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A Social Defense of Sarbanes-Oxley

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I. INTRODUCTION

If one were to ask today in business and financial circles what has been, five years after its passage, the impact of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")[1] on the regulation of public corporations, one would be greeted by a litany of complaints and doomsday predictions. The legislation is now perceived as a media-driven congressional overreaction to a few salient corporate scandals (as opposed to a rational legal reform governed by hard-edged empirical analysis), which ended up imposing costs on U.S. public corporations that exceeded the benefits that the regulations attempted to create.[2] According to this view, Sarbanes-Oxley has had unintended, but predictable, consequences. To avoid its heavy regulatory burdens, foreign companies have been reluctant to list their securities in the United States, and domestic public companies have been forced into the private market.[3] According to the prevailing view, the legislation designed to protect the U.S. public capital markets ironically ended up contributing to their demise. The message from this perspective is that it is necessary to repeal or weaken the legislation before it is too late—that is, before the public capital markets atrophy and before the United States loses its dominant position as the world's center of finance.[4]

There is, however, another perspective on Sarbanes-Oxley.[5] The history of modern U.S. business can be seen as one of occasional overreaching by the managerial and financial elite in public companies and the financial markets.[6] Mem-

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.). Sarbanes-Oxley is the federal act passed by Congress to address the corporate scandals of the late-1990s and early-2000s. It primarily amended the federal securities laws. *See generally* Press Release, SEC, Summary of SEC Actions and SEC Related Provisions Pursuant to the Sarbanes-Oxley Act of 2002 (July 30, 2003). For my other writings about Sarbanes-Oxley and for citations to other scholarship on the act, see James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 Or. L. Rev. 435, 478 n.137 (2004) [hereinafter Fanto, *Whistleblowing*]. *See also* JAMES A. FANTO, DIRECTORS' AND OFFICERS' LIABILITY §§ 3-1–3-88 (2d ed. 2006) [hereinafter FANTO, DIRECTORS' AND OFFICERS' LIABILITY].

2. *See, e.g.*, HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT (2006); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521 (2005).

3. *See, e.g.*, COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT 5 (2006); SUSTAINING NEW YORK'S AND THE U.S.' GLOBAL FINANCIAL SERVICES LEADERSHIP 13–17 (2007) (commissioned by New York City Mayor Michael R. Bloomberg and Senator Charles E. Schumer); U.S. CHAMBER OF COMMERCE, COMMISSION ON THE REGULATION OF THE U.S. CAPITAL MARKETS IN THE 21ST CENTURY: REPORT AND RECOMMENDATIONS 6–7 (2007).

4. *See, e.g.*, U.S. CHAMBER OF COMMERCE, *supra* note 3, at 31–34; COMM. ON CAPITAL MKTS. REGULATION, *supra* note 3, at 8.

5. For examples of positions supportive of Sarbanes-Oxley, see John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 J. ECON. PERSP. 91 (2007); J. Robert Brown, Jr., *Criticizing the Critics: Sarbanes-Oxley and Quack Corporate Governance*, 90 MARQ. L. REV. (2006); Craig Doidge et al., *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listings over Time* (Fisher Coll. of Bus., Working Paper No. 2007-03-012, 2007), *available at* http://www.ssrn.com/abstract=982193.

6. *See generally* CHARLES R. GEISST, WALL STREET: A HISTORY FROM ITS BEGINNINGS TO THE FALL OF ENRON (2004). There are, of course, other perspectives that can coexist with this perspective, such as that

bers of this elite are checked in their misconduct by competitors and held back by social norms that, if necessary, are enforced by market regulators and prosecutors as representatives of society. The creation of new wealth available for distribution often leads to overreaching by members of the elite, a phenomenon that generally occurs in what financial scholars call a "bubble."[7] In a bubble, members of the elite violate social and legal restraints, often resulting in criminal prosecution and regulatory action in the short term and legislation or regulation that addresses the specific abuses in the long term.

This perspective makes sense of Sarbanes-Oxley. The pre-Sarbanes-Oxley period was one in which, because of the Internet, new technology companies emerged with promises of tremendous growth and huge amounts of wealth to be made.[8] Funds flowed freely to these companies, although only a few ever delivered on their promises. It was a classic bubble period. Company founders, corporate executives, venture capital investors, and investment bankers, who helped take these companies public, in addition to accountants, lawyers, and even lay people, were affected by the "gold rush" environment. The Securities and Exchange Commission ("SEC") even went so far as to issue warnings meant for the many novice day traders.[9]

The promises of great wealth overwhelmed social checks, informal codes of conduct, and even legal restraints, in the single-minded pursuit of self-interest. Investment and commercial bankers alike began to engage in such questionable practices as abandoning longstanding client relationships, switching allegiances to other companies to obtain higher fees, and acquiring future business by allocating shares of "hot" initial public offerings ("IPOs") to executives of prospective clients.[10] Some large public companies that had become successful during this period, like Enron, perverted the rules of capitalism altogether when they raised

this elite's activity is primarily beneficial for all of society. *See, e.g.*, ROBERT J. SHILLER, THE NEW FINANCIAL ORDER: RISK IN THE 21ST CENTURY (2003) (extolling the virtues and inventions of modern finance).

7. *See* CHARLES P. KINDLEBERGER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES 16 (4th ed. 2000) ("[A] bubble is an upward price movement over an extended range that then implodes."). Kindleberger explains how the bubble can be formed by excessive speculation in assets, an overestimation in their value, and excessive lending to purchase the assets. *Id.* at 16–17. These situations remind me of the scene in a documentary where Jane Goodall introduces numerous bunches of bananas to the chimpanzees that she is studying in her African wildlife refuge of Gombi. The chimps go crazy and become insanely aggressive when faced with this surfeit of bananas, and their surprisingly complex social structure, which is highly dependent upon cooperation, collapses temporarily in a winner-take-all free-for-all. *See* AMONG THE WILD CHIMPANZEES (National Geographic 1984).

8. For a brief discussion of this episode, see RAGHURAM G. RAJAN & LUIGI ZINGALES, SAVING CAPITALISM FROM THE CAPITALISTS 99–101 (2003).

9. *See* SEC, DAY TRADING: YOUR DOLLARS AT RISK, http://www.sec.gov/investor/pubs/daytips.htm (last visited Feb. 2, 2008). Day trading is an activity whereby an investor buys and sells securities rapidly, generally on a daily basis, to make quick profits from fluctuations in the prices of the securities. *Id.*

10. For a discussion of the changes in investment banking, which involved the demise of client-centered codes of conduct for the unbridled pursuit of wealth, see JONATHAN A. KNEE, THE ACCIDENTAL INVESTMENT

funds based upon a fraudulent view of their financial condition,[11] and some companies simply fabricated their financial results.[12] This excessive pursuit of self-interest was widespread.[13] When the bubble burst with the NASDAQ crash of 2000[14] and the corporate scandals of Enron, WorldCom, and Tyco, among others, were revealed, public disapproval of the pursuit of self-interest by the elite could finally be expressed.[15] Since the overreaching by the elite was widespread, gov-

BANKER 171–87 (2006); PHILIP AUGAR, THE GREED MERCHANTS: HOW THE INVESTMENT BANKS PLAYED THE FREE MARKET GAME 65-87 (2005).

11. *See, e.g.*, William W. Bratton, *Enron and the Dark Side of Shareholder Value,* 76 TUL. L. REV. 1275, 1294–99 (2002). In this article, Bratton shows that Enron moved poorly performing assets off its balance sheet to special purpose entities and received funds from outside investors for these "sales," but the company guaranteed the investors a return based on the price of Enron stock, which was high because investors did not realize that the sales were sham transactions. Although Enron was originally an "old-line" pipeline company, it had transformed itself to engage primarily in trading commodities, like oil and gas, and derivative contracts on these commodities. In a sense, Enron typified the "get rich quick" mentality of executives operating in a bubble period, where individuals become more concerned with apparent, not actual, results so long as the appearance can be translated into wealth for the individuals. *See id.*

12. This was the case with WorldCom. When other telecommunications companies were struggling, it was producing positive financial results by disguising its line costs as assets, which meant that these costs did not reduce its income. *See, e.g.*, Simon Romero & Alex Berenson, *WorldCom Says It Hid Expenses, Inflating Cash Flow $3.8 Billion,* N.Y. TIMES, June 26, 2002, at A1; Jesse Drucker & Henny Sender, *Sorry, Wrong Number: Strategy Behind Accounting Scheme,* WALL ST. J., June 27, 2002, at A9.

13. The evidence comes from the large number of restatements of financial statements by public companies in the bubble years. *See* U.S. GEN. ACCOUNTING OFFICE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES (2002) (summarizing data on the increase in financial restatements in the period 1997–2001). Indeed, the stock-option backdating scandal, the facts of which are still emerging, took place during that period and is yet another example of this misbehavior, involving, as it did, directors, chief executive officers, and other senior executives. In this scandal, insiders gave as a reported grant date for executive stock options a date that was earlier than the date of the actual grant so that the stock option would be immediately in the money when awarded—that is, the executive would have an immediate gain. This practice made a mockery of executive stock options, which were supposed to be incentive compensation and, thus, were supposed to convey value to the executives if they increased the company's value. *See* Sunil Panikkath et al., Options Backdating: A Primer, Part I (Oct. 5, 2006) (unpublished manuscript), *download available at* http://www.nera.com/\Publication.asp?p_ID=2935.

14. I refer to a significant decline in that year of the NASDAQ, which listed many of the Internet companies that were revealed to be overpriced. This decline led to an investigation of practices in the securities industry dealing with IPOs of these companies and contributed to this overpricing. *See, e.g.*, E.S. Browning, *Nasdaq Falls to Nearly 50% Below Record High—Earnings Warnings Push Index Down 4%; Blue Chips Lose 2%,* WALL ST. J., Dec. 1, 2000, at C1.

15. Along with disapproval, the public expressed dismay at the incredible wealth loss suffered by those who were holding the stock of overvalued or fraudulent companies when the music stopped. *See, e.g.*, Alan Murray, *Twelve Angry CEOs—the Ideal Enron Jury,* WALL ST. J., Feb. 15, 2006, at A2 ("Between 1998 and 2000, total compensation paid to Enron's top 200 executives, fueled by the exercise of soaring stock options, went from $193 million to $1.4 billion—a sevenfold increase in the two years preceding bankruptcy. The top three executives, who were making mere tens of millions in 1998, earned more than $100 million each in 2000. And then, after, the stock price turned south in 2001, the company awarded another $54 million in special bonuses to 'retain' key employees. Is that illegal? Well (gulp), I guess that's up to the jury in Houston to decide. Is it obscene? You bet. The more you learn about what happened at Enron, the harder it is to escape the conclusion that Messrs. Skilling and Lay and their compatriots were looting the firm by pumping up the stock price and cashing in, all at the expense of shareholders and

ernment authorities reacted vigorously.[16] There were criminal prosecutions,[17] regulatory investigations and enforcement actions,[18] changes to SEC and self-regulatory organization ("SRO") regulation,[19] and eventually, Sarbanes-Oxley, which imposed new regulations on public companies.

At its core, therefore, Sarbanes-Oxley was an expression of social outrage at misconduct by some members of the elite during the late 1990s.[20] It is commonly understood that a healthy, vibrant society cannot endure if its dominant members, who are necessary for value creation because of their managerial, technical, and financial expertise, take most of the value for themselves and pursue their self-interest unchecked.[21] Social norms exist to impose limits on this socially destructive behavior.

Sarbanes-Oxley was passed during a crisis after a significant fall in the U.S. public capital markets,[22] and its passage involved all kinds of political horse-trading.[23] The resulting legislation was imperfect—some parts were valuable and followed longstanding regulatory proposals, while others emerged in

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employees. It was their actions that prompted former Federal Reserve Chairman Alan Greenspan (one-time winner of the Enron Prize for Distinguished Public Service) to coin the phrase 'infectious greed.'").

16. For example, former New York attorney general and governor, Eliot Spitzer, derived much political "capital" from pursuing corporate and financial executives. The reputation he gained as a result helped him become elected governor. Moreover, the reaction to the corporate scandals may have grown out of revenge on the part of those who were displaced by people who became rich during the Internet boom. This is reminiscent of the social upheavals among the financial elite in the 1980s. For more on this view of finance in the 1980s, in which establishment figures took revenge on "upstarts" who financed the leveraged-buyout transactions, see DANIEL FISCHEL, PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION (1995).

17. *See, e.g.*, U.S. v. Ebbers, 458 F.3d 110 (2d Cir. 2006) (upholding criminal conviction of former WorldCom chief executive officer Bernard Ebbers).

18. For example, investment banks, the SEC, and the New York attorney general entered into a settlement regarding the banks' practices of selling IPOs during the bubble years. *See* SEC, VOLUNTARY INITIATIVE REGARDING ALLOCATIONS OF SECURITIES IN "HOT" INITIAL PUBLIC OFFERINGS TO CORPORATE EXECUTIVES AND DIRECTORS, http://www.sec.gov/news/press/globalvolinit.htm (last visited Feb. 2, 2008).

19. These are discussed at length in FANTO, DIRECTORS' AND OFFICERS' LIABILITY, *supra* note 1. Several of these changes will also be examined in more detail below.

20. Professor Faith Stevelman Kahn made a similar argument in *Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 TUL. L. REV. 1579, 1630–31 (2002).

21. *Cf.* ROBERT H. FRANK, LUXURY FEVER: WHY MONEY FAILS TO SATISFY IN AN ERA OF EXCESS 146–58 (1999) (demonstrating that what is smart for the individual may not be advantageous for society).

22. Behavioral psychologists have shown that human beings are prone to certain biases that distort rational decision making. For example, immediately after a crisis, individuals may take action with respect to a given event that has caused harm because the event has occurred recently and is vivid in everyone's mind, even though other harms that are less vivid are more deserving of attention and reform. There is an enormous literature on behavioral and psychological limitations on individuals and its implications for the law. *See generally* BEHAVIORAL LAW & ECONOMICS (Cass R. Sunstein ed., 2000).

23. For example, since a main purpose of Sarbanes-Oxley was to regulate the accounting profession with respect to its auditing of the financial statements of public companies, accounting firms lobbied to restrict such regulation. *See, e.g.*, Kara Scannell & Deborah Solomon, *Business Wins Its Battle to Ease a Costly Sarbanes-Oxley Rule*, WALL ST. J., Nov. 10, 2006, at A1.

reaction to certain scandals.[24] Sarbanes-Oxley sent a symbolic message that the excessive pursuit of self-interest was socially destructive. It did this by reaffirming the need for professionalism in the capital markets, which is itself a social value.

This article proceeds as follows. Part II discusses the strength of and possible reasons for the backlash against Sarbanes-Oxley. Part III asserts the need for a social defense of Sarbanes-Oxley, and provides a few examples of social benefits of the legislation to public companies and broker-dealers.

II. THE PRECARIOUS POSITION OF SARBANES-OXLEY: THE BACKLASH

As had been the case with past legislation that regulated capital markets, Sarbanes-Oxley encountered a backlash.[25] Given the financial and political strength of today's executives and bankers, this backlash should not be surprising.[26] There was a time when the managerial and financial elite was represented primarily by the Republican Party, while the Democratic Party would regulate and restrain this dominant group.[27] Today, however, both major political parties have close ties to the elite, particularly its members in finance, such as investment bankers, private equity partners, and hedge fund managers.[28] Today, calls for rolling back Sarbanes-Oxley, or at least enacting sunset provisions for the legislation,[29] come from both sides of the aisle, with many vocal support-

24. The regulation of accountants would be in the former category, while the prohibition on a public corporation's making loans to executives would be in the latter. *See* Sarbanes-Oxley Act of 2002 § 402, 15 U.S.C. § 78m(k) (Supp. IV 2004). This prohibition was based upon WorldCom's $0.5 billion loan to its chief executive officer, Bernard Ebbers. *See* THE SPECIAL INVESTIGATIVE COMM. OF THE BD. OF DIRECTORS OF WORLDCOM, REPORT OF INVESTIGATION 329–34 (2003). WorldCom had assumed the loans made to Ebbers by financial institutions where he pledged his WorldCom stock. The company did this to avoid the embarrassment of having the stock sold when it fell in value and when the financial institutions, worried about the declining value of the stock as collateral, demanded repayment of the loans or else they would sell the stock.

25. For a discussion of earlier backlashes, such as the original enactment of the federal securities laws, see GEISST, *supra* note 6, at 196–243.

26. It often takes a monumental scandal to generate the social outrage necessary for politicians to put aside concerns about their own campaign contributions and future employment and instead do something to restrain the unacceptable conduct.

27. *See* GEISST, *supra* note 6, at 216–22.

28. One only has to witness the rush by Democratic candidates to tap the resources of financiers for campaign contributions and the Democratic affiliation of many investment bankers and fund managers. *See* Brody Mullins & Dean Treftz, *Wall Street Antes Up for 2008*, WALL ST. J., Apr. 17, 2007, at A4. Examples of Democratic politicians with backgrounds in the financial industry include Jon Corzine, governor of the state of New Jersey, and Robert Rubin, former secretary of the treasury under President Clinton.

29. Roberta Romano, professor of law at Yale Law School, has argued for sunset provisions on this and other legislation. *See* Romano, *supra* note 2, at 1600–01. I disagree and believe that her proposal would play directly into the hands of business and financial circles. If, in three or five years, legislation restraining them were to expire, there would likely no longer exist the social outrage necessary to give Congress the backbone to renew it. Again, observe today the almost total absence of public outrage about stock-option backdating, which is particularly egregious misbehavior. It appears that social outrage cannot endure and

ers, including SEC Commissioner Paul S. Atkins, a former management lawyer and business consultant.[30] These circumstances indicate how difficult it is to regulate overreaching by executives and financiers.

The rapidity and intensity of the Sarbanes-Oxley backlash indicate a number of things. First, it shows how powerful the members of the managerial and financial elite have become and how unconcerned they are about any serious political threat to their dominance.[31] They are now pursuing going-private transactions and attempting to privatize the public securities markets[32] without any real threat of regulation being extended to this private world.[33] All the while, they maintain steady pressure on Congress and the SEC, through their defenders in business and the law, to cut back on Sarbanes-Oxley and related regulations, thereby giving themselves complete freedom to maneuver in companies and finance.

Second, the rapidity and intensity of the backlash illustrate that the social norms that triggered the reaction to the scandals, and thus Sarbanes-Oxley (and that even resonate within members of the elite), have been significantly eroded over the last three decades.[34] This erosion has been due to the growing acceptance of the self-interest ideology among executives, financiers, and even many members of U.S. society.[35] In other words, the dominant model of acceptable human behavior in public corporations and the financial industry has become the individual who pursues his or her profit maximization purely in a self-serving way.[36] Acceptance of this behavior signals the triumph of the financial model of the human being, which presents people as rational profit seekers. This model

can surface only from time to time, perhaps because it is tied to fundamental emotions that cannot be sustained. Moreover, in a perverse way, having sunset regulations might encourage extreme, overly destructive regulation of business and finance (as we see in less stable democracies). In addition, if the political party dominating Congress knows that any legislation that it passes will eventually expire, its members might be inclined to make it punitive for as long as it is operative.

30. For Atkins's biography, see SEC, SEC BIOGRAPHY: COMMISSIONER PAUL S. ATKINS, http://www.sec.gov/about/commissioner/atkins.htm (last visited Feb. 3, 2008). To get a sense of the deregulatory flavor of a typical Atkins speech, see Paul S. Atkins, Comm'n, SEC, Remarks Before the Financial Services Roundtable Lawyers Council 2007 Spring Meeting (May 10, 2007), *available at* http://www.sec.gov/news/speech/2007/spch051007psa.htm.

31. The one viable threat to them may come on the tax front, since there are proposals to change the tax laws so that private equity funds pay a higher rate of tax than they currently do. *See, e.g.*, *The Blackstone Tax*, WALL ST. J., June 20, 2007, at A16.

32. *See* COMM. ON CAPITAL MKTS. REGULATION, *supra* note 3, at 34–38.

33. The last major threat of regulation was the SEC's effort to require hedge funds to register as investment advisers, which was struck down as beyond the SEC's power. *See* Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

34. *See* Sumantra Ghoshal, *Bad Management Theories Are Destroying Good Management Practices*, 4 ACAD. MGT. LEARNING & EDUC. 75, 76–77 (2005).

35. *Id.*

36. *See* Margit Osterloh & Bruno S. Frey, *Corporate Governance for Crooks? The Case for Corporate Virtue* 5-10 (Univ. of Zurich Inst. for Empirical Res. in Econ., Working Paper No. 164, 2003).

emerged out of a fundamental opposition to totalitarian and socialist ideologies that placed the social above the individual, particularly in economic activity. In the eyes of many, these ideologies, which triumphed during the period between the two world wars, resulted in the economic destruction of the countries espousing them.[37]

Under the anti-totalitarian model, society benefits (i.e., becomes wealthier overall) when individuals unabashedly pursue their own self-interest and when common programs established by government bureaucrats are rejected in favor of market solutions. This ideology of self-interest, which in public companies takes the form of promoting shareholder value,[38] was inculcated in the business students who came of age in the 1980s and 1990s and who, of course, play major roles in industry, finance, and business law today.[39]

All kinds of social norms—derived from religions, customs, and informal codes of conduct—had held self-interested behavior among executives and financiers in check and had reinforced laws and regulations that placed outer bounds upon and punished illegal or aberrant conduct in the capital markets. Now that these norms have been weakened, however, Sarbanes-Oxley cannot derive much strength from social sources of support.[40]

Accordingly, to many executives and financiers, Sarbanes-Oxley seems to be nothing more than inappropriate government interference with the private markets, which reflects efforts by politicians and regulators to advance their *own* self-interest. That many politicians persistently demand campaign contributions or move to lobbying firms after they lose elections, and that many regulators leave government service for investment banks, private equity funds, and law firms, corroborates this cynical view of government regulation and public service.[41]

That is why Sarbanes-Oxley, perhaps more than earlier amendments to the federal securities laws, is precarious and incomplete legislation. It is precarious

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37. A classic in this perspective is F.A. HAYEK, THE ROAD TO SERFDOM (50th anniversary ed. 1994). *See also* MILTON FRIEDMAN, CAPITALISM AND FREEDOM (1962).

38. *See* MICHAEL C. JENSEN, FOUNDATIONS OF ORGANIZATIONAL STRATEGY 175–98 (1998). That is to say, the public corporation is theorized to be governed ultimately for the benefit of shareholders, who are portrayed in the theory to be concerned only about the maximization of profit in the firm. *See generally* Daniel Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 SO. CAL. L. REV. 1021 (1996) (discussing how human shareholders are reduced to profit maximizers in the theory).

39. The self-interest ideology was inculcated because economics and finance assumed the place of honor in the business school curriculum during the last half of the twentieth century. *See* Ghoshal, *supra* note 34, at 82–86.

40. Exceptions include individuals who were educated and trained outside the new self-interest model or who espouse social values.

41. French sociologist Pierre Bourdieu has closely examined how "symbolic capital" obtained from education, government service, and other sources can be "exchanged" for hard capital in the economy. *See* PIERRE BOURDIEU, LA NOBLESSE D'ETAT (1989) (discussing how symbolic capital from school background is transformed into economic power in France).

because it lacks a strong social foundation to ensure that it will endure (although at least the status quo bias and the difficulty of amending legislation protect it).[42] It is incomplete for a different reason. The assertion of the social interest against the unbridled pursuit of self-interest was needed to counter the excesses of the late-1990s. But what is also necessary, as some business school educators have asserted, is a fundamental reformation of the business school curriculum to offer criticisms of, and alternatives to, the self-interest model (and its version in finance).[43] In fact, given how widespread this model has become, the reform would have to reach beyond business education into other academic fields, including law and the social sciences.[44]

III. THE SOCIAL NEED FOR, AND EXAMPLES OF, THE DEFENSE OF SARBANES-OXLEY

Changing the business and financial culture by moving it away from the self-interest ideology will take time, and it may require a financial catastrophe to upset the status quo and lead people to question the dominant perspective. In the meantime (and with the hope that no catastrophe occurs), if, as I observed above, Sarbanes-Oxley symbolizes the social reaction to self-interest and promotes social values in a concrete way, it merits defense for both its symbolic value and its practical contributions. This part of the article provides a few examples of how

42. *See* Russell Korobkin, *Behavioral Economics, Contract Formation and Contract Law*, *in* BEHAVIORAL LAW & ECONOMICS, *supra* note 22, at 116–43 (referring to the difficulty that people have moving away from their present state of affairs).

43. *See, e.g.*, Herbert Gintis & Rakesh Khurana, *Corporate Honesty and Business Education: A Behavioral Model* 23–24 (2006), *available at* http://www.ssrn.com/abstract=929173. It is interesting that even the "founder" of agency theory, Michael Jensen, arguably feels that the economic approach has been taken too far in business organizations and has been used to justify excessive benefits for executives and financiers. *See* Michael C. Jensen, *Putting Integrity into Finance Theory and Practice* (Harvard NOM, Research Paper No. 06-06, 2006), *available at* http://ssrn.com/abstract=876312. Under agency theory, the governance of firms is theorized in terms of the motivation and monitoring of executives as self-interested profit seekers. The classic work is Michael Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Professor Jensen is one of the most well-known scholars of finance and business organizations. He is a professor emeritus of business administration at the Harvard Business School.

44. Some efforts in this regard are occurring in the legal academy, such as the creation of an interdisciplinary business law course that criticizes the self-interest model and provides alternative models to understanding and governing firms. *See* BROOKLYN LAW SCH.'S CTR. FOR THE STUDY OF LAW, LANGUAGE AND COGNITION, THE BUSINESS FIRM AS SOCIAL ENTITY: A CROSS-DISCIPLINARY COURSE, http://www.brooklaw.edu/centers/cognition/ (last visited Nov. 8, 2007). For a start, the reform would have to establish bases for professional conduct in companies and financial institutions other than the self-interest model. Just stating this so baldly brings home that this reform goes way beyond the regulation of public companies and financial institutions and raises theoretical and practical problems of dealing with the issue of changing social behavior through legislation and regulation.

Sarbanes-Oxley furthers professionalism, a social value, which can counter the excessive pursuit of self-interest in public companies and financial institutions.[45]

The first such example deals with reforms to the way that boards of directors of public companies operate. The board is at the apex of the corporate governance of public companies, yet circumstances sometimes hinder directors' abilities to fulfill their monitoring role. Even though the law requires board members to act as prudent people would in like circumstances,[46] and best practices may impose even greater responsibilities upon them, directors are busy people and, thus, are sometimes acquiescent in approving misconduct by senior executives (of course, directors are usually executives or former executives of other firms themselves).[47] The jurisprudence of the Delaware courts[48] provides relatively low standards of conduct for directors except in certain contexts, such as situations of self-dealing and acquisitions.[49] Indeed, Delaware corporate law does not require corporate fiduciaries, such as directors, to behave in accordance with market expectations or practices, which would impose higher standards of conduct upon them.[50]

45. This is not to say that we cannot criticize Sarbanes-Oxley. In previous articles written relatively soon after its passage, I pointed out that the legislation did not go far enough in countering the excessive self-interested behavior. *See* Fanto, *Whistleblowing*, *supra* note 1, at 524–37. I have also argued that Sarbanes-Oxley would have been more successful if it had been animated by the teachings of social psychology and organization theory so as to have a solid intellectual basis with which to regulate destructive social groups among the financial elite. That said, my criticism was that the legislation did not go far enough, although I felt that political circumstances would not allow Congress to supplement Sarbanes-Oxley. Although not a criticism per se, another article was designed to provide reform proposals related to Sarbanes-Oxley that might be used in the future. *See* James Fanto, *Paternalistic Regulation of Public Company Management: Lessons from Bank Regulation*, 58 FLA. L. REV. 859 (2006) [hereinafter Fanto, *Paternalistic Regulation*].

46. *See* MODEL BUS. CORP. ACT § 8.30(b) (2003).

47. For the background of directors, see SPENCER STUART, SPENCER STUART BOARD INDEX: THE CHANGING PROFILE OF DIRECTORS (2006), *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI-2006.pdf.

48. Delaware corporate law is of key importance to directors because most public companies are incorporated in Delaware, and thus, Delaware law governs directors' responsibilities.

49. This is a large assertion, but would not be surprising to corporate law scholars. To simplify matters greatly, directors' business decisions are not scrutinized by the courts, provided that the directors made an appropriate (i.e., not grossly negligent) effort to make a decision. *See* Smith v. Van Gorkom, 488 A.2d 858, 874–78 (Del. 1985) (illustrating a rare case in which directors were found to have acted in a grossly negligent manner). As all students of corporations know, courts impose heightened standards of scrutiny when a director engages in a self-interested transaction with the company. *See, e.g.*, Hollinger Int'l Inc. v. Black, 844 A.2d 1022, 1061–62 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005). Courts also do so when directors take defensive measures in the face of a hostile offer for their company. *See* Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

50. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 745 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006). In this case, which dealt with a challenge to the Walt Disney Company's ("Disney") board of directors and its board compensation committee in their approval of the hiring and release of Disney president, Michael Ovitz, the court admitted that Delaware law imposes lesser standards of conduct upon directors than what the market understands to be best practices of directors. "[T]he best practices of corporate governance include compliance with fiduciary duties. Compliance with fiduciary duties, however, is not always enough to meet or to satisfy what is expected by the best practices of corporate governance." *Id.*

By contrast, Sarbanes-Oxley sought to change directors' conduct by making them act as independent supervisors of the senior executives and the firm. Because of Sarbanes-Oxley, federal securities law now imposes higher standards of conduct on directors than does Delaware corporate law.[51] In accordance with the way federal securities laws generally operate, Sarbanes-Oxley imposed higher standards in two respects: (1) it addressed the situation through SEC and SRO regulation, and (2) it gave the SEC and federal prosecutors the tools to restrict and punish misconduct.

First, it directed the SEC to impose, or to tell the SROs, such as stock exchanges,[52] to impose, rules of conduct upon directors of public companies. In effect, the legislation transformed directors into professionals, with "profession" understood to mean a group that is devoted to standards of knowledge and conduct and that performs work that is socially beneficial (in this case, the supervision of public companies in a way that produces wealth for all participants, not just senior executives), even if the profession advances the social position of its members as well. Sarbanes-Oxley, for example, directed the audit committee of the board to become an independent, formal (with a charter and defined duties), and financially sophisticated source of power to counter the dominance of the senior executives.[53] Importantly, the audit committee, rather than the senior executives, now gives directions to the outside auditing firm, which in turn is insulated from pressure from executives who might engage in fraud.[54] The audit committee also became the recipient of anonymous complaints (i.e., whistleblowing), which are important in public corporations because employees and even senior executives must often make complaints anonymously if they expect to survive at the company.[55]

The board professionalism spurred on by Sarbanes-Oxley affected other committees of the board as well, even though the legislation did not directly address them. For instance, the audit committee was used as a model for the board nominating committee, which became the gatekeeper to, standard setter for, and evaluator of the board. As a result, members of the board nominating committee

51. Others have made this point. *See generally* Donald C. Langevoort, *On Leaving Corporate Executives 'Naked, Homeless and Without Wheels': Corporate Fraud, Equitable Remedies and the Debate over Entity versus Individual Liability*, 42 WAKE FOREST L. REV. (forthcoming 2008).

52. Public companies that are listed on stock exchanges must follow stock exchange governance rules, which must be approved by the SEC. Thus, regulation of directors under the federal securities laws could come from various sources, including legislation, SEC rules, or stock exchange rules.

53. *See* Sarbanes-Oxley Act of 2002 § 204, 15 U.S.C. § 78j-1(k) (Supp. IV 2004) (setting standards for audit committees of public companies); *see also* 17 C.F.R. § 240.10A-3 (2007) (requiring the SEC to make sure that public companies that did not meet these standards could not be listed on the stock exchanges). *See generally* FANTO, DIRECTORS' AND OFFICERS' LIABILITY, *supra* note 1, §§ 3-13–3-41 (discussing provisions of Sarbanes-Oxley related to the audit committee, as well as SEC and SRO rules).

54. *See* 15 U.S.C. § 78j-1(k).

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

have a real responsibility and are not simply to rubber-stamp the chief executive officer's ("CEO") selections of directors.[56] By its rules, the SEC indirectly supported this committee's independence from the senior executives; that is, it required a company to disclose how the board nominating committee conducts the director nomination process.[57]

The same pattern of professionalism spread to the board's compensation committee, which determined the CEO's compensation in order to obtain his or her best possible performance.[58] The compensation committee became more formal via the requirements of a committee charter, it oversaw compensation consultants, who advised on appropriate compensation packages for CEOs,[59] and its operational methods became more transparent due to enhanced SEC disclosure requirements.[60]

The second classic move in federal securities regulation is punitive: prohibiting improper practices or restricting a party's freedom of action to prevent that party from engaging in future misconduct. Sarbanes-Oxley adopted a particularly harsh approach toward senior executives to stop them from engaging in the questionable practices of the bubble years. In the auditing context, it imposed a certification requirement that forced CEOs and the chief financial officers ("CFOs") of publicly traded companies to certify the material accuracy of their financial statements and the adequacy of their internal procedures (known as "internal controls") for generating these statements.[61] It also provided for civil

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56. *See generally* NYSE EURONEXT, LISTED COMPANY MANUAL § 303A.04 (2007), *available at* http://www.nyse.com/Frameset.html?displayPage=http://www.nyse.com/lcm/1078416930891.html?archive=no. *See also* NASDAQ, MARKETPLACE RULES § 4350(c)(4) (2007), *available at* http://www.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=13.

57. *See* 17 C.F.R. § 229.407(c)(2).

58. The reforms to this committee, as to the nominating committee, were not mandated by Sarbanes-Oxley, but rather were the subject of SRO rules modeled on those of the audit committee. *See id; see also id.* § 229.402(b).

59. *See generally* NYSE EURONEXT, LISTED COMPANY MANUAL § 303A.05, *available at* http://www.nyse.com/Frameset.html?displayPage=http://www.nyse.com/lcm/1078416930891.html?archive=no; NASDAQ, MARKETPLACE RULES § 4350(c)(3), *available at* http://www.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=13.

60. SEC disclosure of executive compensation in public companies predates Sarbanes-Oxley. That is, executive compensation is Item 14 of Schedule A, which was attached to the Securities Act of 1933 to provide a model for the required disclosure when a company goes public. In fact, the SEC recently revealed its dissatisfaction with performances of the compensation committee in public companies when it replaced that committee's report on executive compensation with the annual Compensation Discussion and Analysis. *See* 17 C.F.R. § 229.402(b).

61. *See* Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (Supp. IV 2004) (requiring the SEC, by rule, to establish the appropriate certification); Sarbanes-Oxley Act of 2002 § 906, 18 U.S.C. § 1350(a) (Supp. IV 2004) (requiring CEOs and CFOs to provide written statements certifying financial reports); *see also* 17 C.F.R. § 240.13a-14. In addition, in the auditing context, executives, among others, shall be punished for retaliating against whistleblowers (who, as noted above, report to the audit committee). *See* Sarbanes-Oxley Act of 2002 § 1107, 18 U.S.C. § 1513(e) (Supp. IV 2004).

and criminal liability if the executives made misleading or false certifications.[62] Because of Sarbanes-Oxley, executives are no longer free to let their underlings conduct fraudulent activities with respect to financial statements and then assert that they had no direct knowledge of the fraud, all the while profiting from it. They are now directly responsible for the financial statements and the processes that produce them.[63]

Sarbanes-Oxley took a similar punitive approach toward executives in the compensation area, essentially to punish them if fraud occurred under their watch. It gave the SEC the power to freeze and recapture executive bonuses and profits from the sale of shares received within the twelve months following a company's financial report that later had to be restated because of misconduct in the firm.[64] The SEC was also given the power to petition a court to freeze any "extraordinary payments" to executives if, in the course of an investigation, the SEC discovered evidence of a violation of federal securities laws.[65] In addition, the legislation essentially banned public companies from making loans to their executives.[66]

Sarbanes-Oxley took a similar reformation strategy with respect to financiers. The most salient example of promoting professionalism among financiers is the regulation of research analysts in broker-dealers. Analysts contributed to the corporate scandals in the following manner: bankers would win mandates for IPOs of the hot technology companies and other investment banking business by promising favorable coverage of the IPO companies by their research analysts (and by having analysts themselves promise such to obtain the mandates).[67] This positive coverage from the analysts would help insiders and executives because

62. 18 U.S.C. § 1350(c) (providing for criminal penalties); Sarbanes-Oxley Act of 2002 § 303, 15 U.S.C. § 7242 (Supp. IV 2004) (providing for civil penalties).

63. Admittedly, there have been problems implementing these requirements. *See* COMM. ON CAPITAL MKTS. REGULATION, *supra* note 3, at 131 (recommending modifications to the regulatory implementation of Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (Supp. IV 2004). Yet the emphasis on management's responsibility for internal financial controls may be justified by the large number of financial restatements made by public companies even after the enactment of Sarbanes-Oxley. *See* U.S. GEN. ACCOUNTING OFFICE, FINANCIAL RESTATEMENTS 4 (2006) (pointing out that there were 1,390 restatements involving 1,084 public companies from the beginning of 2002 through September 2005).

64. *See* Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (Supp. IV 2004). The need for a financial restatement might be caused by fraud, misrepresentation, or an accounting error.

65. *See* Sarbanes-Oxley Act of 2002 § 1103, 15 U.S.C. § 78u-3(c)(3) (Supp. IV 2004).

66. *See supra* note 24. Sarbanes-Oxley also gave the SEC new enforcement powers, which, in some cases, allowed the SEC to seek to impose in administrative proceedings certain penalties (such as barring an officer or director from future service in public companies) that it could formerly only ask from a court. *See* Fanto, *Paternalistic Regulation*, *supra* note 45, at 890–95 (discussing these powers).

67. For a general discussion of the abuses, see JOHN C. COFFEE, GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 245–82 (2006); NYSE/NASD IPO ADVISORY COMM., REPORT AND RECOMMENDATIONS OF A COMMITTEE CONVENED BY THE NEW YORK STOCK EXCHANGE, INC. AND NASD AT THE REQUEST OF THE U.S. SECURITIES AND EXCHANGE COMMISSION 1–2 (2003).

later, right before the expiration of the lock-up agreement,[68] the analysts would release a favorable research report (a "booster shot") about the company.[69] Once the company had been in the public markets for some time (i.e., it is a "seasoned company"), the analysts would help executives and other insiders by maintaining a favorable rating on the stock, allowing the executives to sell their stock at a high price (or pledge the stock) at their convenience. Analysts amplified the bubble by touting the future of technology companies that they knew would probably fail and by not revealing the questionable activities of seasoned companies, like WorldCom and Enron, that eventually collapsed because of scandals.[70]

Through Sarbanes-Oxley, Congress added Section 15D to the Securities Exchange Act of 1934, which addressed research analyst conflicts of interest with respect to equity securities.[71] The thrust of Section 15D was to separate research analysts from investment bankers and insulate the analysts from the bankers' salesmanship pressure. It also bolstered the SEC and SRO regulation of research analysts, which was the result of the New York attorney general's and the SEC's investigations.[72] Independently of Sarbanes-Oxley, for example, the SEC promulgated Regulation AC, which, among other things, requires an analyst to certify his or her belief in the research recommendation.[73]

Under these reforms, research analysts are now walled-off from investment banking and told to be objective as to the proper valuation of companies. In a sense, analysts are asked to be professionals, rather than self-interested salespeople. As professionals, the analysts fulfill a social purpose: namely, to help investors in the securities markets arrive at the best available valuations of

68. A lock-up agreement is a contract between the underwriters and the insiders of a company that prohibits the insiders from selling their shares of stock for a specified period.

69. Typically, in an IPO, the underwriter "locks-up" the insiders' securities for one hundred eighty days following the offering. If the insiders sold their shares right after the offering, such sales would put selling pressure on the stock and send a negative signal to the market, which would lower its price. Purchasers in the IPO would be unhappy to watch the stock price fall. At the expiration of the lock-up, insiders may sell some of their shares, and they would appreciate having an analyst issue a favorable report on their company at or near this time.

70. This is all detailed in the New York attorney general's report on financial institutions' misconduct in IPOs. To take one well-known example, Jack Grubman, a former analyst for Salomon Smith Barney, attended WorldCom board meetings and altered his valuation model for the company so that he could continue to recommend it as a "buy." *See In re* WorldCom, Inc., 294 F. Supp. 2d 392, 403–05 (S.D.N.Y. 2003). This was because, among other reasons, Salomon did a large amount of investment banking work for WorldCom.

71. *See* Sarbanes-Oxley Act of 2002 § 501, 15 U.S.C. § 78o-6 (Supp. IV 2004).

72. NASD R. 2711 (2006); *see* NYSE R. 472(b) (2006); *see also* Notice of Filing of Proposed Rule Changes to Amend NYSE Rules Relating to Research Analyst Conflicts of Interest, 72 Fed. Reg. 2059 (Jan. 17, 2007) (proposing rules following the direction of Sarbanes-Oxley).

73. *See* Regulation Analyst Certification, Securities Act Release No. 9193, 68 Fed. Reg. 9482 (Feb. 27, 2003); 17 C.F.R. § 242.501(a)(1) (2007).

companies.[74] Thus, under the SRO rules, research analysts cannot market a transaction, solicit business from an issuer, participate in road shows, or accompany company executives and investment bankers in their visits to investors.[75] The analysts' compensation cannot be based on specific transactions or be determined by investment bankers.[76]

The regulation of analysts even has a punitive aspect similar to that seen in the regulation of the board. The analysts must certify as to their belief in the research opinion and can be punished civilly and criminally for providing intentionally misleading research, which would violate the antifraud provisions of the federal securities laws.[77]

However, the reform of investment banks, as exemplified by the regulation of research analysts, was incomplete. While it reinforced the professionalism of the public faces of the banks (i.e., the analysts), it mainly neglected to do the same for the less-public investment bankers, who found the deals, and the brokers, who sold them to investors.[78] A complete professional reform may have been needed for investment banks because many of the financial institutions involved in the scandals were financial holding companies created after the repeal of the Glass-Steagall Act of 1933,[79] a change that allowed commercial banks to join with investment banks in forming financial conglomerates. These financial conglomerates were punished for their involvement in corporate scandals and some of

74. This has the effect of directing investors' funds toward deserving firms and away from firms that underperform, which arguably makes for a rational allocation of resources.

75. *See* NYSE R. 472(b)(5)–(6); NASD R. 2711(c). There are all kinds of qualifications to these restrictions that are not significant for the discussion. For example, after the investment bank has received an IPO mandate an analyst may discuss pricing information with investment bankers, participate in due diligence of the company, and talk with investors separately and educate the broker-dealer's sales force, provided that the discussion is "balanced."

76. *See* NYSE R. 472(h); NASD R. 2711(d). Research analysts also have personal trading restrictions: an analyst is not allowed to purchase securities of private companies in the same line of business as that covered by the analyst; there is a blackout period for purchases or sales of company securities by the analyst around the release of a research report; and the analyst is prohibited from trading against his or her recommendation in the report. *See* NYSE R. 472(e)–(f)(4); NASD R. 2711(f)(4)–(g). These rules are subject to detailed exceptions.

77. *See, e.g.*, 15 U.S.C. § 78j(b) (2000); 17 C.F.R. § 240.10b-5.

78. The only regulation of the investment bankers and brokers has been to stop them from engaging in specific abusive IPO practices used during the late-1990s. *See* 1 NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION §§ 13-62–13-69 (4th ed. 2007).

79. *See* Glass-Steagall Act of 1933, ch. 89, § 20, 48 Stat. 188, *repealed by* Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12, 15, 16 and 18 U.S.C.). To simplify things, Glass-Steagall separated investment banks from commercial banks, although this separation was somewhat eroded over the years by banking authorities responding to the needs of banks to expand their powers and affiliations. Gramm-Leach-Bliley ended the separation and, among other things, allowed commercial banks to be in a group (a financial holding company) with an investment bank as an affiliate.

their dysfunctional internal procedures were corrected in settlement agreements.[80] Their involvement in the scandals occurred despite the fact that banking institutions had historically been subject to more extensive regulation than public companies or even investment banks. Moreover, at least in commercial banking, there has historically been a strong sense of professionalism among bankers. As the boundaries between financial institutions continue to blur, however, and the competition among them heightens, professionalism remains in need of regulatory and legislative support to reach all kinds of financial personnel, not just research analysts.[81]

IV. CONCLUSION

My message and conclusion are straightforward. Sarbanes-Oxley and its backlash repeat a historical pattern: regulation of executives and financiers followed by a strong resistance to the regulation based on predictions of dire financial consequences and damage to the economy if the legislation is not reversed or at least weakened.

In this article, I have argued that the scandals leading to Sarbanes-Oxley and the resulting rapid and powerful backlash arose because of the prevalence of the self-interest ideology in business, finance, and indeed, U.S. society, which views individuals solely as profit-maximizers.

Sarbanes-Oxley is fundamentally a reassertion of social values against the socially destructive aspects of the self-interest ideology. I have provided several examples of the law's social orientation, which require professionalism in the boards of directors of public companies and in the research analysts in investment banks. Changing the ideology of executives and financiers will likely require more than the legal reforms offered by Sarbanes-Oxley. Yet, this law's contribution to an alternative, more pro-social perspective and its practical reforms are grounds for its defense.

80. *See, e.g.*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., WRITTEN AGREEMENT BY AND BETWEEN CITIGROUP INC. & FEDERAL RESERVE BANK OF NEW YORK (2003), *available at* http://www.federalreserve.gov/boarddocs/press/enforcement/2003/20030728/attachment.pdf. For a general discussion of this subject, see James A. Fanto, *Subtle Hazards Revisited: The Corruption of a Financial Holding Company by a Corporate Client's Inner Circle*, 70 BROOK. L. REV. 7 (2004).

81. There has been a backlash to regulations of investment banks just as occurred with respect to public companies. Moreover, some of the key reforms to the NASD rules dealing with the most egregious IPO abuses by investment bankers have not yet been finalized. *See* Proposed NASD Rule 2712, Form 19b-4 Proposed Rule Change by NASD (Sept. 15, 2003). The Financial Industry Regulatory Authority ("FINRA") is the new SRO that combines the NASD and the New York Stock Exchange's member regulation, enforcement, and arbitration departments. This consolidation will give broker-dealers one SRO, rather than multiple ones, as a governing body.

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