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Can Public Pension Funds Make SOX Meaningful?

By

Barbara J. Hart and Deborah A. Rogozinski
Lowey Dannenberg Cohen & Hart, P.C.

The Sarbanes-Oxley Act (“SOX” or the “Act”) of mid-2002 was enacted in the wake of the Enron scandal. The Act was designed to strengthen existing disclosure requirements and internal controls at corporations in an effort to provide corporate transparency and safeguards for the investing public. Against the backdrop of recent events, the public is skeptical about corporate ethics, and the notion of keeping money under the mattress is back in vogue. The market collapse must bespeak on some level that SOX is mere window-dressing, generating a considerable amount of work for lawyers and accountants, yet failing to achieve the dual ideals of corporate transparency and accountability. In this new landscape, public pension funds – based on the size of their corporate stock ownership and their credibility as fiduciaries – have a unique opportunity to bring about reform, including specific changes to SOX.

Ironically, pre-market meltdown, SOX detractors were actively challenging it as harmful to American financial markets.¹ David Chavern, Director of Corporate Practices for the U.S. Chamber of Commerce, stated that SOX § 404, governing audits of internal financial controls, has “been implemented in a way that risks damaging the long-term competitiveness of U.S. companies and the U.S. capital markets.”² Critics proclaimed the Act too complex, burdensome, costly, and onerous.³ *The National Survey of CEOs on Business Ethics* reported that 68 percent of executives said “the Act was an overreaction to the ethical failures of a handful of executives.”⁴ Now, in light of the market failure, those sentiments seem misplaced, but it is quite apparent that SOX has fallen short of its goals.

One of the core “reforms” arising out of SOX was in-house counsel’s obligation to “report up the ladder,” *i.e.*, the idea that in-house counsel, as an officer of the Court, operates with dual loyalties and could be relied upon to safeguard the public. In accordance with SOX § 307, the SEC adopted rules requiring attorneys who become aware of credible evidence of a material violation to report such evidence up the corporate ladder.⁵ If the attorney did not receive an appropriate response, further action, such as a report to the audit committee or the board is required.⁶

Unfortunately, this provision starts from a false premise. In-house counsel are not immune from temptation. Indeed, numerous counsel have been implicated in options backdating scandals as the architects of such schemes. For example, William F. Sorin, former general

counsel of Comverse Technology, Inc. pled guilty to options backdating charges, received a prison sentence and was ordered to pay \$51.8 million in restitution.⁷ In *In re Comverse Technology, Inc. Sec. Litig.*, 543 F. Supp. 2d 134, 142 (E.D.N.Y. 2008), the Court found that it was likely that Sorin and other executives had hidden the backdating scheme from other board members and auditors. KLA, Amtel Corporation and Monster Worldwide, among other companies, have allegations centered on counsel misconduct.⁸

The failure to report is not limited to backdating stock options. Every company that is now melting down due to sub-prime lending, failure to mark-to-market and credit default swaps had a general counsel whose “reporting up” requirements failed to prevent this crisis.

Equally ineffectual is the provision for audit partner rotation. Pursuant to the SEC rule adopted to implement SOX § 203, lead and concurring partners as well as other “audit partners” are subject to rotation and a time out requirement.⁹ While in theory a fresh and independent set of auditor eyes should benefit public investors, it is doubtful that a partner at one firm would be motivated to criticize the audit work of a partner at the same firm, where they share exposure for liability if wrongdoing is uncovered. Vocal critics of the Act were successful in thwarting an effort to impose truly rotating auditors, an innovation that may well have served investors’ interests. Specifically, pursuant to SOX § 207 the General Accounting Office studied the idea of mandatory rotation of accounting firms, and observed that due to the “additional financial costs and loss of institutional knowledge of the public company’s previous audit of record” mandatory firm rotation was not warranted.¹⁰ As a result, auditor rotation, in the true sense, was never enacted and should now be reconsidered.

These are just two examples of how SOX, which was enacted to strengthen disclosure requirements and improve internal controls, has failed. Private enforcement is supposed to augment government watchdog efforts and this policy has recently been reaffirmed by both the SEC and the United States Supreme Court. The Private Securities Litigation Reform Act of 1995 has placed sophisticated institutional investors at the helm of private enforcement, but none of SOX’s provisions provide for or enhance the private right of action.

It certainly is not an endorsement of SOX in its current incarnation that such a catastrophic market failure could occur. Amid the financial chaos, systemic change and an opportunity to make SOX meaningful is presented. It is possible that the present economic bailout, financed with taxpayers’ fund, should be coupled with a greater public voice. This public funding may be an opening for representation of the public funds on the boards of the public companies in whom they entrust their beneficiaries’ retirement monies. SOX does address board composition to some extent within SOX § 301 on audit committee independence. Perhaps now SOX can be amended to further consider board composition. The idea that in-house counsel would act as eyes and ears for the public is flawed and has demonstrably failed. A push for actual audit firm rotation may see repeat resistance. Instead, the public funds may need to push to be their own eyes and ears. One way to achieve this goal may be to insure that institutional investors have a seat at the table. For instance, by way of analogy, Taft-Hartley trust funds and the assets of the funds are managed by boards of trustees. Management and labor are equally represented on such boards. These divided constituencies which comprise the Taft-Hartley fund boards ideally act as a system of checks and balances for the benefit of the funds’

beneficiaries. Using balanced board composition as a model could be a relevant jumping off point, perhaps calling for seats on the board designated to institutional investors where public pension funds hold a certain percentage of a public corporation. Obviously, such a proposal has many complex ramifications that would need examination. Regardless of how it is achieved, SOX should be enhanced and meaningful reform can come from public pension fund leadership.

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1. William A. Niskanen (Op-Ed Contributor), *Enron's Last Victim: American Markets*, The New York Times, January 3, 2007.
 2. Transcript of U.S. Chamber of Commerce Radio Actuality (April 11, 2005), at http://www.uschamber.com/press/actualities/2005/050411_sarbanes_oxley.htm.
 3. See for example, Tamara Loomis, *Socked by SOX*, Corporate Counsel Vol. 10 Issue 07 (July, 2003); Andrew Ross Sorkin, *Citing Sarbanes-Oxley Reins, Chairman Leaves Shutterfly*, The New York Times, Jan. 9, 2007 (Dealbook) (In explaining his resignation from Shutterfly, chairman states that Sarbanes Oxley had "gone too far"); Floyd Norris, *Too Much Regulation? Corporate Bosses Sing the Sarbanes-Oxley Blues*, The New York Times, Jan. 23, 2004.
 4. Georgia State University Press Release, Survey: *CEOs view Sarbanes-Oxley as ineffective, burdensome* (June 11, 2008).
 5. 17 CFR § 205.3(b)(1) (2008).
 6. 17 CFR § 205.3(b)(3) (2008).
 7. W. David Gardner, "*Prison Sentence for Ex-Comverse Executive*," InformationWeek (May 11, 2007), at www.informationweek.com/story/showArticle.jhtml?articleID=199501078.
 8. Other recent actions where General Counsel have been involved in options backdating include: *In re Monster Worldwide, Inc. Sec. Litig.*, 549 F. Supp. 2d 578, 581 (S.D.N.Y. 2008) (in a prior proceeding, the former General Counsel pleaded guilty to conspiracy to commit securities fraud and securities fraud in regard to options backdating); *In re Amtel Corp. Derivative Litig.*, No. 06-4592 JF (HRL), 2008 WL 2561957 (N.D. Cal. June 25, 2008) (General Counsel, Michael Ross accused of involvement in backdating scheme); *S.E.C. v. Berry*, No. C-07-04431 RMW, 2008 WL 4065865 (N.D. Cal. Aug. 27, 2008) (Berry accused of options backdating at two different companies).
 9. 17 CFR § 210.2-01 (2008).
 10. United States General Accounting Office, *Public Accounting Firms Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, GAO-04-216 (November 2003).