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before the

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on

The 10th Anniversary of the Sarbanes-Oxley Act

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Chairman Garrett, Ranking Member Waters, members of the Subcommittee, thank you for the opportunity to appear before you today on the occasion of the 10th anniversary of the Sarbanes-Oxley Act. It is an honor and a privilege to appear before the Subcommittee today.

I am the Founder and President of Fund Democracy, a nonprofit investor advocacy group, and a Jessie D. Puckett, Jr., Lecturer and Associate Professor of Law at the University of Mississippi School of Law. I am also a Vice President of the financial planning firm, Plancorp LLC; a member of the CFP Board's Public Policy Council; and an Accredited Investment Fiduciary. I was formerly a member of the SEC's Investor Advisory Committee and chaired its Investor as Purchaser Subcommittee; an Assistant Chief Counsel in the SEC's Division of Investment Management; and an attorney in the securities practice of Wilmer, Cutler & Pickering (now WilmerHale).

This testimony is based on my general experience over a number of years as an investor advocate, journalist, academic, regulator, financial planner, private practitioner and expert witness and consultant. I have been engaged in securities regulation issues from a variety of perspectives and attempt to provide testimony that reflects the interests of investors, diverse views of various constituents, and the practical exigencies of real-world legal practice and compliance.

I. Introduction and Summary

The primary focus of the Sarbanes-Oxley Act of 2002 ("SOXA") reflects the accumulation of corporate accounting scandals that was its primary impetus.[1] First, the Act includes a wide range of provisions that are designed to ensure the

[1] *See*, *e.g.*, S. Rep. No. 107-205, at 23 (2002) ("Senate Report") ("Defects in procedures for monitoring financial results and controls have been blamed for recent corporate failures."); H. Rep. No. 107-414, at 18 – 19 (2002) ("House Report") ("The Committee's hearing on the Enron matter, the collapse of Global Crossing LLC, and the operations of the Nation's capital markets all indicated that reforms were necessary both for the regulators and the regulated.").

reliability of financial information provided by public companies. Second, the Act includes numerous provisions that are specifically designed to hold corporate executives, directors, and public auditors to the highest standards of integrity. Together, these provisions aim to enhance the reliability of financial reporting and hold CEOs, CFOs, directors, and public auditors who engage in financial fraud accountable for their actions.[2]

It would be a mistake, however, to explain the Act simply as a reaction to the scandals *de jour*. While corporate accounting scandals may have created the tipping point for action, many of the Act's provisions reflected long-debated policies.[3] The scandals gave the problems that the Act is designed to address a more concrete face and solidified broad-based support. Nor could the Act could not be said to reflect partisan lawmaking. Of 525 votes cast in the House and Senate, only three opposed the Act. The President's statement issued at the signing of the Act was unequivocally positive.[4]

Although parts of the Sarbanes-Oxley Act have been the subject of criticism -- Section 404 in particular -- it also has enjoyed broad support among investor advocates, public companies and auditing firms. Some parts of SOXA have been quite successful, but some parts could be improved. Due to the size of the Act and

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[2] *See* Remarks by President Bush at the signing of the Sarbanes-Oxley Act of 2002 (July 30, 2002) ("President's Remarks") ("This law says to shareholders that the financial information you received from a company will be true and reliable, for those who deliberately sign their names to deception will be punished."); Senate Report, *supra* at 2 (the Act "requires steps to enhance the direct responsibilities of senior corporate management for financial reporting and for the quality of financial disclosures made by public companies"); House Report, *supra* at 16 (the Act "will protect investors by improving the accuracy and reliability corporate disclosures made pursuant to the securities laws. The bill achieves this goal through increased supervision of accountants that audit public companies, strengthened corporate responsibility, increased transparency of corporate financial statements, and protections for employee access to retirement accounts.").

[3] *See, e.g.*, *The Numbers Game*, Remarks by Arthur Levitt, Chairman, SEC, before the NYU Center for Law and Business, New York, NY (Sep. 28, 1998) *available at* http://sec.gov/news/speech/speecharchive/1998/spch220.txt.

[4] *See President's Remarks, supra*.

time constraints, this testimony discusses only a few of SOXA's provisions in any detail, in addition to the Fostering Innovation Act. The primary points in this discussion are as follows:

- The bifurcation of public companies between those that are subject to SOXA Section 404's broad internal control provisions and those that are not compromises the quality and reliability of public company accounting, and undermines investor confidence[5] and the integrity of the markets. The costs of compliance results not from Section 404, but from its implementation by regulators who are in the best position to evaluate costs and make appropriate adjustments. In my view, the Fostering Innovation Act would exacerbate these problems. The details of Section 404 implementation should be left to the expert regulators based on their weighing of the costs and benefits for issuers and investors.

- SOXA's whistleblower provisions have been substantially undermined by a First Circuit holding that they do not protect employees of nonpublic companies, even if the whistleblowing relates to a public company's compliance. Congress should amend SOXA Section 806 to clarify that public companies cannot evade whistleblower protections simply by retaining nonpublic companies for accounting and other compliance-related services.

- Section 403 of SOXA has substantially mitigated executive compensation abuses by requiring that executives report transactions in company securities within two business days. This provision has been particularly effective in preventing fraudulent backdating of stock options. However, empirical research shows that such backdating continues to be a problem because a large percentage of executives are violating the two-day reporting requirement. Enhanced enforcement and penalties should be considered to ensure compliance with this requirement.

In addition, I have briefly addressed below a series of issues for which time constraints have not permitted fuller discussion.

- <u>Public PCAOB Proceedings</u>: Section 105 of SOXA permits PCAOB proceedings to be public only if the PCAOB finds good cause and both sides consent, which, as a practical matter, ensures that these proceedings will never be made public. Secret proceedings improperly deny the public, including issuers' audit committees, material information regarding auditors, and

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[5] *See* Jeffry Love, *Sarbanes-Oxley: A Survey of Investor Opinions*, AARP and Knowledge Network (2007) ("*AARP Investor Survey*") (SOXA has made more than half of surveyed investors more confident in the information they received from companies).

increase auditors' incentives to litigate actions.[6] PCAOB enforcement proceedings should be public, just as SEC proceedings have been for 25 years. I urge Congress to amend SOXA to require that PCAOB proceedings be public except by order of the Board.[7]

- Auditor Rotation: A mandatory auditor rotation requirement was considered during the debates leading to SOXA but not enacted.[8] This proposal continues to have significant potential for improving auditor independence, especially in view of the decades-long tenure that some auditors have with their clients, notwithstanding that there would be undeniably material costs.[9] Although some have proposed to preempt the PCAOB by prohibiting an auditor rotation requirement,[10] in my view this issue is not ripe or appropriate for legislative action.[11] The PCAOB has been very sensitive to rotation concerns and is undertaking a careful re-evaluation of auditor term limits[12] that, when completed, should be afforded the deference due an expert regulator.

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[6] *See* Hearing before the Subcommittee on Capital markets and Government-Sponsored Enterprises, U.S. House of Representatives (Mar. 28, 2012) (testimony of James Doty, Chairman, PCAOB ("*Doty Testimony*") *available at* http://pcaobus.org/News/Speech/Pages/03282012_DotyTestimony.aspx; Statement of Claudius Modesti, Director of Enforcement, PCAOB, before the New York State Society of CPAs', New York, NY (Sep. 28, 2010) *available at* http://pcaobus.org/News/Speech/Pages/09282010_ModestiTransparency.aspx

[7] *See* H.R. 3503 (Nov. 18, 2011) (requiring public PCAOB proceedings except by determination of Board) *available at* http://www.gpo.gov/fdsys/pkg/BILLS-112hr3503ih/pdf/BILLS-112hr3503ih.pdf.

[8] However, Congress generally required the rotation of audit partners in Section 203 of SOXA.

[9] *See* Letter from Barbara Roper, Director of Investor Protection, Consumer Federal of America, to Office of the Secretary, PCAOB (Dec. 14, 2011) *available at* http://pcaobus.org/Rules/Rulemaking/Docket037/484_CFA.pdf.

[10] *See* Memorandum from Committee Staff to Members, Committee on Financial Services, U.S. House of Representatives (Mar. 23, 2012) (citing discussion draft of bill to prohibit mandating auditor rotation) *available at* http://www.corpgovcenter.org/Carcello/capmrkts.pdf.

[11] *See Doty Testimony*, *supra*.

[12] The PCAOB requested public comment on auditor terms limits in August 2011, the comment period for which has not yet closed. *See* Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011-006 (Aug. 16, 2011) *available at* http://pcaobus.org/Rules/Rulemaking/Docket037/Release_2011-006.pdf. In March and June of this year, the PCAOB held roundtables on terms limits. *See PCAOB Public Meeting on Firm Independence and Rotation*, Washington, D.C. (Mar. 11 – 12, 2012) *transcript available at* http://pcaobus.org/Rules/Rulemaking/Docket037/2012-03-21_Transcript-Notice.pdf and (June 28, 2012) *transcript available at* http://pcaobus.org/Rules/Rulemaking/Docket037/2012-6-28_Transcript-Notice.pdf.

- Auditor Certifications: SOXA Sections 302 and 906 require CEOs and CFOs to certify that the company's filings are not misleading and that any weaknesses in the company's internal controls have been disclosed to the company's auditors, and impose significant criminal penalties for knowing violations. Congress should consider requiring similar certifications for audit engagement partners[13] or that partners be required to sign audit reports (the latter has been proposed by the PCAOB).[14]

- Auditor Financials: Auditors are not themselves required to disclose audited financial statements. Congress should consider requiring the largest auditing firms provide and disclose audited financial reports in order to permit a fair evaluation of their financial condition, as has been recommended by a former member of Boeing's audit committee[15] and major institutional investors,[16] among others.

- Foreign Auditors: Section 106 of SOXA grants authority to PCAOB to register and inspect auditors, including foreign auditors, that play a substantial role in the preparation or furnishing of an audit report for a public company. [17] However, certain jurisdictions have prevented the PCAOB from conducting such inspections,[18] citing, among other things, conflicts with internal law.

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[13] *See* Submission of Paul Haaga, Jr., Vice Chairman, Capital Research and Management Company, to the Advisory Committee on the Auditing Profession (Feb. 4, 2007) ("*Haaga Submission*") *available at* http://www.treasury.gov/about/organizational-structure/offices/Documents/Haaga020408.pdf.

[14] *See Improving the Transparency of Audits*, PCAOB 2001-007 (Oct. 11, 2011) (proposing to require disclosure of name of engagement partner in audit reports) *available at* http://pcaobus.org/Rules/Rulemaking/Docket029/PCAOB_Release_2011-007.pdf; *Concept Release on Requiring the Engagement Partner to Sign the Audit Report*, PCAOB 2009-005 (July 28, 2009) *available at* http://pcaobus.org/Rules/Rulemaking/Docket029/2009-07-28_Release_No_2009-005.pdf.

[15] *See* John Biggs, Statement to the Advisory Committee on the Auditing Profession to the U.S. Department of Treasury (June 3, 2008 (revised June 5, 2008)) ("With our greatly increased responsibilities and consequent risks as audit committee members, we rely heavily on the quality and strength of the audit firm we select to probe into all aspects of the company financial reporting. We need to know more about the firms we select and the risks of doing business with them.") *available at* http://www.treasury.gov/about/organizational-structure/offices/Documents/Biggs060308.pdf.

[16] *See*, *e.g.*, *Haaga Submission, supra*, and other submissions cited at: Advisory Committee on the Auditing Profession, Department of the Treasury at n.93 (Oct. 6, 2008) *available at* http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf note 93.

[17] *See* PCAOB Rule 2100.

[18] *See Updated information on PCAOB International Inspections*, PCAOB (Dec. 11, 2011) *available at* http://pcaobus.org/International/Inspections/Documents/12312011_international_inspections_information.pdf; *Issuer Audit Clients of Non-U.S. Registered Firms in Jurisdictions where the PCAOB is*

> Issuers that use foreign auditors thereby enjoy a "documented cross-listing premium for bonding themselves to U.S." standards[19] without having to comply with those standards. The PCAOB has made significant progress in this area, and Congress should continue to support its efforts in this area.

Finally, much of the foregoing relates the responsibilities of the PCAOB, but without noting the importance of the PCAOB itself. The creation of the PCAOB is the centerpiece of SOXA and has been the Act's greatest contribution to the U.S. securities markets. The PCAOB has directly addressed the insidious lack of independence in the self-regulation of accounting under which no major accounting firm had ever been issued an adverse or qualified report.[20] In its brief history, the PCAOB has identified hundreds of accounting deficiencies in accounting firms in almost 2,000 inspections of firms' quality controls. It has appropriately exercised its authority to resolve issues with these firms and, when necessary, to conduct investigations and commence enforcement proceedings.[21] The PCAOB has made significant improvements in the standard-setting process while working assiduously to consider the interests of all affected parties, including especially small businesses. I strongly encourage Congress to continue to support the work of the PCAOB's and afford appropriate deference to its independent, expert judgment.

Denied Access to Conduct Inspections, PCAOB, *available at* http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx. *See generally* James Doty, *The Relevance, Role, and Reliability of Audits in the Global Economy*, 90 Texas L. Rev. 1891, 1907 - 10 (2012) *available at* http://www.texaslrev.com/sites/default/files/issues/vol90/pdf/Doty.pdf.

[19] Doty, *supra* at 1908.

[20] *See id.* at 1891.

[21] *See id.* at 1897 (record of 26 revocations of firms' registrations and 53 sanctions against individuals).

II. Section 404

The most heated criticism of SOXA has been reserved for its provisions on financial reporting internal controls.[22] Section 404(a) of SOXA requires that management assess and report on the effectiveness of internal control over financial reporting. Section 404(b) requires that a company's auditor attest to the effectiveness of the internal controls assessment under Section 404(a). Most of the criticism of these provisions has focused on the cost of compliance, particularly for smaller companies that have a smaller revenue base over which to spread fixed costs (*i.e.*, costs that do not decline with the size of the company being audited).

However, the actual text of Section 404 undercuts the logic of such criticism. The text requires nothing more than that management assume individual responsibility for financial reporting internal controls – a responsibility that a *bona fide* fiduciary duty under state corporate law presumably would already impose – and that the company's "registered public accounting firm" – which already would have responsibility for auditing the company's financial reports – attest to the effectiveness of internal controls. These general requirements are fundamental to effective accounting regulation. Section 404 leaves the details of implementation, that is, the elements that would actually determine the costs of compliance, to the Commission and the Board.[23]

Since the enactment of Section 404, regulators have demonstrated their sensitivity to cost issues. The Commission and the Board have considered and acted to reduce the costs of compliance borne by small companies, then measured the effect of their efforts, then again acted to reduce compliance costs, then again measured the effect of their efforts in what has been a fairly continuous re-

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[22] *See* John Coffee, *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, Columbia Law School Working Paper No. 414, at 25 (Jan. 9, 2012).

[23] *See, e.g.,* SOXA Section 404(b) (authorizing PCAOB to establish standards for attestation under Section 404(b)).

evaluation.[24] The PCAOB revised its initial auditor attestation standard after only two financial reporting cycles had been completed, specifically with the purpose of reducing costs for smaller companies. During this period, the costs of Section 404 compliance have steadily declined.[25]

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[24] In the course of adopting a auditor attestation standard, the PCAOB conducted a roundtable to solicit input from interested parties, *see* PCAOB Roundtable on Reporting on Internal Control, Washington, DC (July 29, 2003) *webcast available at* http://pcaobus.org/News/Webcasts/Pages/07292003_Roundtable.aspx; developed and issued a proposed standard, *see Proposed Auditing Standard*, PCAOB Rel. No. 2003-017 (Oct. 7, 2003) *available at* http://pcaobus.org/Rules/Rulemaking/Docket008/2003-10-17_Release_2003-017.pdf; revised the standard based on public input including 189 comment letters ("virtually all" expressed support for the PCAOB's approach, although some issuers raised cost concerns), *see* Auditing Standard No. 2, PCAOB Rel. No. 2004-03, Appendix E (Mar. 9, 2004) *available at* http://pcaobus.org/Rules/Rulemaking/Docket008/Form_19b-4_Auditing_Standard_2.pdf; submitted its proposed standard to the Commission, *see Notice of Filing of Proposed Rule on Auditing Standard No. 2*, File No. PCAOB-2004-03 (Apr. 4, 2004) *available at* http://sec.gov/rules/pcaob/34-49544.htm, considered comments on that draft proposal, *see* comment letters at http://sec.gov/rules/pcaob/pcaob200403.shtml; filed a final rule for approval with the Commission, *see* Order Approving Proposed Auditing Standard No. 2, File No. PCAOB 2004-03 (June 17, 2004) (finding PCAOB carefully considered cost issues) *available at* http://sec.gov/rules/pcaob/34-49884.htm; held another roundtable on Section 404 compliance (with the Commission), *see* 2006 Roundtable Discussion on Implementation of Internal Control Reporting Provisions (May 10, 2006) *transcript and briefing document available, respectively, at* http://www.sec.gov/spotlight/soxcomp/soxcomp-transcript.txt & http://www.sec.gov/spotlight/soxcomp/soxcomp-briefing0506.htm; responded to complaints regarding cost of compliance by proposing a revised, more scalable standard, *see Proposed Auditing Standard,* PCAOB Rel. No. 2006-007 (Dec. 19, 2006) *available at* http://pcaobus.org/Rules/Rulemaking/Docket%20021/2006-12-19_Release_No._2006-007.pdf, which was approved by the Commission in 2007. *See* Order Approving Proposing Auditing Standard No. 5, Sec. Act. Rel. No. 56152 (July 27, 2007) *available at* http://sec.gov/rules/pcaob/2007/34-56152.pdf. The PCAOB has established an Office of Outreach and Small Business Liaison and hosted numerous meeting with small business interests, including a forum series on audit reform. *See, e.g.*, *Forum on Auditing in the Small Business Environment* (May 2, June 7 & 19, July 18, Sep. 13, and Nov. 7 & 29, 2012).

[25] *See Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers with Public Float Between $75 and $250 Million*, Office of Chief Accountant, Securities and Exchange Commission at 7 (2011) (*2011 SEC Study and Recommendations*) (academic and other research on Section 404: Indicates that the cost of compliance with Section 404(b), including both total costs and audit fees, has declined since the 2007 reforms"; "costs of Section 404(b) have declined since the Commission first implemented the requirements of Section 404, particularly in response to the 2007 reforms") *available at* http://www.sec.gov/news/studies/2011/404bfloat-study.pdf; *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements*, Office of Economic Analysis, Securities and Exchange Commission at 2 (2009) ("*2009 SEC Study*") ("evidence also indicates that there is an economically and statistically significant reduction in Section 404 compliance costs following the 2007 reforms.") *available at* http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

In this respect, Section 404 has worked exactly as effective regulation should. Congress established a flexible, broad standard for ensuring the accuracy of financial reporting. Regulators have implemented that standard applying a generally balanced view of the costs of compliance and the benefits of reliable financial information and they continue to adjust their implementation of the Act to reflect new information and changing circumstances.

However, from Section 404's inception small firms representing a substantial percentage of public companies have been exempted from Section 404. Rather than allowing the rulemaking process to resolve inevitable missteps in the implementation of Section 404, business interests have demanded and been granted wholesale exemptions from Section 404 for entire categories of small companies. This was accomplished through a series of administrative exemptions,[26] followed by Dodd-Frank Act's Section 989G permanent exemption for all non-accelerated filers from Section 404(b), which represent approximately 60 percent of reporting issuers.[27] Section 103 of the Jumpstart Our Business Startups Act ("JOBS Act") exempted all "emerging growth companies," which includes any company, for up to almost six years after its IPO, with less than $1 billion in annual revenues.

While studies have found a steady decline in the costs of Section 404 compliance, the blanket-exemption approach followed by regulators and Congress has prevented any evaluation of the cost to small companies.[28] It is likely that costs would have declined for small companies as well, and information on such costs would have provided needed guidance for adjusting the implementation of Section 404 in the future. But blanket exemptions from Section 404 have prevented the maturation of its internal controls requirements into a consistent standard for

[26] *See* Securities Act Rel. Nos. 8392 (Feb. 24, 2004), 8545 (Mar. 2, 2005) & 8618 (Sep. 22, 2005). *See also Exposure Draft, supra* (recommending small company exemption from Section 404).

[27] *See 2011 SEC Study and Recommendations*, *supra* at 9.

[28] *See 2009 SEC Study, supra* at 1 - 2.

public companies in the U.S. Simply dividing companies between those to which the ***full attestation*** applies – larger companies that need it less – and those to which ***no attestation*** applies – smaller companies that need it more – is not an appropriate solution to the problem of compliance costs.[29] Rather, regulators should be allowed to evaluate compliance costs and adjust internal control requirements on an ongoing basis, including narrowing further the scope of the attestation.[30]

The foregoing reflects two broader problems that characterize much of current debates about securities regulation. First, the evisceration of Section 404 has undermined the coherence of the concept of a "public company" in the U.S. markets. The public company represents a distinctly U.S. brand, the integrity of which has played an instrumental role in the success of U.S. securities markets. When "public company" means something different for every company that wears that label, that brand loses its value as a coherent set of default rules on which investors can rely.

Second, the evisceration of Section 404 reflects the kind of regulatory tinkering that should be left to regulators. The legislative process is not an appropriate vehicle for the micromanagement of accounting standards and processes. Administrative agencies provide the combination of technical expertise, responsiveness, predictability and public accountability that is necessary for effective regulation.

[29] *See AARP Investor Survey*, *supra* (less than one-fifth of surveyed investors believe that small companies should be exempt or that there should be a compliance transition period for companies entering U.S. markets).

[30] *Accord* Separate Statement of Curt Schacht, *Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies*, Sec. Act Rel. No. 8666, 123 – 29 (Mar. 3, 2006) ("*Exposure Draft*")(recommending small company exemption from Section 404) *available at* http://www.sec.gov/rules/other/33-8666.pdf.

It should be noted that neither of these two concerns militates for or against the requirements of Section 404 as such. Rather, they reflect fundamental principles of effective regulation that should guide Congressional action.

III. Fostering Innovation Act

The Committee has requested comment on the Fostering Innovation Act ("FIA"), which relates directly to the foregoing discussion of Section 404. The FIA appears to designate as an "accelerated filer" any company that has more than $100 million in annual revenues or a public float equal to or greater than $250 million but less then $700 million. Currently, accelerated filers include companies with a public of float as small as $75 million. The effect of the FIA therefore would be to remove companies from this category that have $100 million or less in annual revenues or a public float of equal to or greater than $75 million but less than $250 million and accordingly exempt them from compliance with SOXA Section 404(b).

In my view, the Fostering Innovation Act would further undermine the important standards set forth in Section 404, weaken the reputational value of the public company brand in the U.S., and exacerbate the problem of Congressional micromanagement of accounting standards. First, as a matter of good public policy all public companies should be required their auditor to attest to their internal controls.[31] If there are concerns regarding the scope of the required attestation (which Section 404(b) does not itself establish, but rather delegates to the PCAOB), then it is the scope of the audit that should be reformed. Second, it is the smallest companies that are most likely to experience difficulties in this respect. Thus, the FIA exempts from Section 404(b) the companies for which the auditor attestation is

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[31] *See generally* Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 Cardozo L. Rev. 703 (2007); *see also AARP Investor Survey, supra* (8 in 10 surveyed investors say auditing standards should be stronger).

most beneficial,[32] which directly contradicts the structure of IPO regulation, for example, where regulatory requirements are heightened for smaller, less seasoned issuers.[33] Third, analysis by academics and regulators has found that the costs of Section 404 compliance have steadily declined since its enactment. A recent, detailed analysis, the SEC's Office of Chief specifically recommended against exempting issuers with up to a $250 million float.[34]

The foregoing points could viewed as policy objections to the FIA. They go to the substantive standards that apply to public companies. There are also broader reasons that the approach taken by the FIA, rather than the policy position it reflects, will weaken the regulation of U.S. securities markets. The following concerns address the broader issue of the efficient operation of administrative law, regardless of its substantive content.

First, the implementation of Section 404, including the scope of any exemptions, should be left to the determination of the regulators that are directly responsible for the administration of that Section's standards and have the appropriate technical expertise. Exemptions created by the FIA, as with exemptions previously created by the Dodd-Frank Act and the JOBS Act, create regulatory unpredictability and inefficiency that increases the costs of regulation for regulators and regulated entities alike.

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[32] *See* Mark Beasley, Joseph Carcello, Dana Hermanson and Terry Neal, *Financial Fraud Reporting 1998 – 2007: An Analysis of U.S. Public Companies* at 10 (2010) (survey of 347 financial fraud cases from 1998 to 2007 finding that companies involved had median revenues of $72.4 million and median stockholders' equity of $39.5 million) *available at* http://www.coso.org/documents/COSOFRAUDSTUDY2010_001.pdf.; M.P. Narayanan and J. Nejat Seyhum, *Effect of Sarbanes-Oxley on the Influencing of Executive Compensation* at 10 (March 2006) (both pre- and post-SOXA, smaller firms had substantially greater lags in reporting than larger firms) *available at* http://sitemaker.umich.edu/m.p.narayanan/files/060320replag.pdf

[33] *See Securities Offering Reform*, Securities Act Release No. 8591 (Aug. 3, 2005) (describing tiered approach to regulation depending company size and history).

[34] *See 2011 SEC Study and Recommendations*, *supra*.

Second, a statutory requirement for the Commission to amend a Commission rule creates significant uncertainty regarding the legal status of the rulemaking. For example, Commission rulemaking is subject to a broad array of statutory mandates, such as the consideration of the costs and benefits of regulation and other regulatory purposes that a rule may serve, that may directly contradict the FIA's rulemaking mandate.[35] The FIA may undermine the ability of the Commission to engage in effective rulemaking and broadly conflicts with the efficient operation of administrative regulation.

Finally, the FIA would further atomize the concept of the public company as a form of investment that provides the markets with a predictable set of default rules regarding for financial reporting. The concept of the "public company" generally reflects the view that companies that sell their shares to retail investors (the Securities Act trigger) or have a large shareholder base (the Exchange Act trigger) should be subject to heightened regulation. The lion's share of the public company regulation entails more rigorous reporting requirements, which reflects Congress's watershed determination in the 1930s that the appropriate primary role of securities regulation should be to ensure that investors have the information they need to make informed investment decisions, rather than to evaluate the substantive merits of investments. However, *ad hoc*, statutory exemptions from reporting requirements, such as the exemptions from Section 404(b) provided by the Dodd-Frank Act, JOBS Act and, possibly, the FIA, threaten to render the concept of "public company" meaningless.

[35] *See generally* Letter from Fund Democracy, Consumer Federation of America, Consumer Action, AFL-CIO and Americans for Financial Reform, to Elizabeth Murphy, Secretary, SEC (May 24, 2012) (noting that amending Regulation D to permit general solicitation and advertising for private offerings, as required by the JOBS Act, does not relieve the Commission of its obligation to satisfy statutory cost-benefit standards that may militate against the mandated amendment) *available at* http://sec.gov/comments/jobs-title-ii/jobstitleii-14.pdf.

IV. Whistleblower Provisions

In the aftermath of the Enron and Worldcom scandals, Congress was concerned that such "corporate whistleblowers are left unprotected under current law."[36] Whistleblowers such as Enron's Sherron Watkins and Worldcom's Cynthia Cooper played a major role in exposing fraudulent conduct at their companies. Senator Patrick Leahy noted that "when sophisticated corporations set up complex fraud schemes, corporate insiders are often the only ones who can disclose what happened and why."[37] Congress believed that the lack of protection for insiders when they attempt to prevent fraud was:

> a significant deficiency because often, in complex fraud prosecutions, these insiders are the only firsthand witnesses to the fraud. They are the only people who can testify as to 'who knew what, and when,' crucial questions not only in the Enron matter but in all complex securities fraud investigations. Although current law protects many government employees who act in the public interest by reporting wrongdoing, there is no similar protection for employees of publicly traded companies who blow the whistle on fraud and protect investors. With one in every two Americans investing in public companies, this distinction fails to serve the public good.[38]

Congress accordingly enacted Section 806 of Sarbanes-Oxley, which generally prohibits discrimination against employees of public companies (*i.e.*, companies registered or reporting under the Securities Exchange Act) in retaliation for assisting in the investigation of a violation of the federal securities laws. The whistleblower provision has been called "the single most effective measure possible to prevent recurrences of the Enron debacle and similar threats to the nation's

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[36] S.Rep. 107-146 at 10 (May 6, 2002).

[37] Beverley Earle and Gerald Madek, *The Mirage Of Whistleblower Protection Under Sarbanes-Oxley: A Proposal For Change*, 44 Am. Bus. L. J. 1, 4 (Spring 2007) (quoting 148 Cong. Rec. S 6,439-440 (daily ed. July 9, 2002) (statement of Sen. Leahy)).

[38] S.Rep. 107-146, *supra*.

financial markets."[39] It is, indeed, an important component of Sarbanes-Oxley's overall approach to combating corporate fraud.

Nonetheless, the First Circuit has held that the employee of a nonpublic company is not covered by Section 806, ***even if the company and its employees are responsible for securities compliance of a public company that is covered by Section 806***.[40] In other words, the whistleblower provision can be circumvented by a public company to the extent that it outsources compliance to a nonpublic company, such as a nonpublic accounting firm. This holding was particularly egregious under the facts of the case because the private company was the investment adviser to a mutual fund. As described below, the unique structure of mutual funds means that, as a practical matter, the ***only*** "employee" to whom the whistleblower provision will apply in relation to a mutual fund's compliance with the federal securities laws is an employee of the fund's investment adviser. Thus, the First Circuit effectively repealed Section 806 for virtually all employees of nonpublic companies who blow the whistle on mutual fund misconduct.[41]

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[39] Richard Moberly, *Unfulfilled Expectations: An Empirical Analysis of Why Sarbanes-Oxley Whistleblowers Rarely Win*, 49 Wm. & Mary L. Rev. 65, 68 (Oct. 2007) (quoting Taxpayers Against Fraud).

[40] *See Lawson v. FMR LLC*, 670 F.3d 61 (1st Cir. 2012) (Section 806 does not apply to employees of nonpublic companies), *pet. for cert. filed* 81 USLW 3007 (Jun 28, 2012). I have no economic interest in this case, but in the interest of full disclosure I note that I provided compensated expert services to the plaintiffs. This testimony is not intended and should not be read to express any opinion regarding that particular case or any other case.

[41] *See* Rosanne Felicello, *No SOX Whistleblower Protection for Employees in the Mutual Fund Industry According toe First Circuit Decision in* Lawson, 3 Sec. Litig. Rpt. 9 (March 2012) ("The *Lawson* decision is remarkable for the labor that the Circuit Court undertook to reach a result at odds with both the text of the statute and the purpose of the antiretaliatory provisions.. . . the opinion eviscerates any protection for employees in the mutual fund industry, even those employees who work directly with the fund. This is due to the unique set up of the mutual fund industry. The public mutual funds themselves generally do not have any employees (as is the case for the Fidelity funds at issue in *Lawson*). All of the employees who work on the funds are employed by private companies who contract with the mutual fund to provide their services. According to the First Circuit's opinion, none of the employees of the private fund advisers are protected by the whistleblower protection of SOX.").

A mutual fund conducts virtually no securities law compliance activities itself, for it is generally nothing more than a shell comprised of the fund board of directors. Rather, mutual fund compliance responsibilities are assumed almost entirely by the fund's investment adviser. Mutual funds are structurally unique because they typically farm out ***all*** of their service needs to third parties, including compliance. The fund's board of directors negotiates contracts with the fund's service providers and oversees the operation of the fund, but the fund typically does not have any employees;[42] its "employees" are employed by a third-party service provider.[43] As a practical matter, the investment adviser exercises *de facto* control over the fund throughout the fund's life.[44]

The most prominent scandal in the history of the mutual fund industry involved shareholder abuses that were brought to light by precisely the kind of whistleblower to which the whistleblower provision is intended to apply.[45] The

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[42] *Insider Trades During Pension Fund Blackout Periods*, Investment Company Act Rel. No. 25795, at Part II.B(1)(d) (Nov. 6, 2002)) ("[i]nvestment companies . . . typically do not have employees because they are externally managed, with investment advisory and other services provided by affiliated and unaffiliated parties pursuant to contracts with the investment company."); Letter from Dorothy M. Donohue, Associate Counsel, Investment Company Institute to Jonathan Katz, Secretary, SEC (Dec. 13, 2002) ("Unlike operating companies, investment companies typically do not have employees, . . . The vast majority of investment companies do not have employees because they are externally managed, with investment advisory and other services provided by affiliated and unaffiliated parties pursuant to contracts with the investment company.").

[43] "Unlike most corporations, an investment company is typically created and managed by a pre-existing external organization known as an investment adviser. . . . the adviser generally supervises the daily operation of the fund and often selects affiliated persons to serve on the company's board of directors.'" *Investment Company Governance*, Investment Company Act Rel. No. 26323 at Part I (Jan. 15, 2004) (quoting *Burks v. Lasker*, 441 U.S. 471, 481 (1979) (quoting *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 808 (2d Cir. 1976))). As stated by Robert Pozen at the time that he was President and CEO of Fidelity Management and Research Co., the defendant in the First Circuit case: "Virtually all mutual funds are externally managed. They do not have employees of their own. Instead, their operations are conducted by affiliated organizations and independent contractors." Robert Pozen, The Mutual Fund Business, at 22 (1999).

[44] *See* Investment Company Act Rel. No. 26323, *supra* ("a fund adviser is frequently in a position to dominate the board because of the adviser's monopoly over information about the fund and its frequent ability to control the board's agenda.").

[45] *See generally*, Mercer Bullard, *The Mutual Fund as Firm: Fund Arbitrage, Frequent Trading and the SEC's Response to the Mutual Fund Scandal*, 42 Houston L. Rev. 1271 (2006); *see also* Todd Wallack, *Anatomy of a Scandal Anonymous Tip Helped Mutual Fund Regulators Find Where To Dig Up Bodies*,

allegations contained in the complaint that launched the market timing scandal were brought to the New York Attorney General's attention by Noreen Harrington, an executive at Canary Capital Partners.[46] In early 2003, Peter Scannell, an employee of Putnam, reported to the staff at the Securities and Exchange Commission and the Massachusetts Securities Division that, among other things, the investment adviser of the Putnam family of mutual funds and affiliates of the adviser were permitting trading in fund shares that violated fund disclosure documents. In describing his experiences to a U.S. Senate subcommittee, Scannell specifically commended Sarbanes-Oxley's whistleblower provision.[47]

As a general matter, Section 806 should be amended to cover employees of nonpublic companies to the extent that the relevant misconduct relates to a public company's compliance. This amendment is particularly imperative with respect to mutual funds, where an employee of the nonpublic investment adviser is likely to be the ***only*** employee to which Section 806 will ever apply. The trial court,[48] dissenting Appeals Court Judge Ojetta Thompson,[49] Securities and Exchange Commission,[50] and Department of Labor[51] (which has adjudicatory authority over whistleblower complaints) ***all*** disagreed with the two judges who decided the First Circuit case. The Department of Labor's Administrative Review Board has repeatedly held that

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San Francisco Chronicle at B1 (Dec. 23, 2003) ("In March, an unnamed whistleblower told Massachusetts securities regulators that Morgan Stanley executives pressured brokers to steer clients toward their in-house mutual funds, prompting both Massachusetts Secretary of State William Galvin and New York State Attorney General Eliot Spitzer to investigate.").

[46] *See* Complaint, *New York v. Canary Capital Partners, LLC* (N.Y. Sup. Ct. 2003).

[47] *See* Testimony of Peter Scannell before the Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate Committee on Government at 17 (Jan. 27, 2004).

[48] *See Lawson v. FMR, LLC*, 724 F.Supp.2d 141 (D. Mass. 2010), *rev'd in part by Lawson*, *supra.*

[49] *See Lawson*, *supra* at 83 (Judge Thompson dissenting).

[50] *Brief for the Securities and Exchange Commission as Amicus Curiae in Support of Plaintiffs-Appellees/Cross-Appellants Supporting Affirmance*, 2011 WL 1977769 (Apr. 8, 2011).

[51] *Brief for the Secretary of Labor as Amicus Curiae in Support of Plaintiffs-Appellees/Cross-Appellants Supporting Affirmance*, 2011 WL 1977768 (Apr. 8, 2011)

Section 806 applies to employees of agents of public companies, even if the agent is not itself a public company.[52] Nonetheless, the interests of ensuring securities law compliance as reflected in Section 806 will be frustrated unless Congress takes up the First Circuit's invitation "amend the statute."[53]

V. Option Grant Reporting

One of the most effective provisions of SOXA has been its requirement that insider transactions in issuers' securities, including executive option grants, be reported within two business days of the transaction. Prior to SOXA, stock options grant could be disclosed up to one year after the grant.[54] In contrast, Section 403 of SOXA requires that stock options grants be reported within two business days. This provision has been effective in reducing the practice of fraudulent backdating of stock options, a pervasive practice that was exposed in 2005, when research showed that options backdating was pervasive among public companies.[55] Options that are reported within SOXA's two-day requirement cannot be materially manipulated through backdating.[56] Some have therefore concluded that SOXA

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[52] *See Spinner v. David Landau and Assoc., LLC*, 2012 WL 2073374 at *3 (U.S. Dept. of Labor May 31, 2012) (employee of private accounting firm providing SOX compliance services to public companies are covered by Section 806; citing supporting decisions).

[53] *See Lawson, supra* at 83. Senator Fitzgerald previously proposed such an amendment in Section 116(b) of the Mutual Fund Reform Act of 2004, which clarified that Section 806 applied to employees of an "investment adviser, principal underwriter, or significant service provider" of a mutual fund, regardless of whether the entity was a public company. Section 922(b) of the Dodd-Frank Act amended Section 806 to clarify that it covered employees of nationally recognized statistical ratings organizations (whether or not they are public companies).

[54] *See* Securities Act Rule 16a-3; *see generally* Jesse Fried, *Option Backdating and Its Implications*, 65 Wash. & Lee L. Rev. 853, 882 (2008) *available at* http://www.law.harvard.edu/faculty/jfried/option_backdating_and_its_implications.pdf .

[55] *See* Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 Management Science 802 (2005) *available at* http://www.biz.uiowa.edu/faculty/elie/Grants-MS.pdf.

[56] *See* Narayanan and Seyhum, *supra*.

effectively eliminated the practice of options backdating.[57] Consistent with this view, research shows that patterns suggesting improper backdating did not appear when post-SOXA options were disclosed within one day of the grant date.[58]

However, the same research showed that the disclosure of a large percentage of options has not complied with SOXA; "roughly one-fifth [of executives] violate the two-day reporting requirements."[59] There is substantial evidence that thousands of companies have continued to backdate options while violating the SOXA's two-day reporting requirement,[60] which raises the question of whether the requirement is being adequately enforced.

On the whole, the SEC's options backdating enforcement effort has been extensive. The Commission has brought dozens of enforcement actions related to options backdating[61] including, for example, a case in which it obtained a permanent bar from serving as a director or officer of a public company against a company's former general counsel and chief accountant for, among other things, options backdating and violations of the post-SOXA, two-day reporting requirement.[62]

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[57] *See generally* Hearing before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (Sep. 6, 2006) (testimony of Christopher Cox, Chairman, Securities and Exchange Commission) (SOXA "slammed the door" on options backdating) *available at* http://www.sec.gov/news/testimony/2006/ts090606cc.htm; *see also* John Zarian, *Backdating Requires Caution, Forethought*, Idaho Bus. Rev. (Oct. 9, 2006) ("The practice of backdating options virtually disappeared in 2002 when the Sarbanes-Oxley Act tightened reporting requirements.") *available at* http://www.stoel.com/files/Backdating_IBR2006.pdf.

[58] *See* Randall Herron and Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants*, 83 J. Fin. Econ. 271 (2007) *available at* http://www.uic.edu/classes/actg/actg593/Readings/Stock-Options/Does-Backdating-Explain-The-Stock-Price-Pattern-Around-Executive-Stock-Option-Grants-Heron,-RA,-E-Lie.pdf.

[59] Herron and Lie, *supra* at 274; *see* Narayanan and Seyhum, *supra* at 4 (finding continued evidence of backdating and late reporting of 24% of option grants).

[60] *See* Fried, *supra* at 883 – 84.

[61] *See* cases listed on the SEC's *Spotlight on Stock Options Backdating* webpage at http://www.sec.gov/spotlight/optionsbackdating.htm.

[62] *SEC Charges Take-Two's Former General Counsel and Former Controller/Chief Accounting Officer with Stock Option Backdating*, Litig. Rel. 21163 (Aug. 3, 2009) *available* at

In addition, reporting compliance may have improved, thereby arguably lessening the need for increased enforcement. None of the data cited above covers reporting during the last 5 years, and I have not found any research that measures more recent options reporting compliance levels. Indeed, some research suggests that SOXA options reporting compliance improved from 2002 to 2004,[63] and such improvement may have continued.

However, it appears that inadequate enforcement may be permitting a significant degree of backdating to continue.[64] The number of enforcement actions involving post-SOXA reporting violations is not consistent with research evidencing thousands of violations during SOXA's early years. And it is not clear why enforcement of the two-day reporting requirement would not be a fairly simple matter. Form 4 is an electronic report that presumably could be searched to generate an automatic red flag when the filing date falls more than 2 days after the grant date. The possibility of creating such an automatic flagging system should be considered (although such a system may already be in place). In addition, it may be appropriate, given the evidence of continued, widespread backdating, to impose automatic penalties for late reporting of options. Penalties could be structured to ensure that they are sufficiently severe that they would not be treated simply as a cost of doing business, such as through higher penalties for repeat offenders.

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http://www.sec.gov/litigation/litreleases/2009/lr21163.htm; *SEC v. Selterman and Tay*, Civ. Act. No. 09-CV-6813 (S.D.N.Y. July 31, 2009) *available at* http://www.sec.gov/litigation/complaints/2009/comp21163.pdf.

[63] *See* Nurayanan and Seyhum, *supra* at 9 (average post-SOXA reporting lag decline from 17.65 to 8.62 days).

[64] *See* Nurayanan and Seyhum, *supra* at 24 ("In order to further restrict [backdating and camouflaged timing], SEC needs to enforce the SOX reporting requirements, and, if possible, limit the use of unscheduled option grants to legitimate purposes.").