified the established framework offered by the report on internal controls issued by the Committee of Sponsoring Organizations of the Treadway Commission, popularly known as “COSO,” as guidance that satisfies management’s obligation to evaluate “internal control over financial reporting.”<sup>253</sup>

*O. Interplay of SEC Rules Implementing Sections 302 and 404*

As discussed in the previous section, the final section 404 release amended existing section 302 rules by replacing the term “internal controls,” which had been the center of confusion, with the more clearly defined “internal control over financial reporting.” In adopting the rules implementing section 404, the Commission tried to clarify the relationship between “disclosure controls and procedures” and “internal control over financial reporting.”

The SEC’s definitions suggest that “disclosure controls and procedures” and “internal control over financial reporting” overlap. Recognizing this overlap, the Commission integrated the rules implementing sections 302 and 404 to achieve consistency in the operation of the two sets of rules. First, revised Rule 13a-15 defines these two concepts in subsections (e) and (f) respectively.<sup>254</sup> Second, Rule 13a-15(b) establishes management’s affirmative obligation to evaluate “disclosure controls and procedures” to fulfill the certification re-

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250 Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, 67 Fed. Reg. at 66,219.

251 See, e.g., ABA Commission on the Federal Regulation of Securities Letter, *supra* note 200, at 84.

252 Controls and Procedures, 17 C.F.R. § 240.13a-15(c) (2004).

253 See Final 404 Rule Release, 68 Fed. Reg. at 36,642. The COSO report provides certain guidance on management reporting on internal controls, which had been applied by certain banking institutions and bank holding companies subject to the Federal Deposit Insurance Corporation Improvement Act in connection with their managements’ evaluation and report on internal control. The release did not make the guidance contained in the COSO Report mandatory.

254 Controls and Procedures, 17 C.F.R. § 240.13a-15(e)-(f).

quirement under section 302.<sup>255</sup> Third, Rule 13a-15(c) and (d) establish management's affirmative obligation to evaluate the effectiveness and to disclose material changes in "internal control over financial reporting" to fulfill the reporting requirements under section 404 and the certification requirement under section 302 respectively.<sup>256</sup> Fourth, revised Rule 13a-15(a) directs the issuer to maintain both "disclosure controls and procedures" and "internal control over financial reporting."<sup>257</sup> Finally, Items 307 and 308 of Regulation S-K require the issuer to disclose, as different line items, management's section 302 certifications and section 404 reports respectively.<sup>258</sup> In practice, there may be different opinions about whether certain internal control processes should fall into "disclosure controls and procedures" and "internal control over financial reporting." Such differences should not affect a company's compliance with a series of well organized SEC rules because the establishment, maintenance, and disclosure of such controls and process are required as long as they fit into the definitions of either "disclosure controls and procedures" or "internal control over financial reporting."

#### *P. The SEC Role Regarding Section 906 of the Act*

As discussed above, section 906 of the Act is a criminal provision, which is codified as an amendment to the federal criminal code. The SEC has taken the position that section 906 is not within its jurisdiction, since the SEC has no criminal enforcement powers.<sup>259</sup> However, since section 906 mandates a separate executive certification, the most effective way to operate section 906 certification is through the existing federal securities law framework dealing with disclosure of certifications.

On June 5, 2003, the SEC adopted requirements for disclosure of the certification required by sections 302 and 906 of the Act.<sup>260</sup> The rule requires both 302 and 906 certifications to be filed as an exhibit to the applicable periodic reports, rather than as a separate section

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255 *Id.* § 240.13(a)-15(b).

256 *Id.* § 240.13(a)-15(c)-(d).

257 *Id.* § 240.13(a)-15(a).

258 Regulation S-K, *id.* §§ 229.307-.308.

259 SEC staff and commissioners stated this position during its open meeting on August 27, 2002. See Bruce C. Bennett & Graham Robinson, *Executive Certification*, in PRACTISING LAW INST., 34TH ANNUAL INSTITUTE ON SECURITIES REGULATION 529, 551 n.49 (2002).

260 Final 404 Rule Release, Exchange Act Release No. 47,986, 68 Fed. Reg. 36,636 (June 18, 2003); Certification of Disclosure in Certain Exchange Act Reports, Exchange Act Release No. 47,551, 68 Fed. Reg. 15,600 (Mar. 31, 2003).

following the signature section.<sup>261</sup> The SEC's amendments require issuers to furnish the section 906 certifications as an exhibit to the periodic reports.<sup>262</sup> Although filed as an exhibit to the periodic reports, the certifications required by section 906 are "deemed" to be "furnished," rather than "filed" to the SEC.<sup>263</sup> Therefore, certifications under section 906 will not be subject to liability under section 18 of the Exchange Act, which is applicable only to filed documents and will not be subject to automatic incorporation by reference into an issuer's Securities Act registration statements. However, since the section 906 certification disclosure is mandated, failure to file may result in a violation of section 13(a) of the Exchange Act.

### *Q. Certification Summary*

In response to the collapse of Enron, the Commission sought to enhance the responsibility of top management to their companies' financial disclosures by renewing its previous executive certification rule proposals. Apart from top management's certification of the accuracy and completeness of financial disclosure, the SEC proposal would have required the issuer to maintain a sufficient internal control process for financial and non-financial reporting, and would have required management certification of the effectiveness of the internal process. These proposals were enacted in sections 302 and 404 of the Sarbanes-Oxley Act. Section 906 of the Act further enhanced management's responsibility for financial disclosure by seriously increasing the criminal penalties for knowingly or willfully false certifications. Through the rules implementing sections 302, 404, and 906, the Commission has in effect mandated the management of public companies to establish a comprehensive internal control system that can capture both financial and non-financial information for disclosure purposes. To be able to certify both the results and the procedures for financial disclosure, top management must devote sufficient time and effort to preparing SEC periodic reports. The SEC executive certification rules are dramatically changing the internal disclosure and control environment in most public companies and effectively improving the quality of public company disclosure.<sup>264</sup>

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261 Certification of Disclosure in Certain Exchange Act Reports, 68 Fed. Reg. at 15,602.

262 *Id.*

263 *Id.*

264 Many corporations are complaining that compliance with the section 404 certification requirements regarding internal controls is too costly. The appropriate reply is that these controls will greatly increase the public's confidence in corporate finan-

### R. Conclusion Regarding the SEC's Disclosure Initiatives

The SEC's reforms of the disclosure system have effectuated fundamental improvements to the existing disclosure system. The SEC has ensured more timely information flows to investors by accelerating filing deadlines of periodic reports and current reports, and by expanding the triggering events of the current reports. It has enhanced the disclosure in the MD&A section of the periodic reports by mandating detailed discussions of companies' critical accounting policies, off-balance sheet transactions, and material contractual obligations. It has adopted pro forma disclosure regulations.

In contrast to the familiar methods of disclosure in Forms 10-K, 10-Q, and 8-K, the new provisions mandating executive certification present a major departure from prior practice. The certification provisions address not only the accuracy of disclosure, but also the integrity of companies' internal disclosure processes. The affirmative duties imposed on top management, combined with increased potential criminal liability imposed by the Sarbanes-Oxley Act, should cause management to be active in assuring that controls are in place and disclosures are sufficient. The disclosure reforms mandated by Sarbanes-Oxley together with the SEC's actions in expanding disclosure duties should substantially improve public companies' disclosure and help to restore public confidence in the securities market.

## IV. SEC RESOURCES

The Commission's enforcement and disclosure actions and policy initiatives both before and after the Enron scandal present a record of an SEC that has actively pursued its mission. Nevertheless, the SEC has not had the levels of staff and funding that permit it to accomplish its goals in the most effective manner. During the period prior to the adoption of the Sarbanes-Oxley Act, the Commission regularly sought increases in its budget, telling Congress that it did not have sufficient resources to perform its regulatory mission.<sup>265</sup> From 1991 to 2001, the SEC staff grew from 2301 to 2936.<sup>266</sup> Comparing the Commission's staffing levels during that period shows that Commission staff levels did not keep pace with industry growth:

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cial statements, particularly in those companies whose internal controls were so insufficient that large expenditures are required to bring them into compliance.

265 See, e.g., Pitt, *supra* note 40.

266 See *infra* app. A.

- Although the value of public offerings increased from \$587 billion to \$2535 billion, the SEC's disclosure review staff increased from 238 to only 259.
- Although the assets of New York Stock Exchange member firms grew from \$604 billion to \$2718 billion, the SEC's review staff increased from 180 to only 281.
- Although investment adviser assets under management increased from \$5.4 trillion to twenty trillion dollars the SEC review staff increased from 140 to only 376.<sup>267</sup>

In March 2002, the General Accounting Office issued a report on SEC operations showing the disparity between the growth of the SEC and the growth of the market it regulates.<sup>268</sup> It noted that in 2001, the SEC was charged with supervisory duties relating to nine securities exchanges; the over-the-counter market, approximately seventy alternative trading systems; twelve registered clearing agencies; 8000 registered broker dealers employing over 700,000 registered representatives; 8000 transfer agents; 5000 investment companies; 7400 registered investment advisers; and 14,000 companies that file annual reports with the Commission.<sup>269</sup> The report also noted dramatic growth in the number of individuals investing in mutual funds, the total dollars invested in mutual funds, and the increased complexity and internationalization of the securities markets.

The GAO identified challenges faced by the Commission as follows:

First, resource constraints have contributed to substantial delays in the turnaround time for many SEC regulatory and oversight activities, such as approval for rule filings and exemptive applications. Second, SEC's resource constraints contributed to bottlenecks in the examination and inspection area as workload grew. Third, limited resources have forced SEC to be selective in its enforcement activities and have lengthened the time required to complete certain enforcement investigations. Fourth, certain filings were subject to less frequent and less complete reviews as workloads increased. Fifth, today's technology-driven markets have created ongoing budgetary and staff challenges. Finally . . . the SEC has been increasingly challenged in addressing emerging issues, such as the

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<sup>267</sup> SEC. & EXCH. COMM'N, AGENCY RESOURCES AND INDUSTRY GROWTH (2002) (on file with the authors).

<sup>268</sup> U.S. GEN. ACCOUNTING OFFICE, REPORT TO CONGRESSIONAL REQUESTERS, SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES (2002).

<sup>269</sup> *Id.* at 3.

ongoing internationalization of securities markets and technology-driven innovations like ATs and exchange-traded funds.<sup>270</sup>

The Commission's authorized budget for fiscal 2002 was approximately \$514 million, and its appropriated budget during that year was \$487 million. The Sarbanes-Oxley Act dramatically increased the SEC's authorized budget for fiscal year 2003 to \$776 million.<sup>271</sup> The Commission's appropriated budget for fiscal year 2003 increased to \$619 million. Its estimated appropriated budget for fiscal year 2004 is \$791.5 million, and its requested budget for 2005 is \$913 million.<sup>272</sup> As a result, Commission staffing levels have, and will, increase dramatically, from 2936 staff members in fiscal year 2001 and 3009 in fiscal year 2002 to 3932 (estimated) in fiscal year 2005.<sup>273</sup> These increases should have the largest impact in the Commission's enforcement program and in the ability of the Division of Corporation Finance to review disclosure documents. Nevertheless, the SEC's use of rulemaking, interpretations, and concept releases as a means of affecting conduct in the disclosure area will remain its primary means of increasing the quality of corporate disclosures.

#### CONCLUSION

This Article has reviewed aspects of the responses by the Securities and Exchange Commission to Enron and other corporate frauds, and the Commission's prompt actions in implementing the Sarbanes-Oxley Act's provisions. Examination of the timing and content of the Commission's actions leads to the conclusion that despite its lack of adequate resources, the SEC has done an admirable job of protecting the public interest. Its enforcement program has been vigorous. Its strong influence on the self-regulatory organizations had the effect of increasing corporate governance protections for shareholders. Its imaginative suggestion for an accounting oversight board provided important impetus for congressional creation of the Public Company Accounting Oversight Board. Its disclosure initiatives, both before and after adoption of Sarbanes-Oxley, have greatly enhanced the environment for corporate disclosure in the public interest.

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270 *Id.* at 11-12.

271 Sarbanes-Oxley Act of 2002 § 601, 15 U.S.C.A. § 78kk (West Supp. 2004).

272 *See infra* app. A.

273 *Id.*



APPENDIX A. SEC BUDGET AUTHORITY, ACTUAL OBLIGATIONS,  
AND STAFF YEARS (\$ IN 000'S)

| <b>Fiscal Year</b> | <b>Budget Authority</b> | <b>Actual Obligations</b> | <b>Staff Years<sup>274</sup></b> |
|--------------------|-------------------------|---------------------------|----------------------------------|
| 1991               | 189,083                 | 187,689                   | 2301                             |
| 1992               | 225,792                 | 224,281                   | 2491                             |
| 1993               | 253,235                 | 251,871                   | 2673                             |
| 1994               | 269,150                 | 266,249                   | 2650                             |
| 1995               | 300,437                 | 284,755                   | 2705                             |
| 1996               | 300,921                 | 296,533                   | 2767                             |
| 1997               | 311,100                 | 308,591                   | 2771                             |
| 1998               | 315,000                 | 311,143                   | 2768                             |
| 1999               | 341,574                 | 338,887                   | 2776                             |
| 2000               | 377,000                 | 369,825                   | 2840                             |
| 2001               | 422,800                 | 412,618                   | 2936                             |
| 2002               | 513,989                 | 487,345                   | 3009                             |
| 2003               | 716,350                 | 619,321                   | 3060                             |
| 2004               | 811,500                 | 791,500*                  | 3592*                            |
| 2005               | 913,000                 | 913,000**                 | 3932**                           |

\*Estimated

\*\*Requested

274 Staff years are given in full-time equivalents. See SEC. & EXCH. COMM'N, BUDGET ESTIMATE, FISCAL 2005 (2004); SEC. & EXCH. COMM'N, BUDGET ESTIMATE, FISCAL 2004 (2003); Sec. & Exch. Comm'n, *Frequently Requested FOIA Document: SEC Budget History vs. Actual Expenses*, available at <http://www.sec.gov/foia/docs/budgetact.htm> (last modified Apr. 2, 2003); Sec. & Exch. Comm'n, *SEC Frequently Requested FOIA Documents: Full-Time Equivalents History*, available at <http://www.sec.gov/foia/docs/fulltimes.htm> (last modified Apr. 2, 2004).