

## LET'S GET REAL-WHY THE SARBANES OXLEY ACT IS A SHAM

**David B. Kahn**  
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While it may quiet the voters, the Sarbanes Oxley Act will do little to prevent the false and inflated reports on the financial condition of our public companies. The act does not deal with the pervasive incentives of the providers of financial information about public companies to hide bad news. Unless these incentives are extensively realigned, we will not receive the information needed to make informed investment decisions after the current furor subsides. To stop the bleeding we need real checks and balances-- outside auditors who are truly independent and boards which actively represent shareholders, not management. Unfortunately the provisions of the Act which are supposed to address these needs are illusory.

The Act still leaves the fox in charge of the chicken coop. The audited companies still have the power to hire, fire and pay the supposedly "independent" auditors leaving them firmly under the influence of people with a tremendous interest in favorable financial reports. While directors are supposed to supervise management on behalf of shareholders, management continues to dominate their selection leaving shareholders virtually no role.

The Act pretends that increasing the penalties for criminal conviction of corporate executives and requiring them to certify financial statements will solve the problem but these provisions are not significantly different from the situation that led to the costly hemorrhaging of money and human capital. Before the Act, the problem wasn't that penalties were insufficiently severe but that the prosecutions were rare and difficult to win. They remain so after the Act. Nor is the certification requirement new. The frequent suggestion that the markets are self correcting simply ignores the fact that such corrections are temporary and cyclical and accompanied by the enormous costs we are seeing now. Absent serious changes these problems will continue.

### **We can afford no less than a real solution.**

The failure to enact real solutions will cost us dearly. Even greater losses than those suffered by investors result from misallocating money and human capital into firms masquerading as successes. While referred to by innocuous terms like "earnings management" or "accounting shenanigans" the perpetrators of these financial manipulations, are reaping fortunes while causing more harm than the mafia.

Our pricing system is the mechanism on which we depend to channel resources to productive enterprises. Financial misrepresentations cause massive misallocations of both monetary and human resources robbing us of what could be produced by investment in productive enterprises. While the monetary missallocations are obvious, society also loses productivity from the allocation of human effort to unproductive businesses and from the extravagant rewards paid talented people in management and at audit firms and investment banks who promote and benefit from these destructive illusions. The problem is compounded because

managements' ability to hide problems, lessens their need to address them. Hiding them permits them to retain their jobs and continue to reap extravagant compensation while deferring the problems to a successor administration which can disclaim responsibility.

We respect the sanctity of banks as a depository of our savings. But the equity markets for public company stock are the real depository of our life savings. The absence of checks and balances in our capital markets has devastating effects on our retirement assets.

We acknowledge that financial misrepresentations undermine the confidence of our citizens and threaten the ability to raise capital for worthwhile businesses. But it also threatens foreign investment, which is critical to our capital markets. These misrepresentations exacerbate the dislocations of the boom and bust cycle inherent in a capitalist system, creating unnecessary instability for people who build their lives around companies that have already failed but are depicted as succeeding. Finally the financial misrepresentations weaken the rule of law. A lawful society depends not merely on enforcement but on respect for the law and the flouting of the rules by influential, highly rewarded people seriously diminishes the ability to persuade others to play by those rules.

The absence of real checks and balances not only damages our economy but it profoundly damages our democracy. Management and their boards are essentially unelected and unaccountable. The fact is that shareholders have no real choice and directors get upwards of 98 percent of the vote- not very different than Saddam Hussein. The fact that Public companies have great resources and managements' control over these resources give it enormous influence over government and the Nation's political agenda. Control in the hands of unelected and unaccountable people seriously undermines our democracy.

### **The problem is as broad as the incentives which cause it are pervasive .**

A realistic appraisal of the incentives operating on the providers of financial information should lead us to conclude that we should have expected just what we have received. Our current arrangements are not unlike having the pitcher call balls and strikes and letting him hire and pay the "unbiased" umpire. It is not surprising that these wrongs have occurred. What is surprising is that we are surprised.

All of the major providers of financial information for public companies have a significant interest in reporting favorable results and a strong aversion to revealing bad news. Were it in their interests to stop financial overstatements, management, auditors, analysts, investment bankers and boards of directors would blow the whistle long before public companies implode. It is a simple fact of life that each of these constituencies endorse, promote and profit from good news. None profit from revealing bad news. If we fail to change the incentives, we will continue to suffer the consequences.

Financial statements are prepared by management and they are management's report card. Unfavorable financials are costly to careers. Favorable ones can result in huge paydays from increased salaries, bonuses and the exercise of lavish stock options at high market prices. Yet,

under the current system, management writes its own report card and has practical control over the hiring and compensation of those who are supposed to audit it on behalf of the public. When Congressman Condit hired his own lie detector examiner to substantiate his innocence in the Chandra Levy affair, the public reacted with justified skepticism. Were students to write their own report cards we would hardly expect objectivity. Were they given millions for a good report and publicly fired from high paying jobs for bad ones, the grade inflation would be even worse. Add the right to hire, pay and fire the people who review their reports and you would have even less basis for confidence. We have no greater basis for expecting objectivity from management.

The outside auditors don't solve the problem. They often make it worse by providing management cover and creating the illusion of an independent review. Auditors are paid to conduct audits and want the job badly. Although nominally hired by company boards, management has functional control over the auditor's retention and pay. Loss of an audit client is bad for an auditor's firm and his career. As a result, rather than being independent auditors function more like advocates for rosy financials. When a lawyer advocates he is opposed by a lawyer for the adverse party and a decision is made by an impartial judge. The auditor, however, is supposed to be that judge. Instead, much like lawyers, auditors find arguments to support interpretations of Generally Accepted Accounting Principles ("GAAP") that permit the issuance of good looking financial statements even when the company has no viable business.

As currently constituted, boards of directors and their audit committees also come up short creating the illusion but not the substance of an independent, responsible review. They are supposed to supervise management on behalf of shareholders but they don't. Management has enormous influence over their slating and their pay. Shareholders have virtually none. Those chosen are not inclined to curb management abuses in large part because they are feeding at the same trough. Plenty of prominent people sat on Enron's Board, including a prominent and respected accounting professor. Boards generally act out of embarrassment after a problem has become public. It is difficult to recall any examples of boards or audit committees blowing the whistle on financial misrepresentations by management beforehand. Nor have they done anything to curb the truly abusive level of management compensation. The Act has done nothing to prevent any of this.

Investment bankers and the analysts who work with them are another major source of investment information. They often represent both buyers of shares and those selling them. This conflict often sacrifices the interests of the share buyers for the fees to be derived from the issuers. They make money selling deals. They do not take the economic risk of the deal and they have far more incentive to paint a positive picture than a negative one. Analysts are part of the investment bank's sales staff. They cater to management in order to further the investment bank's business.

### **Industry examples show why the Act will not work.**

In our system it is inevitable that some companies will fail in the competitive process. The problem is not, as some would have it, that companies fail but that the critical market elements often work together to prevent investors from learning that companies are failing.

Auditors find GAAP interpretations which help companies pretend to be profitable by deferring the recognition of costs, accelerating the recognition of income and hiding debt, effectively digging their clients into deeper and deeper financial holes while sucking in more and more investment. While the methods differ from industry to industry, the method of choice is often similar throughout a single industry.

Investment bankers, analysts, auditors and management have recently made fortunes on telecommunications companies that attracted enormous investment long after the companies were in serious trouble. The method of choice for creating the illusion of profitability in this industry involved the purchase and sale of line capacity. Taking a simplified example, a telecommunications company could buy line capacity rights at \$1,000,000 per year for 20 years. It could also sell line capacity rights for 20 years at the same \$1,000,000 per year sometimes to the same company. On the sale, the company would include in the current year's income the entire present value of the \$20,000,000 in payments it would expect in the future. By contrast, the company would report only the \$1,000,000 it paid in the current year as a current year expense. Accounting for these essentially offsetting transactions in opposite ways creates the illusion of profitability without the critical element-profit. Of course in subsequent years the Company would be in an increasingly deeper hole because it had previously harvested the income from those years and would have to report the costs deferred from the prior years. In order to avoid revealing that it was unprofitable the company would have to repeat this procedure in greater amounts creating even bigger future deficits. Insofar as disclosed, this seems to have been blessed by major auditing firms.

Another example is the subprime auto loan industry. Bad debt costs are the principal costs of such companies and these costs are recognized through the creation of a loan loss allowance or, in common parlance, a bad debt reserve. Before they collapsed in 1997, these companies avoided charging income for bad debt costs. They deferred their costs by reporting small reserves based on unrealistic assumptions. As the loan charge off rates grew higher, the auditors did not require the companies to increase their reserves as a percentage of the loan portfolio and even approved decreasing the reserves. The companies accelerated the reporting of income by funding the reserve exclusively through dealer discounts--the amount less than the face value the company pays the auto dealer for the loans it purchases.

In a simplified example a company might suffer an average of 20 percent in nonpayment on each loan portfolio it acquires. The company purchases a \$100 million face amount portfolio in its first year for \$95 million constituting a 5 percent dealer discount. Instead of carrying a 20 percent or \$20 million bad debt reserve to cover such losses, it would carry a 5 percent reserve which it covered with the \$5 million dealer discount. Because the loans were newly issued, there was a small charge off rate in the first year and the \$5 million reserve more than covered their first year losses. Even though the company was paying far more for the loans than it could hope to recoup it buys an even greater loan volume in the next year. In that year the loss rate on the first year loans increases significantly. However in the second year the company would buy three times the volume of loans or \$300 million and book an additional \$15 million dealer discount in reserve. Because the newly acquired loans also have low first year loss rates, the dealer discount on the newly acquired loans exceed their initial year losses and the company uses

them to cover the charge offs of the old loans in their second year when their losses became much larger. By buying ever increasing amounts of new loans and using the new loan dealer discounts to cover the old loan losses, the company could hide greater and greater losses. This process could only continue by the purchase of exponentially greater volumes of, albeit, money losing, loans. When financing dried up in 1997, subprime auto loan companies were unable to continue hiding their losses through dealer discounts by acquiring larger new pools and many went bankrupt.

It would have been apparent that these companies were losing money on their loan pools if they ever tried to estimate the loss rate on each loan pool and compare it to what the company was paying for that pool. A thorough review of the records of two such companies and of their auditing firms revealed no such computations. That the companies were losing money on each pool seemed irrelevant to management and the auditors so long as dealer discounts on ever larger new loan pools would cover the prior pool losses.

All of the financial statements were certified by officers and directors in both industries. No officers whose company's machinations had been supported by its auditors as complying with GAAP were prosecuted for securities fraud in either industry. Nor was a single auditor. To date the only prosecution begun at either industry has been in the telecommunications industry at Adelphia where the controlling family is accused of looting and at Worldcom where the methods used had no auditor support.

**Auditors must provide an independent check and balance and the Act is insufficient to assure they will.**

The pervasive incentives to inflate, make the need for the checks and balances of independent outside auditors critical. This is implicit in the term used to describe the position-- "independent auditor". Unfortunately the Act continues the delusional concept that you can hire, fire and pay somebody and they are still independent. If nothing else were done, changing to truly independent auditors would go a long way. Unfortunately the Act does not do this. The Act's principle approach is its limitation on (not elimination of) the consulting or non-audit work auditors can perform for clients. The notion that eliminating such services would make the auditors independent is supported by neither data nor logic. Consulting services may exacerbate the problem but the notion that there is no significant conflict without them is borne only of the desire to avoid the greater political confrontation needed for a realistic solution. Enron's auditors were reportedly paid \$26 million for auditing and \$27 million for non-auditing services in 2001. Where is it written that if Andersen had only received the \$26 million fee for auditing it would not have been eager to help its clients by signing off on financial statements constructed to hide Enron's weak financial position. Like many others, accountants can be induced for far less. The supposition that an under- the- table bribe provides an auditor incentive to go along but a fee paid in response to an audit bill provides no such incentive has no basis. The only reason for continuing the current arrangement is because the auditors and their management clients benefit by it and have had the political muscle to keep a proposal for true auditor independence from even getting on the agenda. Indeed the financial press has already reported that auditing fees

have risen substantially.

The auditing culture is oriented to making large sums of money. This is reflected in the additional businesses auditing firms have been branching into including consulting, political lobbying and until recently legal services. Nothing is wrong with wanting to make money. It does, however, run counter to the kind of priestly mentality required for auditors to ignore the financial rewards which depend on their helping the client company look good. The auditors are supposed to be independent of those they are reporting on and serve the interests of the public in assuring it gets accurate information about public companies. Auditors are hired fired and paid by the companies they audit. Auditors make big money by pleasing the company. Under this structure auditors serve the wrong master.

Public companies should not be able to hire or fire those who audit them and should not control their compensation; rather the companies should name a pool of a number of audit firms with the auditor selected at random from among them.<sup>1</sup>

In most cases ten audit firms should be named to the pool but the number could vary for companies whose size and operations would require the largest audit firms and for small companies in smaller markets for which there may not be ten practical choices. Adjustments might have to be made by an oversight body if an audited firm becomes over- subscribed in which case a second firm would have to be selected.

The company should pay into a fund which would pay the auditors at market rates for accountants working in the same area.

In addition to the disgorgement remedies discussed below, there should be a suspension from practice for auditors involved in a bad audit directly or in a supervisory capacity. Supervisory capacity could include those at the top of the audit firm if they fail to meaningfully exercise supervisory responsibility.

Audit firms should not be dischargeable by the audited company. They could be replaced for bad audits but only by the new oversight body and not at the option of the audited company.

Periodic prescheduled changes of auditing firms might be considered.

The auditing firm should not be permitted to provide any other services to the company or its management presently or in the future.

In the audit process the company's officers attempt to persuade the auditor to adopt its position. The auditor is supposed to decide the merits in an almost judicial capacity. However under current circumstances while there is an advocate for the company, there is no advocate for the public in these negotiations. The public is unrepresented and it shows.

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<sup>1</sup> Indented paragraphs represent changes suggested by the author.

The role of the auditor in these negotiations should be like that of a public ombudsman trained in financial and economic matters. The auditor should participate on behalf of the public to make sure that the financial report provides the information about the company's financial position needed to make an informed investment decision. The auditor should act for investors at large, not just the issuers' shareholders.

It would be helpful to provide that for the publication of the views of the auditor which are needed to properly understand the company's financial statements.

In conducting an audit, the auditor opines only as to whether the company's financial reports violate GAAP. In doing so the auditor must grant the company's financial reports deference. She is not entitled to require that the reports reflect the company's financial position as accurately as possible or that they provide investors with the information necessary to make an intelligent investment decision. As a result we would be far better served if the auditors' scope was broadened so that the auditor created the report in the first instance eliminating or minimizing the deference accorded managements inherently biased reports.

To the extent possible, the auditor should create, not merely review, the financial reports. To the extent that the auditor's role is confined to a review, the scope should be broadened. The auditor should not be required to defer to managements conclusion, but should be free to rewrite the report to the extent necessary to fulfill its purpose.

In doing so the applicable standard should be to provide investors with the information necessary to make an intelligent investment decision.

As noted above the culture of public auditors has been entrepreneurial, encouraging them to find ways to construe GAAP to help convince the public that their clients are more valuable than an objective presentation would show. The auditors ethos and the GAAP rules reflect these motivations. The auditors need to be retrained and GAAP needs to be restructured to produce meaningful financial statements.

If the people who have grown up in the current auditing culture are to continue they need to be retrained in the purposes of financial reporting and the cost to society of finding constructions of the rules which deceive investors about a company's financial position.

GAAP needs to be restructured to assure that it requires the meaningful disclosure of the information needed to intelligently evaluate a company.

We might consider economists to provide leadership in this effort but auditors should not have the lead. The power and wealth of auditing firms have given them influence over our major business schools. This has to be considered in selecting those who would rework GAAP and

retrain auditors.

It would also be helpful if what the auditors did was, in the current vernacular, more transparent. People would be shocked if they saw the machinations reflected in auditor work papers. The auditors claim that disclosing their work papers deprives them of legitimate business advantages but the work papers often reveal the auditors' culpability.

Make the auditors work papers publicly available.

The Act creates a new Public Company Accounting Oversight Board to deal with auditing standards and to review auditor conduct. Such a board cannot cure the absence of auditor independence anymore than improvements in the major league front office could cure the problem arising if baseball pitchers hired and paid the umpires. The purported benefit of the new oversight board is that it limits the number of accountants who may serve on it. Before the Act, the SEC was one of the important bodies performing oversight functions. The enormous political influence of the auditing firms and their client companies limited the SEC's success in doing so. Under the Act, the SEC maintains complete control over the functioning of the Board. Pressure from the auditing firms and their clients limited the effectiveness of the SEC oversight before the Act and there is little assurance that the SEC will be less vulnerable to such pressure in exercising control over the new Board.

**Boards must supervise management on behalf of shareholders and the Act does nothing to assure they will.**

We must have oversight of management by independent people representing the interests -- not of management-- but of the shareholders, the owners for whom management is supposed to work. That is what boards are supposed to provide. It is obvious that under our current system boards are unequal to the task. Neither boards nor their audit and compensation committees have exercised serious oversight over managements' self-serving financial statements, curtailed their obscene compensation arrangements or limited their often ego driven transactions. Boards are generally subservient to management and shareholders have little control over the companies they own -- a sort of "taxation without representation".

Boards are inadequate for several reasons. First, the Shareholders who they are supposed to serve have no real control over the selection of directors. Instead that control is lodged in those who boards are supposed to supervise -- the managers. Thus, managers have the ability to choose and control their supposed bosses while shareholders are shut out. Director candidates get upwards of 98 percent of the vote, not because shareholders are so enthusiastic, but because they have so little choice. Mounting a challenge to management's slate results in the notoriously expensive and, difficult long shot of a proxy fight. The reality is that directors are invited on boards by management to whom they owe an allegiance.

One problem is slating. Slating is tantamount to election and management has functional control over the slating of board candidates.

Federal law should require that shareholders of publicly traded companies who individually or in the aggregate hold three percent of the vote for a period of perhaps two years should be able to nominate candidates using the company proxy. Board committees and management should be removed from the slating process subject to the exception that they would slate only if the shareholders fail to do so.

This would go along way towards improving boards. Resistance to such changes comes from the obvious self-interest of those in control. They argue that independent candidates elected by shareholders might cause harm if given any real power. This concern ignores the well documented harm caused by the unchecked power currently exercised by self-interested managements, has no empirical basis and constitutes a rejection of the democratic process.

Voting is an even more complex problem. In many cases the owners' voting rights are excised by institutional intermediaries sympathetic to management. Many institutional investors suffer business conflicts. Mutual funds seek investment business from management including the investment of 401 k and other ERISA funds. Some mutual funds are owned by investment banks whose conflicts are obvious. Even the large public pension funds may be tainted because their trustees are often controlled by state politicians who may be beholden to management as a source of campaign contributions. Nonetheless these public pensions have become increasingly interested in constraining management excesses and at this point are more a part of the solution than the problem.

The beneficial owners should have the option of having voting rights transferred from mutual funds, pension trustees and other corporate intermediaries to themselves.

Transferring voting power is no magic bullet however. Voting by individual shareholders is burdensome and difficult. Having to vote all of the shares in an index fund, for example, is a breathtaking chore for the average investor.

One possible solution is the employment of paid proxy services like those employed by some Taft Hartley pensions that could be chosen and hired by shareholders to vote all or a portion of their shares.

Additionally the internet, not just printed proxy statements, should be used for providing candidate materials and for voting.

Another problem is that public boards are composed of the wrong kind of people. Management protects itself by the sympathetic, pro forma oversight of people whose own interests are aligned with theirs. Why would directors who are themselves in management of other companies move to restrain management or curtail excessive compensation, when that rising tide floats their own boats? And this situation is only worsened by the presence of company management-- the very people boards are supposed to supervise-- on their own boards. Input from officers can be obtained without having them sit on the board. Those who are to

review and pass on management advice must be independent. The characteristics of those who serve on the board must change. Board allegiance to management is reinforced by the background of those typically invited on boards. CEOs, politicians and luminaries should not head any list.

Boards should not include management or any one working for or doing business with the company.

Boards should not include management of other public companies

Board members should be precluded from obtaining business from the company or management for several years before and after they cease serving on its board.

Board members often lack the training and the time to protect shareholders from management overreaching. Board members should be trained and compensated sufficiently to permit them to actively supervise management.

The Act simply does not address these problems.<sup>2</sup>

### **The Investment Bank Conflicts Must Be Addressed**

Investment Banks and their brokerage businesses have substantial and complex conflicts with their clients. The investment banks receive huge fees for the fairness opinions they give in connection with corporate transactions but these fees are often contingent on the approval of the shareholders receiving the opinions and the completion of the transaction-neither of which will happen if the banker's opinion is unfavorable. Many of the large investment banks have brokerage operations and their brokerage customers rely on their advice. Yet they often represent sellers and buyers in the same transactions.<sup>3</sup> The analysts they employ are motivated to tell shareholder good things about companies in hopes of obtaining or keeping the company's underwriting business. All of this creates substantial motivation to mislead investors.

Investment banks and companies which own them should not be permitted to also own retail brokerage businesses.

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<sup>2</sup>There are a number of proposed solutions abroad but the most prominent of them only seek to assure that some board members do not work for or do business with the company. These proposals are inadequate because they do not create boards that will have the inclination, the time or the ability to actively and independently supervise management on behalf of shareholders. For example CEOs of other companies often serve on boards but do not curtail management abuses because they are sympathetic to the very excesses which need to be addressed.

<sup>3</sup>The fees they charge brokerage clients also create conflicts because the brokerage only profits from selling securities to the client. This problem is compounded by the fact that the brokerages are paid fees by companies whose mutual funds they sell and in some instance by the fact that they actually own the funds they sell the clients.

The beginning of analyst reports should prominently disclose that the analyst company could profit from investment banking relationships and that there may be significant biases. This admonition should be as prominent as those on cigarette packages.

The beginning of analyst reports should prominently disclose that analysts have not verified the information provided by management.

All fairness opinions should prominently disclose at the beginning the fees paid for them and any contingencies in connection with those fees. The specific facts and assumptions on which the opinion rests should also be disclosed in sufficient detail to permit an informed investors to reasonably understand the risks.

### **CEO certification is no cure.**

The act mandates that the CEO must certify the accuracy of company financial statements to the best of his or her knowledge. Like many of the Acts provisions these measures are long on symbolic value but short on substance. Despite the folderol, it is difficult to see what these certification requirements add to the prior certification requirements that will provide increased deterrence. The annual and quarterly reports contain company financial statements and were signed by officers and directors before the Act. Under pre-Act law such signatories could be held liable if the financial statements were materially misleading and they knew or were reckless in not knowing of this. This did not provide sufficient deterrence in the past and it is unclear why the new provision would do so.

### **Increased criminal penalties are not the solution.**

The Act increases the penalties on criminal conviction. However problems in deterrence were less the result of deficiencies in the severity of penalties than the low incidence of prosecution. The Act does not solve this problem. Criminal prosecutions are virtually unheard-of in the garden variety financial misrepresentations that go on all the time. In these misrepresentations the auditors construe GAAP to permit a company to accelerate its income and to defer its costs. These are very tough cases and take more legal resources than the government has ever been in a position to devote. Crimes have to be proven beyond a reasonable doubt. There is a great deal at stake for defendants and they typically have very deep pockets and can spend a great deal on a defense. In fact these costs are often born by the company and its shareholders.

Managers always claim that they relied on the auditors. The auditors say that what they did was consistent with GAAP and point to the fact that other auditing firms did the same thing. They also assert that the sudden costs were unexpected or that they were deceived by management or both. The document destruction case against Andersen in Enron was far simpler. Still, both sides spent enormous resources on a protracted trial. The government had a strong position but barely won. Proving beyond a reasonable doubt to a jury that GAAP is contrary to a defendant's position, inherently a technical battle of experts, is a far tougher case.

I cannot recall a prosecution for the kinds of distortions regarding the telecommunications and subprime auto loan business which were discussed above. Absent very unusual circumstances such as naked bribes (as opposed to large accounting fees or stock options or bonuses) or reliance on an accounting methodology which auditors have not approved, there are no prosecutions for issuing materially misleading financial statements. The paucity of criminal proceedings in the current heated atmosphere reflect this. Thus far, despite issuance of highly misleading financial statements, the government has only initiated prosecutions for document destruction and wire fraud in Enron, looting in Adelphia and personal property tax evasion in Tyco. There are no prosecutions in Qwest. To date, only in Worldcom has the government initiated a prosecution for filing false and misleading financial statements and there the accounting technique was apparently not approved by the auditors and is not claimed to be consistent with GAAP. The Act increases the SEC budget but not nearly enough to make criminal prosecution a realistic deterrent in most cases.

### **Excessive compensation and stock options must be addressed.**

Those who work in the top management of public companies are not sufficiently superior to the rest of us to justify the truly obscene pay we are witnessing. Excessive management compensation is diluting the ownership of the shareholders for whom management supposedly works, reducing the compensation to non-management employees and encouraging widespread financial manipulation. The Act does nothing to solve this problem.

Compensation arrangements providing executives with pay packages sometimes approaching hundreds of millions of dollars, are not the product of competitive market forces but of non-independent boards spending other people's money. Gary Winnick made almost a billion at Global Crossing, Joseph Nacchio a quarter of a billion at Qwest, Steve Case about a half billion at AOL and Ken Lay did awfully well at Enron to name a few. Published reports indicate that 47 executives at the 100 worst performing companies in the S&P 500 index took home at least \$5 million each in 2002. Honest talented people can be hired in other walks of life for far less - federal judges, distinguished college professors, big time corporate lawyers, brain surgeons, US senators and even the President of our great land make a tiny fraction of what is paid corporate insiders. But the managements pay packages approved by public company boards are approved by people loyal to management and paid with other people's money -- people whose interests are unrepresented by those making the decisions. The process is essentially collusive. Using the compensation levels of other companies' management as a benchmark places reliance on other collusively established pay packages.

Stock options and even stock awards are areas of particular harm. The supposed justification for stock options and awards has been that they provide management incentives by rewarding them for good performance. Not only is it difficult to see why conventional pay structures administered by proactive boards of directors would not serve but stock options and awards do not provide the incentives advertised. At best they are a useless giveaway and at worst an invitation to financial manipulation. They can richly reward management even for mediocre performance as long as the company's stock price rises with stock prices in the entire market.

Even worse, boards of directors can and do re-price stock options to compensate management when a company's share price goes down. Good performance is not required. Serious reform is needed.

Restructure corporate boards so that boards serve the public shareholders not the insiders and make compensation decisions as if it were their money.

Given the theory that executive profit on stock options and awards is a reward for increasing the value of the company, some basis for linking the increase in stock value to management performance is required. The amount of gain attributable to a rise in stock prices for the industry as a whole should be removed from the gain to the stock recipient.

Stock options should not be repriced.

The full dilutive effect of management compensation should be disclosed to shareholders in understandable form.

Stock options and awards provide strong incentives to manipulate financial results. Such options can be exercised and sold at the first opportunity if the stock price is high enough to make exercise and sale profitable. This provides a motive to pump up stock prices not to build strong durable companies.

In order to reduce the incentive to inflate financial statements, stock options and awards should not be saleable by a management recipient until he or she has been out of the company for several years.

The accounting for stock options and stock awards also distort financial results. Plainly stock options are valuable and the company awarding them is giving up the right to itself sell the underlying stock in the capital markets. It does cost the company. Issuers are not required to treat options used to compensate management as an expense.

Stock options should be expensed.

While management stock awards are treated as an expense their true cost is not expensed. Both stock awards and stock options should be fully expensed. Stock awards are generally restricted and expensed at a discount from value. Proposals have been put forward to require that stock options be expensed using the Black-Scholes model which captures only the time value of having a right to buy the stock. However it is submitted that neither capture the true cost to the company. Management recipients harvest much more from these securities when they sell the restricted stock or the exercise the options and sell the underlying stock than either the restricted stock or the Black-Scholes values. Expensing these limited amounts understates the true cost to the company.

Managers selling the stock awards and optioned stock are company fiduciaries who are

being paid to advise the company. By letting management have these interests, the company is losing the right to harvest, with management guidance, the same values at the same times as management. That is the companies true cost. For example Gary Winnick, Global Crossing CEO and Board Chairman reportedly made almost a billion dollars selling Global Stock. To the extent that stock came from stock options or awards, that is a billion dollars Global could have reaped under Winnick's guidance.

Companies should be required to treat stock options as an expense deducted from reported earnings in two stages. They should expense the Black-Scholes values at the time of grant and the remainder at the time the underlying stock is sold.

Companies should also be required to treat restricted stock awards as an expense deducted from reported earnings in two stages. They should expense the restricted value at the time of grant and the remainder at the time the stock is sold.

### **The legal standards for proving fraud should be clarified.**

An overly narrow application of the legal standards has hampered civil and criminal enforcement of the anti fraud laws. These laws say that a statement is fraudulent even if literally true if it omits something which makes it materially misleading. Unfortunately the material omission standard has not been fully applied. In consultation with its auditors, Enron worked to structure transactions which complied with GAAP but hid enormous debt. The telecommunications industry swap transactions which accelerated income on the sale of capacity but deferred the costs on capacity purchases were clearly misleading but, according to the auditors, they complied with GAAP. Probably as a result of the deference historically accorded auditors, courts have generally interpreted the anti fraud laws to mean that publishing a financial statement which complies with GAAP is not actionable even if it materially misleads investors. As a result compliance with GAAP is a defense and GAAP has been used to hide the truth. Any financial statement which materially misleads investors should be actionable whether or not it complies with GAAP.

Congress should direct the courts to apply the anti fraud provisions so that a financial statement that misleads investors can be actionable fraud even if it complies with GAAP.

A related problem arises when companies make positive announcements which are literally true while omitting material adverse information. This causes investors to understand that things are going well when they are not. While courts have found such omissions actionable, too many have absolved corporate actors because what they said was literally true.

Congress should direct the courts to apply the anti fraud provisions so that misleading investors by making positive announcements which are literally true but omitting material adverse information is actionable.

**Funding criminal enforcement should be significantly increased.**

Criminal enforcement of the anti fraud laws is expensive but critically important. Even in this superheated climate the government is not in a position to enforce any but the most notorious and easiest to prove cases. The Act does increase SEC funding but not enough for criminal prosecutions in any but the largest or most flagrant cases.

**Shareholder class suits should be streamlined.**

Because government resources are not sufficient to broadly pursue criminal prosecutions, shareholder class actions are the only significant avenue for enforcing the anti fraud laws. Such actions are also the only practical means for such shareholders to obtain redress. In 1995, as a result of intense lobbying by big auditing firms and public companies, Congress passed the Private Securities Litigation Reform Act (the "PSLRA") which greatly delays and complicates such suits. The PSLRA deprived securities fraud suits brought on behalf of large groups of shareholders of the benefits of the streamlined discovery rules by which parties are able to obtain evidence in normal suits. As a result such actions are subject to delays of almost 2 years beyond the norm delaying and reducing the redress of shareholders injured by corporate fraud.

Congress should direct the courts to apply normal discovery rules for security class actions to eliminate the delays.

The premise of the PSLRA was that those who ran public companies were of unimpeachable integrity and were so unlikely to take advantage of their positions that their conduct did not need to be scrutinized. It should now be clear to everyone that the accumulations of unsupervised power do require scrutiny. When a public company issues announcement after announcement full of good news and insiders exercise stock options and sell at high prices followed by a surprise disclosure of bad news, insiders invariably deny advanced knowledge. This needs scrutiny and current law too often prevents it. Unlike normal suits, the law requires that before securities fraud suits brought on behalf of large groups of shareholders may proceed, the plaintiffs must be able to allege, with particularity, what insiders knew before the surprise announcement and when they knew it. Such information normally comes from discovery of facts inside the company but, under current law, the required allegations must be made before such discovery is permitted. This unrealistic requirement results in dismissal of cases which could well prove meritorious if discovery were allowed to proceed. These cases are important to the operation of a clean financial market and this should be changed.

Congress should eliminate the requirement of pleading specific facts which show what the insiders knew and when they knew it and normal pleading rules should apply to securities fraud suits on behalf of broad classes.

**Aiders and abettors should be liable.**

We need to make accountable those who participate in misleading the public even if they

do not actually make the misleading statements. Current securities fraud laws only assign liability for damages to those who actually make a false statement not those who aid and abet a fraud. Lawyers and investment bankers who profit from helping a company mislead the public are not currently liable.

Make those who aid or abet the making of misleading statements to investors jointly and severally liable for damages caused by frauds they aid or abet.

**A realistic liability standard for false projections and opinions is needed.**

The PSLRA provides that those who make false projections (forward looking statements) can only be liable if the shareholders who relied on them prove that those who made them did not believe what they said. Some courts have imposed similar requirements for statements of opinion. Non-belief is necessarily subjective and hard to prove. As a result those who make misrepresentations of present fact are liable if they do so either knowingly or recklessly unless their non-belief can be proved. The higher burden of proof for projections and opinions has provided an open invitation for management to issue misleading estimates and opinions which permit their exercise of stock options at high prices. There is no reason that the liability standards for misleading forward looking statements and opinions should be any different than for misleading statements of present fact.

Those who make false and misleading forward looking statements or opinions should be liable for the resulting damages if they do so knowingly or recklessly.

Fairness opinions given by investment bankers to convince shareholders to approve a deal sought by management are a related area of importance. These opinions generally state that they are relying on assumptions which are often unspecified management projections of future performance. Investors do not know what the underlying assumptions are and are in no position to independently evaluate them in any case. Investors will naturally assume that the investment banker is not knowingly or recklessly relying on false or patently unreasonable assumptions. When they do, the opinion misleads investors. Courts have sometimes denied liability for misleading fairness opinions even where the investment banker knew or was reckless in not knowing that the material assumptions on which it relied were false. This should be changed.

Those who issue misleading fairness opinions should be liable for the resulting damages if they knowingly or recklessly rely on false or unreasonable assumptions.

**Broader disgorgement remedies are needed.**

Insiders continue to make fortunes based on the distortion of the financial position of public companies. Qwest insiders reportedly made \$500 million on the basis of financial reports the Company now says were false. Insiders also profit from exercising stock options and selling shares at high prices as a result of false profit estimates or opinions. Investment bankers have made billions selling the public investments in such companies. Auditors are also profiting from

such conduct. Andersen made over \$50 million in one year from Enron alone. These people should not be able to retain profits from false and misleading activities. The securities fraud laws generally provide liability only where there is proof that the person knew or was recklessly indifferent to the fact that the statement was materially misleading or, under certain limited circumstances, that were negligent. Proof of knowledge or recklessness can be difficult in such circumstances and such a requirement not only insulates such persons but encourages them to close their eyes to the truth. Putting them at risk for at least what they make would give them a greater incentive to protect the public.

The Act provides disgorgement remedies for CEOs and CFOs. This disgorgement remedy is constructive but has serious limitations. At the outset, the Act does not provide disgorgement for profit made from selling stock at high prices based on false estimates or opinions rather than on false financial statements. But even with respect to disgorgement related to false financial statements, the Act is too limited. First it only applies when there is a restatement and restatements only arise when two conditions are fulfilled-- the auditors must take the position that one or more prior financial statements do not comply with GAAP and that investors are continuing to rely on those statements. The overwhelming bulk of misleading financial statements are not restated even though they are misleading because the auditors say that they technically comply with GAAP or that they are no longer being relied on. In any event there is no reason that insiders should be able to retain profit based on false or misleading financial statements simply because they have not been restated.

Second this provision seems to leave enforcement in the hands, not of the shareholders, but of the very company over which the CEO and CFO have significant influence. As a result there is no assurance that any disgorgement will be enforced even where applicable. Moreover the influence of these officers could also result in the suppression of restatements in the long run. Third this disgorgement applies only to two officers leaving all of the other critical participants and beneficiaries of false financial statements unscathed. No disgorgement remedies for any other officer or any board member, auditor, analyst or investment banker are provided. Much broader disgorgement remedies are needed.

Like the Act's disgorgement remedies, those recommended here are not based on proof of fault. They are based on the fact that the public, which is not at fault, bears the burden and that management, auditing firms, analysts and investment bankers are in a better position to correct these problems. They need to be encouraged to be proactive. These persons should bear the burden by requiring them to disgorge profits made as a result of material misrepresentations without proof that they knew or were recklessness or even negligent.

Profits made by corporate officers or directors as a result of false or misleading financial statements or opinions projections or estimates issued by any of them or the company should be disgorged.

Auditing firms should be required to disgorge fees made from corporate clients during years when the audited financial statements were later revealed to be materially false or misleading.

Analysts and investment bankers should be required to disgorge fees made from underwriting activities based on financial statements later revealed to be false or misleading.

Recoveries should be traceable to any one to whom the disgorging party has transferred the proceeds for less than fair value<sup>4</sup>

Disgorgement should be made to shareholders damaged by the misrepresentations. Where the corporation is the party harmed, it should receive the disgorgement. However corporate insiders have inherent conflicts in enforcing these remedies (even against the auditors and investment bankers). As a result modification of the normal rules that boards control suits on the corporations' behalf should be considered in order to enable shareholders to initiate such suits as well.

### **Conclusion**

The Sarbanes Oxley Act fails adequately to deal with the significant financial rewards bestowed on the critical market elements who participate in financial manipulations. There is tremendous cost from allocating our resources based on misrepresented financial descriptions. The pervasive financial incentives to mislead investors must be changed well beyond the Act if we are to solve this problem. Unfortunately the Act is much sound and fury signifying far too little.

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<sup>4</sup> The only discernable effort to bolster civil enforcement in the Act is the extension of the statute of limitations- something which will have extremely limited impact. Securities frauds usually continue until they are revealed and civil suits occur within days so very few wrongful acts are found out only after the statute of limitations has expired. Increasing the statute of limitations will increase the time period covered by the suit but this will not significantly increase the recoverable damages, because of the way securities fraud damages are computed.