Rollback of post-Enron corporate regulations in US

Joe Kay
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US government agencies have moved quickly following the November midterm elections to begin rolling back a number of regulatory measures put in place after a wave of corporate scandals in 2002. These steps have been taken under intense pressure from American corporations and Wall Street, which have raised their voices in opposition to the supposed "excesses" of business regulation.

Business opposition has focused on the Sarbanes-Oxley Act, passed in 2002 in response to major accounting scandals at Enron, WorldCom and other companies. Sarbanes-Oxley was itself a tepid measure, intended more to assuage the concerns of investors and restore confidence in American financial markets than to impose serious regulations to prevent corporate malfeasance. The fact that little has changed in corporate America can be seen in the ongoing revelations of financial misconduct, including the widespread practice of backdating stock options by CEOs and directors.

However, the Sarbanes-Oxley Act did put in place certain measures, including increased auditing oversight of internal financial controls at large corporations. These measures are now being scaled back.

On December 21, the Public Company Accounting Oversight Board (PCAOB), an agency established by Sarbanes-Oxley to oversee accounting firms and their audits of corporations, proposed new standards for auditors to reduce the burden on audited companies. The proposed regulatory changes could be finalized after a 70-day period of public comment.

The proposed changes announced by the PCAOB center on regulations put in place by Section 404 of the Sarbanes-Oxley Act. Many of these changes are highly technical, but they all serve essentially the same purpose.

While the changes are being billed as an attempt to force auditors to focus on "the most important matters" in reviewing company financial controls, they in fact reduce the extent to which the auditors must independently investigate corporations, while increasing their scope to rely on internal company evaluations.

Auditors would be directed to take a "top down" approach, beginning with the company's own financial statements, rather than the actual financial operations of the company. Auditors would also be instructed to cease evaluating the mechanisms by which managers certify their internal financial controls, a requirement created by the Sarbanes-Oxley Act.

The measures proposed by the PCAOB follow by one week other changes announced by its parent agency, the Securities and Exchange Commission (SEC). The SEC changes, which are directed at management rather than auditors, would have the same effect: loosening restrictions on corporate management.

Both the SEC and PCAOB proposals include elements designed to lighten the regulatory pressures on "small businesses," which are defined as public companies with market capitalizations of less than $700 million and revenues of less than $250 million. These businesses are currently not required to have internal audits, an exemption that the SEC extended for one more year.

Treasury Secretary Henry Paulson, formerly the chairman and chief executive of the Wall Street firm Goldman Sachs, outlined the direction that the government would be taking in a speech on November 20, when he argued that "the single biggest challenge with Sarbanes-Oxley is section 404, which requires management to assess the effectiveness of a company's internal controls and requires an auditor's attestation of that assessment . . . It seems clear that a significant portion of the time, energy, and expense associated with implementing section 404 might have been better focused on direct business matters that create jobs and reward shareholders."

Another measure was taken earlier this month, when the Justice Department announced that it was softening 2003 guidelines on the investigation and prosecution of corporate fraud. The government will reign in the ability of federal prosecutors to seek internal corporate documents and halt procedures designed to pressure companies to turn over internal communications while blocking them from financing the defense of corporate executives charged with fraud.

A December 13 article in the *Washington Post* reported, "Under the revisions, prosecutors who seek information about suspected wrongdoing must first win approval from the top official in their home offices before asking a business to waive its attorney-client privilege. Government lawyers who want to review contacts between a company and its attorneys under a

privilege waiver must go all the way to the Justice Department in Washington for permission from its second-highest-ranking official."

"In practice, former government lawyer Timothy J. Coleman said, the changes likely will reduce the number of waiver requests by adding another layer of red tape, taking resources away from the investigation itself and directing often unwanted attention onto a rank-and-file prosecutor," the *Post* wrote.

The effect of these changes as a whole will be to substantially reduce the ability of government prosecutors to go after companies, rather than individuals. In the past, prosecutors have occasionally responded to uncooperative behavior by corporations (such as refusing to turn over documents relevant to an investigation) by indicting the company itself. This will no longer be allowed.

The *Post* article further noted, "The motivation among industry groups is in no small part a pocketbook issue. Waiving legal privileges to avoid criminal indictment can put scores of sensitive documents into the hands of plaintiff lawyers, driving up the costs of settling related shareholder lawsuits."

These Justice Department changes have been pushed by corporate America in response to the collapse of Enron's accounting firm Arthur Anderson, which was forced out of business after being indicted by the government. The government itself acknowledged that the changes were a direct response to industry groups, including the US Chamber of Commerce and the National Association of Manufacturers.

All of these steps have been prepared over the past several months, but the announcements were held off until after the November elections in order to prevent the question of corporate corruption form becoming an election issue. Perhaps more important than the immediate regulatory changes is their cumulative effect and the general tone they set. They send a signal that the government will ease up on its oversight and back off on investigating and prosecuting corporate corruption.

Calls for changes in corporate regulations, including many of the specific proposals, have been developed by the Committee on Capital Markets Regulation. The committee is co-chaired by R. Glenn Hubbard, the dean of the Columbia School of Business and a former Bush administration official, and John Thornton, the chairman of the Brookings Institution and a former executive at Goldman Sachs. From 2001 to 2003, Hubbard was the chairman of Bush's Council of Economic Advisors, where he helped design the Bush tax cuts. The rest of the committee consists mainly of prominent executives at financial and accounting firms.

Because of its close ties to Bush's treasury secretary, the Committee on Capital Markets Regulation has been dubbed the "Paulson Committee."

In addition to the modifications to Section 404 and the changes implemented by the Justice Department, the committee is also pushing for restrictions on investor lawsuits under rule 10b-5 of the SEC. Rule 10b-5 is one of the essential mechanisms, established under the 1934 Securities and Exchange Act, which investors can employ to challenge illegal actions by corporate management, including insider trading and fraud. One proposal would stipulate that only the SEC itself could bring these lawsuits against corporate management.

Another measure that the committee is proposing is a cap on the extent to which accounting firms can be held liable for fraud at corporations which they oversee.

These are all part of a broader attempt to dismantle the entire structure of post-Enron regulatory measures. A lawsuit eagerly awaited by Wall Street challenging the constitutionality of the Sarbanes-Oxley Act began on December 21 in the US District Court for the District of Columbia.

Many of the changes have the endorsement of Democrats as well as Republicans. The incoming chairman of the House Financial Services Committee, Democrat Barney Frank, announced before the November elections that he would support efforts by regulatory agencies, including the SEC and the PCAOB, to change their rules. Democratic Senator Charles Schumer, a member of the Senate Finance Committee, is sponsoring another review of corporate regulations that will produce a report next year.

The scaling back of corporate regulation comes amidst mounting reports of large-scale manipulation of stock options. Executives and directors at many companies have had the dates of their stock option grants backdated to coincide with low points in their company's share price. This enhances the value of the options when they come due.

According to a new report by academics Lucian Bebchuk, Yaniv Grinstein and Urs Peyer, entitled "Lucky Directors," an estimated 1,400 outside directors received stock options manipulated in this way between 1996 and 2005. A companion report, published last month, estimated that 1,150 stock options grants to CEOs were deliberately backdated during the same period.