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The Sarbanes-Oxley Act - An Answer to Corporate Governance Scandals

Abstract

The Sarbanes-Oxley Act is considered to be the result of the great corporate scandals of 2002. However, it is to be noted that the regulatory framework of corporate governance was placed under heavy criticism since 1998, when the Russian capital market crisis broke out. Finally it took another four years and another wave of global corporate scandals to conclude in to a comprehensive and more international approach of regulation. Motivated by vast corporate frauds like Enron and Worldcom, the Sarbanes-Oxley regulation was on the one hand genuinely American, while on the other hand more international as it was first expected t be. Nevertheless, both American corporations, and international investors approached the new provisions of the Act with rising suspicion. Moreover, the extraterritorial effect of the regulation often demotivated seasoned companies from their original plan to register on the New York Stock Exchange.

Key words: Auditor, CDO, CEO, corporate governance, Enron, PCAOB, Sarbanes-Oxley Act,

I. Introduction

The corporate scandals of 2002 can be considered[1] as a failure of corporate governance systems. Besides the fact that the market exhaustion of an industry – the IT sector – was the direct cause of the bankruptcies, it also turned out that the previous results were not real: they were based on false accounting, irresponsible financial strategies, fictional or veiled contracts and backstage agreements. Consequently, the lack of good corporate governance deepened the

[1] See KECSKÉS, András: *Az Enron botrány és az üzleti jog rohadt almái,* Magyar Jog (2008/June) p. 429

crisis that recoiled on the markets, which made the crisis even graver. The media showed a marked interest in this phenomenon, which put the issue of corporate governance in the focus. Information technology and modern telecommunication also contributed by widening the access of investors, so the circle of the investors of public corporations has become wider, and these investors can be considered directly affected as a result of the security crisis. In addition, the concepts that defined a greater range of stakeholders in connection with the business sphere became more and more accepted. Therefore stakeholders are not only those having a contractual connection with the processes (managers, investors, creditors and others), as many more were affected by the impacts that globally jeopardised *sustainable development*, the long-term trends of society and economy, and the environment in both a broader and a narrower sense.[2]

Basically these phenomena of crisis raised awareness to corporate governance, as more and more realised that the functioning of the business sphere has a great influence on our everyday lives. The need for corporate governance was confirmed – besides other factors – by the intense legislation of this field. Since the adoption of the Securities Exchange Act in 1934, there was no such vociferous and overall reform as the Public Company Accounting Reform and Investor Protection Act, the Sarbanes-Oxley Act of 2002.[3] The reform brought an unprecedented strictness for the companies in the capital markets of the United States. The reason behind this is the very intense interest of the public and the media in revealing the causes of the crisis and in the efforts taken to produce efficient remedies for the problems. American politics – with a perceptibly behaviourist attitude[4] – was forced to make a move. The pressure was increased by the central role of the United States in the global economy. No wonder that the following phrase became an adage: "when America sneezes, the whole world catches a cold". Thereafter the elements of the regulation applied to American capital markets have become the foundations of the planned reforms in other parts of the world as well (European Union, Japan, etc.) – a result of the competition in ensuring the safety of investors.

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[2] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 198.

[3] See KECSKÉS, András: *Befektetővédelmi reformok az Egyesült Államokban és Európában,* Magyar Jog (2009/May) p. 298–304.

[4] Political responses to corporate scandals tend to efface professionalism by soothing behaviourist emotions in the short term.

Furthermore the role of conscious consumer behaviour - which favours socially responsible companies and their products – keeps growing in the developed Western countries. Concurrently socially harmful companies applying notoriously negligent governance systems have become a target of criticism. This attitude was not only expressed towards consumer goods and commodities markets, but also towards the products of the capital market. Therefore regulated markets followed the example of governments – while governments laid down law, stock exchanges created "soft law".[5] Such soft law comprises recommendations that may not be obligatory[6], but compliance with them might be a condition of registration.[7]

The resistance of the business sphere against efforts to strengthen corporate governance was eventually broken by the consideration of socially responsible companies (or the ones that intended to be seen as socially responsible) to define themselves by the renewed institutions of *corporate governance* before investors, consumers, business partners and the society. Emphasising corporate governance facilitates that corporations engaged in redefining themselves, can distance themselves from the companies that were involved in the scandals. Therefore companies intending to maintain the illusion of social usefulness must take part in the reforms and bear the costs of good corporate governance.[8] The consequences of the regulatory reform were not at all cheap. The new instruments in the highlight of the reforms of 2002 significantly increased the operational costs of the internal control systems (such as committees) of the companies. Additionally, external control (for example auditing) became demonstratively more expensive too. The civil liability of managing directors was expanded, the members of managing bodies (management board, board of directors) have been placed under a joint and several liability. As a consequence of the regulatory reform, managers have to exercise a stronger control over *each other's* activities, because the principle of joint and several liability has come to the front and has become applicable in many fields. In this regard

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[5] See WYMMEERSCH, Eddy: *Implementations of the Corporate Governance Codes*, p. 403–419. In Corporate Governance in Context Corporations, States and Markets in Europe, and the US (ed.: HOPT, Klaus J., WYMEERSCH, Eddy, KANDA, Hideki, BAUM, Harald: Oxford University Press, 2009) p. 418.

[6] Cf. WOLFF, Lutz-Christian: *Self-Governance German Style: Comply or Explain... But If You Explain We Will Make You Comply*, The Corporate Governance Law Review (2005) Vol. 1 No. 3 p. 371–383.

[7] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers*, (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 199.

[8] See ROMANO, Roberta: *The Sarbanes-Oxley Act and the making of Quack Corporate Governance*, Yale Law Journal (2004–2005) Vol. 114. p. 1564–1565.

we must enhance joint and several liability for financial reports, which is justified by the fact that the corporate scandals which swept over the American capital market in 2002 were triggered by false financial reports.

Due to the corporate scandals, companies made efforts to attribute a central role to corporate governance. Pursuant to the latest practices of the science of corporate governance, it is a competitive advantage of bigger companies that the operation of the necessary institutions is pro rata less costly. Of these companies it is the listed corporations that need to comply with the strictest requirements of corporate governance, as it has become a basic expectation of the shareholders and thus an indispensable element of the strife for shareholder confidence.[9]

II. General remarks on corporate scandals

Recent corporate scandals shook the shareholder confidence in the United States and all over the world. It was clear to the decision makers that serious scandals, such as the ones surfacing in the case of *Enron*, cannot be left without consequences in the legislation affecting the operation of corporations. Therefore the experiences of the *Enron* scandal converged in the *Sarbanes-Oxley Act*. In order to gain a deeper insight into the issue, it is worth looking back at the end of the 20th century and at the beginning of the new millennium, when the overly optimistic attitude of investors was broken by the incorrect – on several occasions fraudulent – operation of the business sphere.[10]

The end of the 1990s was the era of hopefulness and excessive optimism in the American capital market. Although the negative effects of the Russian stock exchange crisis in 1998 had a serious impact on the world economy, positive tendencies became dominant by the end of the millennium. Markets kept growing, confidence was restored, thus a period of continuous development could be expected. Concurrently with technical development, new fields became the subject of investors' interest, as the new techniques and solutions in the business sphere became more and more accessible to consumers (on a global level as well). All that generated

[9] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 199-200.

[10] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 200.

an unprecedented amount of profit for the ones that invested in the IT sector. Consumers demanded developed information technology innovations, so they became more and more popular. In the developed Western countries the use of the internet became part of everyday life, the World Wide Web moved into every household along with the (hardware and software) equipment it necessitated. The demand thereof made several companies extremely successful in a sector, which went through an immense progress throughout those years. Therefore the players of the IT industry became the centre of investors' attention. The possibilities to grow seemed so favourable that during this period millions of laymen (people with very little knowledge of business) invested in the securities of these successful (or seemingly successful) companies. The excessive investor confidence in the IT industry blew the dot-com bubble, which, when burst, posed several questions to the economists engaged in the efficient functioning of the markets.[11]

In this period offering serious business opportunities, the activities of corporate managers were motivated by quick profit maximising. In the course of this they often neglected the proper quality of financial reports. In the middle of the general upswing, this phenomenon did not get serious attention from investors, as there were no worrisome signs on the markets.

The situation changed in the spring of 2000 and the market bubble seemed to burst. The possibilities of growth were over the summit, and more and more investors tried to get out of the companies that had performed extremely well previously. The selling of the shares resulted in an excessive supply on the market, which decreased the price of the securities. The terrorist attack against the twin towers of the World Trade Center on 11 September 2001 generated great insecurity at the stock markets, therefore the former investor confidence was not restored.

Many things that were self-evident and natural in the very recent past were buried under the twin towers. Global problems of a new type emerged at the beginning of the 21st century. The United States was preparing for a new kind of war, which within the war against terrorism, aimed at eliminating the threat that certain regimes represented and thereby increased security in the world. On the other hand, new trends appeared in the field of economy as well, projecting the birth of a new capitalism. Developing economies, such as China, India or even South-America, became more and more significant and were the new engines of the world

[11] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 200-201.

economy and growth. Concurrently the economic growth of the developed Western countries started to slow down. In the United States it was revealed about many companies with wonderful results and growth that their fantastic financial reports were founded on false data. Consequently 2002 was the year of corporate scandals; the dot-com bubble, accounting frauds and the Enron scandal were constantly in the centre of attention in the United States. Soon it became obvious that corporate governance needed reforms in order to be able to promote the responsible operation of companies.[12]

In his speech on 9 July 2002, President George W. Bush commented on the scandals, where he not only emphasised necessity of strictly enforcing conformity with existing rules, with special regards to the personal accountability of the members of the management board, but also called for reforms and governmental intervention to restore trust in the markets.

The *Enron scandal* was however, only an overture to a series that demonstrated the irresponsible corporate governance applied by several big corporations during the recent era of growth. Companies like *Global Crossing, AOL, Xerox, Adelphia Communications* and *Tyco International* became involved in scandals similar to *Enron's*. These events were followed intensely by the media[13] and caused the massive indignation of the public. When on 25 June 2002 *Worldcom* disclosed its genuine financial data, the panic reached its peak. Together with *Worldcom, Qwest* was put down on this long list as well. The fact that many audit companies – of the largest ones – were involved in the scandals demonstrated the shortcomings of the effective regulatory system. It is notable that the auditor of *Enron, Global Crossing, Worldcom* and *Qwest* was *Arthur Andersen*.[14]

By collapsing, *Worldcom* has made history with the greatest bankruptcy ever. Apparently it attained this dubious title by beating the record of *Enron*. As the scandals were evolving, it became clear that due to the pressure of the media, the wrath of the injured investors, and the

[12] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 200-201.

[13] See WESTBROOK, David A.: *Corporation Law After Enron: Possibility of a Capitalist Reimagination,* Georgetown Law Journal (2003–2004) Vol. 92 p. 65–67.

[14] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 201-202.

indignation of the public, government intervention was unavoidable with regard to the reforms of the current regulation.[15]

III. Brief History of Legislation

One should note in connection with the adoption of the Sarbanes-Oxley Act that it received large support – from both parties. On 18 June 2002 the House of Representatives passed the bill of Representative Michael Oxley by a vote of 334 to 90, whereas on 18 June 2002 the Banking Committee of the Senate passed it by a vote of 17 to 4. On 15 June 2002 (not even three weeks after the outbreak of the Worldcom scandal) the Senate unanimously passed the bill by a vote of 79 to 0. Then the House of Representatives and the Senate formed a Conference Committee in order to reconcile the differences between the two bills, and on 24 June 2002 the final version of the bill was adopted, which was named the Sarbanes-Oxley Act of 2002. The following day the bill was approved with an overwhelming majority – by a vote of 423 to 3 in the House of Representatives and by a vote of 99 to 0 in the Senate -, and on 30 July 2002 President George W. Bush signed it into law. We find it necessary to introduce the proposers of the act and the related legislative process.[16]

IV. Paul Sarbanes and Michael Oxley

The full name of the Act which was adopted as a reaction to the corporate scandals in the United States is the *Public Company Accounting Reform and Investor Protection Act of 2002*. The preamble of the Act indicates that the correct form of its name shortened for the purpose of reference is *Sarbanes-Oxley Act of 2002,* which not only showcases the names of its sponsors but also captures the memories of the different legislative phases as well. The Act has become known as the *Sarbanes-Oxley Act* worldwide (and for certain reasons perhaps it has become notorious as well) among professionals in business and auditing circles, moreover

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[15] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 202.

[16] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 202.

the even shorter version of "*SOX*" is often used as well. For the above reason we should recall the political career and works of Paul Sarbanes, a democratic senator and of Michael Oxley, a republican representative.

Senator *Paul Sarbanes* was born into an Greek immigrant family from Laconia in 1933 in the town of *Salisbury*, on the Eastern shore of *Maryland*. He graduated from *Princeton University*, but he also won a scholarship to the *University of Oxford* in England, where he achieved outstanding results in his studies. He was elected as senator in 1976 for the first time, but he was continuously re-elected up until his retirement in 2006. Thereby he was and still is the longest serving senator of Maryland. He was a member of several house committees, including the Watergate Committee in 1974 (he was already a representative then) and the Budget Committee. In 2002 he was the Senate sponsor of the Sarbanes-Oxley Act, which soon put his name in the limelight.[17]

Representative *Michael Garver Oxley* was born in 1944 in *Findlay, Ohio*. He received a law degree from *Ohio State University* in 1969. In the early stage of his career he worked for the *Federal Bureau of Investigation (FBI)*, he was elected a representative in 1981. In 2004 he defeated the Democrat Ben Konop in a sharp-edged election campaign, and soon thereafter he announced his retirement as of the expiry of his mandate in 2007. In 2002 he was the Congress sponsor of the *Sarbanes-Oxley Act*, which brought him fame all over the world.

The above facts reveal that both the Democratic and the Republican Parties supported the act during the legislative process. The consensus achieved, however, was not only due to the well-founded professional conviction, but also to the fact that in the midst of the increasing attention and pressure from the public, both parties wished to reap the benefits of determinedly acting against corporate frauds. Therefore party interests, propaganda purposes and aims of political marketing might have had a role in the cooperation. Even the name of the act brings up one of the most vehement criticisms: professional objectives were overshadowed by goals of popularity. Wide-ranging cooperation does not necessarily guarantee professional quality.[18]

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[17] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 202-203.

[18] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 203.

V. Provisions of the Sarbanes-Oxley Act

1) Introductory provisions

The *Sarbanes-Oxley* Act comprises three short introductory sections prior to the first substantive chapter. The first section – as we have mentioned before – stipulates the short title of the act and lists the titles.

The second introductory section includes definitions on the one hand[19], and on the other hand it stipulates that Section 3 of the *Securities Exchange Act of 1934* shall be amended by the contents of the *Sarbanes-Oxley Act*.

The third – and last – introductory section sets forth the sanctions of violating the Act. Pursuant to the above, the *Sarbanes-Oxley Act* is in fact the amendment of the *Securities Exchange Act of 1934*, so its system of sanctions is arranged accordingly. It is stated that a violation by any person of the *Sarbanes-Oxley Act* (or any rule or regulation of the Securities and Exchange Commission or any rule of the Public Company Accounting Oversight Board) shall be treated in the same manner as a violation of the *Securities Exchange Act of 1934*, and any such person shall be subject to the same penalties.[20]

2) Public Company Accounting Oversight Board (PCAOB)

The *Sarbanes-Oxley Act* established the *Public Company Accounting Oversight Board* (hereinafter: the *PCAOB*) in order to supervise independent audit firms, aiming at the efficient institutional oversight of auditors. This measure was justified by the fact that audit firms had a contradictory role in the corporate scandals.

Title I of SOX prescribes the establishment of the *PCAOB*, its composition, its duties and competences and its financing. The Board is a non-profit corporation set up by the Sarbanes-Oxley Act – therefore under federal law – that supervises the auditors of public corporations.

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[19] Including the term of PCAOB, issuer, board, etc.

[20] Sarbanes-Oxley Act, Sections 1–3. Also see KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 204-205.

The main purpose of its activities is to ensure that investors receive informative, realistic and independent auditor's reports.

In order to do that, *the PCAOB* firstly registers companies that are engaged in the auditing of public corporations. As a part of its legislative activities, it sets the standards for audited reports with regards to auditing, quality control, ethics and independence. It furthermore oversees the companies it has registered and applies the necessary sanctions in the case of any abuse.[21]

The name of the Board gives the opportunity for a special pun. The American business slang often calls the Board '*Peekaboo',* similar to but not exactly the same as the abbreviation *PCAOB*. Peekaboo is a game, usually played with babies by hiding and suddenly revealing one's face in front of a child and saying: 'Peekaboo! I can see you!'. This nickname obviously refers to the wide ranging authorities[22] and supervisory functions of the see-it-all Board.

The Act sets forth strict rules regarding conflicts of interest obliging the members of the Board, so that they duly perform their supervisory obligations. These rules guarantee their independence from both the government and the business sphere.

Consequently the PCAOB operates as a non-profit, non-governmental organisation. No members of the US government can be appointed as members of the Board.

As regards the composition of the Board, it comprises five financial experts, whose mandates last for five years. Two of the members shall be certified public accountants, whereas the other three members may not be accountants either currently or previously. The chairperson of the Board may be a certified public accountant, however only if he or she has not been a practicing accountant of a public corporation for at least five years prior to his or

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[21] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 205.

[22] Cf. ACEVEDO, Arthur: How Sarbanes-Oxley Should be Used to Expose the Secrets of Discretion, Judgement and Materiality of the Auditor's Report in De Paul Business and Commercial Law Journal (2005–2006) Vol. 4 p. 8

her appointment.[23] This last provision should be viewed as an instrument of ensuring independence and preventing possible conflicts of interest.[24]

The members shall serve on a full-time basis. It is also a guarantee of their independence that they cannot receive any kind of payment from the companies falling under the scope of SOX. Obviously some fixed and continuous payments, such as pension, are exempted, as due to their nature, these payments are not suitable for exercising any kind of financial influence.

The members are appointed by the *Securities and Exchange Commission (SEC)*, after consulting with the Chairman of the Board of Governors of the Federal Reserve System and with the Secretary of the Treasury. They may be re-elected only once. The *SEC* may only remove the members prior to the expiry of their mandates with a proper justification.[25]

The Act prescribes the registration by the *PCAOB* for all companies that carry out accounting services for public corporations. Therefore, pursuant to SOX, an audit company without a PCAOB registration pursues its activities unlawfully. The relevant audit companies must comply with wide-ranging disclosure obligations, including the disclosure of the names of companies for which they prepared an annual report, and of those for which they will presumably prepare one.[26] They also have to report the amount of fees they receive from their clients, indicating the sums they get for audit, accounting and non-audit services. They also have to reply to the PCAOB's questions regarding financial information and reports.

Furthermore they have to present a statement on the quality control of their services. They also have to list all their accountant employees who carry out audit services, and they have to report all criminal, civil and administrative procedures against the company or any of its employees in connection with audit reports.[27]

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[23] See ACEVEDO, Arthur: How Sarbanes-Oxley Should be Used to Expose the Secrets of Discretion, Judgement and Materiality of the Auditor's Report in De Paul Business and Commercial Law Journal (2005–2006) Vol. 4 p. 8

[24] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 205-206.

[25] Sarbanes-Oxley Act, Section 101

[26] See ACEVEDO, Arthur: *How Sarbanes-Oxley Should be Used to Expose the Secrets of Discretion, Judgement and Materiality of the Auditor's Report* in De Paul Business and Commercial Law Journal (2005–2006) Vol. 4 p. 8

[27] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 206.

The audit companies registered by the PCAOB must submit their annual reports to the Board. If the Board requests so, the companies have to comply with further disclosure obligations. The increased administrative burdens and compliance with these disclosure obligations obviously increase the operational costs of the audit companies. Moreover, the PCAOB is entitled to collect registration and membership fees from the registered companies.[28]

The PCAOB has the important legislative task of defining accounting standards. Consequently, it must cooperate with the designated groups of accountants and consultants that are convened in connection with the standards of different fields set forth by the Act. The proposals of such groups do not bind the PCAOB, it can accept them, but it is also entitled to complete, amend, abate or refuse them. The Board must annually report to the SEC on the adoption of standards applicable in audit activities.[29]

Pursuant to the Act, companies registered by the PCAOB shall for a period of seven years keep all the documents and pieces of information related to their audit activities, which can support the conclusions drawn in the reports. Registered companies are obliged to introduce the standards of quality control, and to have their reports reviewed and confirmed by an external partner.

One of the accounting standards – prescribed by Section 404 which we will elaborate on later – aims at the inspection of the internal control system.[30] Pursuant to this standard, the auditor must assess if one can get a clear image of the financial situation of the issuer based on the internal control structure and the data the issuer had processed thereof (transactions, grouping of financial instruments).[31] It is also the obligation of the auditors to make sure that the financial transactions of the issuer are properly documented, as thorough documentation is

[28] Sarbanes-Oxley Act, Section 102

[29] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 206-207.

[30] See ACEVEDO, Arthur: How Sarbanes-Oxley Should be Used to Expose the Secrets of Discretion, Judgement and Materiality of the Auditor's Report in De Paul Business and Commercial Law Journal (2005-2006) Vol. 4 p. 8

[31] See SOLTENBERG, Clyde, LACEY, Kathleen A., CRUTCHFIELD GEORGE, Barbara, CUTHBERT, Michael: A Comparative Analysis of Post-Sarbanes-Oxley Corporate Governance Developments in the US and European Union: The Impact of Tensions Created by Extraterritorial Application of Section 404, American Journal of Comparative Law (2005) Vol. 53 p. 465

necessary for the preparation of the reports in conformity with GAAP and the indication of weak points within the internal control system of the respective company.[32] These provisions were included in the legislation clearly in order to prevent the fraudulent conducts that had been experienced in the corporate scandals.[33]

The legislative role of the PCAOB with regard to accounting standards in the new legislation broke away from the general practice that had prevailed since 1940, according to which the accounting profession itself set the standards of its functioning.[34] This can be regarded as a major step from self-regulation towards obligatory legislation, as at this point the obligatory rules ensuring the safety of investors are defined by an independent body comprising of financial experts.

The Act stipulates inspection obligations as well, the PCAOB was granted wide authority with regard to inspections.

Pursuant to the rules on the inspection of registered companies, the Board shall annually carry out the inspection of the accounting firms that regularly provide audit reports for more than 100 issuers, and at least once in every three years of all other accounting firms.[35]

The PCAOB has a wide competence during the inspection procedures. It can launch investigations if it finds that the registered accounting firms or employees thereof might violate the Sarbanes-Oxley Act, the PCAOB, or other provisions of securities law. As a guarantee of efficient procedures, the registered firms and their employees are bound by a strict obligation to cooperate (provide data, testify). If the investigation establishes a violation, the PCAOB may impose sanctions on the registered firms or their employees (suspension, exclusion, money penalty).[36] The Board may also impose a sanction on firms that have not supervised

[32] Sarbanes-Oxley Act, Section 103

[33] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 206-207.

[34] See ACEVEDO, Arthur: How Sarbanes-Oxley Should be Used to Expose the Secrets of Discretion, Judgement and Materiality of the Auditor's Report in De Paul Business and Commercial Law Journal (2005–2006) Vol. 4 p. 10

[35] Sarbanes-Oxley Act, Section 104. Also see KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 207.

[36] As a general rule, the SOX sets the limit of money penalties at USD 100,000 for natural persons and at USD 2,000,000 for legal entities.

their employees with due care with regard to their audit activities or compliance with quality control provisions. Consequently it is the principle of the regulation that audit firms are responsible for the wrongful conduct of their employees, which will motivate such firms to strengthen their internal control systems.

The documents and data kept by the PCAOB are not public; they are treated as confidential and privileged information during the course of administrative and court procedures. However the Act grants access to these data for the SEC, the Attorney General of the United States and other state organs.[37]

The SOX sets forth that registration is mandatory for foreign audit firms as well if they provide audit services to companies falling under the scope of SOX or to their foreign subsidiaries. The extraterritorial effect of the Act is demonstrated in this aspect as well. Therefore foreign audit firms are bound by SOX and the regulations of the PCAOB and the SEC to the same extent as the audit firms that are established and operate under federal law or the laws of any state.[38]

For the sake of public interest, the interests of investors and legality, the SEC has supervisory and oversight authorities over the PCAOB. As a part of its authority, it is entitled to expand the duties of the Board by instructions or regulations, or to order to document certain data.[39]

The PCAOB notifies the SEC and cooperates with it in the case of all investigations related to the violation of securities law. It also informs the SEC of all resolutions adopted in procedures in connection with any companies within its competence or any employee thereof. Pursuant to the oversight authorities of SEC, it may review the resolutions of the PCAOB and modify the scale of the applied sanctions.[40] The supervisory authority of the SEC offers a professional control over the activities of the PCAOB.

It enhances the flexibility of accounting laws that the SEC may approve as generally accepted accounting principle (i.e. as GAAP) any such principles that are set forth by an

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[37] Sarbanes-Oxley Act, Section 105

[38] Sarbanes-Oxley Act, Section 106

[39] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers*, (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 207-208.

[40] Sarbanes-Oxley Act, Section 107

organisation that complies with SOX – that is being founded for the purpose of setting standards.

According to the criteria set forth by SOX, such organisations must be independent legal entities, and must be managed by a board of trustees the majority of whom have not been associated persons of any registered public accounting firm during the two-year period preceding their service in the organisation. The financing of the organisation must be similar to that of the PCAOB. The decisions of the organisation have to be made by a majority vote that enables the organisation to make decisions speedily. Furthermore, the organisation needs to have discretion when adopting the standards with regard to their updating and international convergence.[41]

Pursuant to SOX, the funding of the operation of the PCAOB mostly comes from audit firms. The income of the PCAOB comprises the registration and annual fees of the audit firms, and it is also entitled to collect from issuers an annual accounting support fee up to a reasonable degree.[42] This financing system supports the arguments of those who see the increase of costs in the business sphere as the most detrimental effect of SOX.

It is a popular opinion with regard to the establishment of the PCAOB that it means the end of the era of self-regulation for the audit profession.[43]

3) Independence of auditors

Title II of SOX sets forth the regulation regarding auditor independence, which has been the subject of increased attention since the corporate scandals. As a result of corporate interlocks, many audit firms were affected by the scandals. *Arthur Andersen* practically went bankrupt due to the loss of credibility it had suffered as a consequence of its role in the *Enron* scandal. Therefore it was especially important to restore investor trust in this field by way of efficient legislation.

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[41] Sarbanes-Oxley Act, Section 108

[42] Sarbanes-Oxley Act, Section 109

[43] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 208-209. Also see ACEVEDO, Arthur: *How Sarbanes-Oxley Should be Used to Expose the Secrets of Discretion, Judgement and Materiality of the Auditor's Report* in De Paul Business and Commercial Law Journal (2005–2006) Vol. 4 p. 7

At this point we must highlight the SOX provision, according to which it is forbidden for an audit firm to provide any non-audit services to issuers if it is in fact the auditor of that particular issuer. (Such non-audit services are bookkeeping or other services related to the accounting records, the design and implementation of financial information systems, appraisal or valuation services, internal audit outsourcing services, management functions or human resources, broker or dealer, investment adviser or investment banking services, any other legal or expert services that are unrelated to the audit, and any other service that the Board determines, by regulation, impermissible.) However the PCAOB may exempt any person, auditor or issuer from this prohibition, but only subject to review by the SEC.[44]

In order to prevent corporate interlocks, the SOX also prohibits that an audit firm performs audit services to an issuer for a period of more than five years. Therefore issuers falling under the scope of SOX are obliged to rotate their audit partners every five years.

In the brokerage scandal in Hungary in which 3 smaller brokerage firms and a savings a loan group declared bankruptcy within 2 months of early 2015 it turned out, that out of 4 bankrupt companies three had the same auditors[45]. This occasion has made the Hungarian authorities to follow suit and apply the above-mentioned provision of changing the audit partners every five years[46] - as part of a new regulation with which the aim was to foster the financial intermediary system. As regards the extensive relations formed in the business sphere, there are many criticisms considering the efficiency of this provision. Another argument against the rotation of audit partners is that auditors lose their up-to-date knowledge about their clients and later on they will have to familiarise with the issuers again. Besides the rotation of audit firms, it would be interesting to inspect the rotation of the auditors as well.

Pursuant to SOX, the auditor has to inform the audit committees of all applied policies and practices, of the discussions and communication with the issuer's management. The independent members of the audit committee can thereby acquire a clear picture of the

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[44] Sarbanes-Oxley Act, Section 201. Also see KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 209.

[45] See Buda-Cash/Quaestor – Egy könyvvizsgáló a közös kapocs a brókerbotrányban *GazdasagPortal.hu*, 13th March 2015. Available at:http://gazdasagportal.hu/index.php/buda-cashquaestor-egy-konyvvizsgalo-a-kozos-kapocs-a-brokerbotranyban/ [Accessed 1st September 2015.]

[46] See Act LXXXV of 2015 on Amending Legislation Regarding Financial Intermediaries to PromoteTheir Development Section 35. paragraph 2.

company's situation and of the applied accounting practices. Due to their liability for the activities of the auditor, the latter is necessary in order to assess the adequacy thereof.[47]

Besides the above, pursuant to the rules on conflict of interest, the registered firms may not audit any company if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in the equivalent position for the issuer, was employed by the respective audit firm during the one-year period preceding the date of the audit.[48]

4) Liability issues

By amending the provisions of the Securities Exchange Act of 1934, the SOX clarifies the duties of audit committees and defines the criteria of membership with regards to professional attributes and independence. Pursuantly, all members of the audit committee of the issuer must be a member of the board of directors. Otherwise however, they must remain independent, which means that besides their functions as directors, they cannot receive any other compensatory fee from the issuer, and they cannot maintain any kind of business relationship with the issuer or any subsidiary thereof (however the SEC can make exemptions in justified cases).

The audit committee is directly responsible for the appointment, remuneration and the supervision of the work of the auditor employed by the issuer. This provision is a serious motivation for the independent members to oversee the lawfulness and the adequateness of the audit. Audit committees also investigate the conflicts between the management and the auditor, and give their comments on the audit report.[49]

The chief executive officer and the chief financial officer shall certify in a statement attached to each annual or quarterly report that the data within are correct and that they fairly present the operation and the financial conditions of the company. In the statement it is confirmed that the

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[47] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 209-210.

[48] Sarbanes-Oxley Act, Section 206

[49] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 210. Also see Sarbanes-Oxley Act, Section 301

signing officer has reviewed the report and concluded that the report does not contain any faults or omit any necessary information and its contents are not misleading with regard to the conditions of the company. This provision was clearly necessary due to the lack of accounting discipline and the occasional fraudulent conducts experienced in the corporate scandals; it was inspired by the creative accounting techniques applied by Enron and Worldcom, and the falsified reports and the manipulations of the management. Pursuant to SOX, the chief executive officer and the chief financial officer are responsible for the establishment and operation of the internal control system as well.[50]

For the above reasons, the SOX emphasises that it is forbidden for any officer or director to fraudulently influence, manipulate or mislead the auditors for the purpose of rendering the financial statements materially misleading. The executive officer and the financial officer bear significant financial responsibility for the accuracy of the reports, as they have to reimburse the issuer for any bonus or other incentive-based or equity-based compensation and for any profits realised from the sale of securities of the issuer, if the reports need to be disclosed anew within 12 months of the original issuing due to a significant mistake or because of a material non-compliance. The SEC is authorised to suspend from their positions any such person employed by a company falling under the scope of the Act if it finds that person unfit for such position.[51]

The SEC sets forth the professional and ethical rules applicable to the lawyers of issuers. Pursuantly the legal counsels are obliged to report evidence of a violation of securities law or capital markets law by the company or an employee thereof. If no measures are taken despite the report, the legal counsel shall present the matter to the audit committee. Legal counsels – as gatekeepers – also had a contradictory role in the series of scandals in 2002.

5) Financial transparency

In connection with the corporate scandals, it has turned out that the respective companies often applied “creative accounting” techniques. Such techniques were tucking away losses or blowing up profits by utilising subsidiaries, concealing “*off the balance sheet*” items and

[50] Sarbanes-Oxley Act, Section 302

[51] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 210-211.

circumventing *non consolidation* rules. Therefore it was a primary purpose of the SOX to ensure adequate publicity for financial data and to strengthen the credibility of financial reports.

To this end, the Act prescribes that financial reports comprise all adjustments made by the auditor during the audit.[52] In order to ensure the transparency of the financial situation of companies and the realistic evaluation thereof, all annual and quarterly reports shall include all off-balance sheet transactions and relations with unconsolidated entities that materially affect the financial conditions of the issuer.[53]

According to the provisions of the SOX, a company is not allowed to grant personal loans to their executives. There are limited exceptions; however, the Act allows such loans in the case of companies engaged in credit activities if the loan is made in the regular course of operation, under the terms applicable for everyone, with market conditions. Executives and shareholders holding at least a 10% ownership shall inform SEC of the transactions of the securities of the company.[54]

Section 404 of SOX includes particularly strict liability rules. Firstly it prescribes that the annual report must comprise an internal control report, which shall state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting. The report shall also include the assessment of the effectiveness of the internal control structure and procedures.

The SEC may review the information disclosed in accordance with SOX. This must take place every three years with regard to each issuer; however, the SEC may perform the review more often.[55]

6) Other important provisions

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[52] Sarbanes-Oxley Act, Section 401

[53] For instance Enron hid a large amount of its losses through its subsidiaries, but on the other hand indicated a remarkable profit deriving from the transactions with the same subsidiaries. Enron also entered into several false transactions and hedges.

[54] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 211. Also see Sarbanes-Oxley Act, Section 402

[55] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 211.

In order to promote the successful retracing of corporate frauds, the SOX ensures the protection of employees that provide information about the issuer related to the fraud in a court procedure. Such employees are the *whistleblowers*. These people cannot be discharged, threatened or in any other manner discriminated against by the employer. If that happens nonetheless, - and if there is substantial evidence thereof – the employee must be reinstated by the employer with the same seniority status and for the same remuneration. In order to remedy any damages and losses, the employer has to pay the amount of back pay with interest and compensation for any costs (such as attorney fees).[56]

The SOX intends to ensure that the credibility and trustworthiness of securities analyses are not influenced by personal interests and considerations. Title five comprises provisions with regard to SEC, the national securities exchange of the United States and to the employees of registered securities associations that publish securities analyses. These entities are obliged to set forth rules of conflict of interest in order to provide an objective and realistic view for the investors.[57] The Act increases the severity of sanctions that are applicable if the executives violate the law. Title eight regulates these matters by prescribing that whoever alters, destroys, falsifies, mutilates or conceals any record, document or tangible object with the intent to impede or influence an investigation by the authorities, shall be fined or imprisoned not more than 20 years.[58] Auditors violating the SOX may face severe sanctions as well. If an auditor knowingly violates his or her obligation to maintain all audit and review workpapers for a period of at least five years, shall be fined or imprisoned for up to 10 years.[59]

In general, one can observe that the Act enhanced the sanctions for white-collar crimes. The upper limit of imprisonment for tax fraud was increased from 5 to 20 years, whereas the violation of rules on the statement of the chief executive officer and the chief financial officer certifying the correctness of the financial report may result in a fine of one million dollars and/or 10 years imprisonment. If the crime was committed wilfully, the penalty is even more

[56] Sarbanes-Oxley Act, Section 806

[57] Sarbanes-Oxley Act, Section 501

[58] Andrew J. Fastow, the chief financial officer of Enron was sentenced to 6 years imprisonment for participating in the frauds.

[59] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 212. Also see Sarbanes-Oxley Act, Section 802

severe: a fine of five million dollars and/or 20 years imprisonment.[60] These provisions can qualify as a significant deterrent later on for executives who believe that "creative accounting" and fraudulent conducts are permissible tools for the short-term maximisation of profits.[61]

VII. Criticism

The SOX has been a target of criticism since its enactment. Many regard – due to the above mentioned circumstances – that legislation was too hasty and unprofessional, claiming that the provisions of the Act were significantly influenced by the media frenzy generated by the corporate scandals, and also by the pressure of the public and by political considerations.[62] According to this approach, the Act reflects political needs rather than the observation of professional arguments.

It was also objected with regard to the contents of the Act that at many points it only repeats (or emphasises) provisions that are already included in other laws. Therefore SOX means no real reforms, and according to critical professional viewpoints, it only reorganises the previous rules on investor protection, corporate governance and accounting. The supporters of the Act however, consider SOX as significant as the securities and capital markets reforms in the 1930s in the United States.

The scope of the Act does not only cover American corporations, but all other public corporations that are registered on the American capital markets (*extraterritorial effect*). European companies therefore often criticise the Act for regulating their operation with regard to problems that are of a specifically American nature. The SOX is relevant even in Hungary, as Magyar Telekom, a member of the Deutsche Telekom group has been listed on the New York Stock Exchange since 1997.[63]

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[60] Sarbanes-Oxley Act, Section 903

[61] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 212-213

[62] See ROMANO, Roberta: *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance,* Yale Law Journal (2004–2005) Vol. 114 p. 1521–1611

[63] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 213.

Presenting corporate scandals and the problems leading to them as strictly American phenomena contradicts our observations. Corporate frauds have been present everywhere and probably they cannot be entirely eliminated. The European scandal of *Parmalat* is often mentioned in the world of business law – with a bit of irony – as the *Enron* scandal of Europe.[64] The reason behind this argument is that the European companies wishing to be listed on the American capital markets view the strict requirements of SOX as a significant obstacle. Furthermore, it may be perceived as an additional difficulty to harmonise the relevant community and domestic law with the provisions of SOX.

Doubtless the American and European solutions are often not in conformity with each other. The SOX is often criticised for making companies that are present on both the American and the European capital markets comply with both sets of requirements.

As an example, we can observe that SOX – in order to ensure the presence of independent members – prohibits the representation of employees in the supervisory board, the board of directors or in other committees. The reason for this is the lack of independence on the side of the employees. In many member states of the European Union there are long-established traditions for employee representation, and this is reflected in the mandatory provisions of domestic laws as well. [65] For instance in Hungary, Section 3:119 of the Civil Code sets forth that if the annual average of the number of full-time employees of the company exceeds 200, the employees are entitled to participate in the supervision of the company – provided that the workers' council has not agreed otherwise with the management. In this case one third of the supervisory board members are the representatives of the employees. If one third is a fraction, the number of the supervisory board members shall be determined in favour of the employees.[66]

Besides Europe, Asia also has had similar scandals out of which two should be mentioned. Both of them happened in Japan, which were rooted in country specific reasons such as

[64] See SOLTENBERG, Clyde, LACEY, Kathleen A., CRUTCHFIELD GEORGE, Barbara, CUTHBERT, Michael: A Comparative Analysis of Post-Sarbanes-Oxley Corporate Governance Developments in the US and European Union: The Impact of Tensions Created by Extraterritorial Application of Section 404, American Journal of Comparative Law (2005) Vol. 53 p. 459

[65] See MOSSOS, Elias: *Sarbanes-Oxley Goes to Europe: A Comparative Analysis of United States and European Union Corporate Reforms After Enron,* Currents International Trade Law Journal (2004) Vol. 13 p. 10

[66] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 213-214.

group-thinking and subordinate attitude of employees which should have been counterbalanced by outside scrutiny of auditors, legal advisers and the strict oversight activities of the authorities for all public companies.

One of such cases was the Olympus scandal[67]. From the early 1990's the company had tried to conceal investment losses by creating a special purpose entity (SPE) to buy battered securities at market value. It was also part of the cover-up scheme that between 2006 and 2008 Olympus had bought three tiny start-up firms with no relation to the core activities of the company for $773 millions. The stake was further raised in 2008[68] when Olympus had paid $687 million advisory fee for stating the much inflated price of preference shares of Gyrus as appropriate. It only took a few months for the new CEO in October 2011 to reveal the frauds of two decades, but Michael Woodford was ousted soon. The stock price started to fall more than 70 % in one month, until in November 2011 a new president, Mr Takayama was appointed, who managed to clean up the previous frauds, as he was not involved. The purge was not simple as the fraudulent practices were intertwined with the company, much like a tumour growth; it took the two outside top managers a while getting the company to face its erroneous past.

The second case was the Toshiba scandal. In June 2015 the company had to postpone publishing its results by three months[69] because as they found that their results were overstated by $1200 million covering the 2010 to 2015 period. On the 31st August 2015[70] the asked for another week delay for announcing results because of 10 newly revealed accounting errors. In this case the top managers had a similar past during their ascent on the corporate

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[67] See LUBIN, Gus 2011. This Olympus Fraud Is Bigger And More Shocking Than You Realize *Business Insider*, 8th of November. Available at: http://www.businessinsider.com/tsuyoshi-kikukawa-olympus-2011-11#ixzz3kUh5POMJ [1st September 2015].

[68]See 2011, Financial adviser falsified estimates for Gyrus buyout *The Japan Times*, 17th of November. Available at http://www.japantimes.co.jp/news/2011/11/17/business/financial-adviser-falsified-estimates-for-gyrus-buyout/#.VeW4DX0ggkt
[1st September 2015].

[69] See NISHIMURA-POUPEE, Karyn 2011. *Toshiba scandal exposes Japan Inc.'s governance flaws* Business Insider, 26th July. Available at: http://www.businessinsider.com/afp-toshiba-scandal-exposes-japan-inc.s-governance-flaws-2015-7#ixzz3kVA0c8GY (1st October 2015).

[70] See ANDO, Ritsuko 2015. Toshiba scandal continues as more accounting errors found 31 August. Available at: http://www.reuters.com/article/2015/08/31/us-toshiba-results-idUSKCN0R00SX20150831 [1st September 2015]

ladder. Both of them knew about the dishonest practices, but they were reluctant to act against it. In this case the top managers shared a similar past during their ascent on the corporate ladder. Because of that, in spite of their knowledge about dishonest practices, they were reluctant to act against them. This case showed a new problem, which can only be rectified at a regulatory authority level, since audit groups did exist only one of three external members had financial background. This is the result of the common practice in Japan that close allies are nominated most of the time, such as former diplomats of the top management, instead of accounting or financial experts which poses a great challenge to uncover errors and frauds and to oppose high ranking officials.

The Act is also criticised from another angle with regard to Section 404. The obligations relating to the internal control regulation cause immense costs annually, while they also result in a profit increase for audit firms. Thus an extra cost is charged on the companies that bring down their efficiency. On the other hand, these costs practically mean considerable profit for those audit firms that were involved in the corporate scandals.

Members of the business world also complained about the five-year rotation of audit firms, as they consider the rule unrealistic. Critics claim that it results in an unnecessary stalling in the course of audit, moreover at the top of the business sphere there are commitments of several directions between the issuers and the auditors, which makes the switching of auditors an uncomfortable formality.

Compliance with the Act and the related costs disproportionately encumber the smaller listed corporations the most. These companies and the Chamber of Commerce representing them criticise the Act for making them pay for the sins committed by large companies at the turn of the millennium. The big companies and their organisation, the Business Roundtable, seem more willing to comply with the Act, demonstrating how they distance themselves from the companies that were involved in the corporate scandals.

It should be noted that SOX takes the activities of fraudulent corporations as a starting point, and therefore it smites those companies as well that keep to the rules and operate fairly in the business world. Thus SOX was criticised for generalising on the basis of the concrete events of corporate fraud, sometimes to an unreasonable extent.[71]

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[71] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 213-214.

VIII. Recent events and the Sarbanes-Oxley Act – Can history repeat itself?

The outbreak of the financial crisis in 2007 became the centre of attention and caused a severe recession in the world, its effects are still perceptible these days. The current state of the world economy is full of uncertainties, so we cannot exclude the possibility of another setback on the grounds of the crisis in 2007. As we can see however, this is not the first recession of a greater volume on the stock exchanges of the world since the turn of the millennium. With the bursting of the American *dot-com bubble* in 2002 it became obvious that the securities of the IT industry – which up to that point seemed unstoppable –were overrated on the markets. The bursting of the *tech bubble* resulted in a stock market crisis of a global extent, largely due to the fact that the biggest financial institutions and asset managers invested large amounts of money in the securities of the industry. Enron and Worldcom, two of the biggest asset managers in the United States also invested a lot of money in these companies, and by falsifying their financial reports; they could hide their losses from their investors for a long time. The deals carried out with subsidiaries and the non-transparent transactions were governed by the intention to demonstrate the greatest possible profit, as it was the only way to establish the grounds for the incredible performance of the company shares, which was indispensable for the executives in order to win the trust of the investors and have them vote for their enormous bonuses and other benefits. In order to make that happen, the executives aimed at disclosing reports that exceeded the results of the previous quarters and surpassed the expectations of analysts. Therefore the purpose of the performance-based remuneration system, which intended to increase the willingness of the risk-avoiding management to undertake risks, was overly successful.[72]

Following the loud burst of the American *dot-com bubble* in 2002, the upswing of the global capital markets reached its peak in the summer of 2007, but was quickly broken by the negative news from the American subprime mortgage market. This launched the process that lead to the subprime crisis all over the world, causing a panic on the stock markets, and resulted in a global financial crisis by the autumn of 2008. Thereafter, the problems of financial systems and the liquidity emergencies of financial institutions had a negative impact on the real economy.

[72] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 214-215.

Later on the banks that had undertaken excessive risks and piled up "toxic assets" had to be rescued by the state in order to prevent even more severe problems. This further increased the budgetary overload of developed economies that had already struggled with a high national debt.

The liberal credit practices prevailing on the real estate markets of the United States were in the background of the causes of the crisis. The optimism of the market was based on the false presumption that intensely growing real estate prices would carry on growing just at the same rate in the future. This consideration motivated financial institutions to make secondary mortgages against properties that had already been encumbered by a previous mortgage, under the presumption that the future growth in the value of the property would provide a sufficient cover. Here we must note the failure of risk analyses and credit ratings, as among the recipients of such loans there were many with low incomes who otherwise would not have been qualified as creditworthy.[73]

Individual borrowers spent a significant amount of the received money on consumer goods and investments on the stock market. We must agree with the popular opinion that American people spent more than they had, and financed the difference partially from mortgage loans.

The financial institutions granting the loans securitised their claims and offered them as financial instruments on the capital market in order to further increase their liquidity. These securities were generally issued through their subsidiaries, often special purpose entities (*SPE*-s), which might remind us of the American corporate scandals of 2002 (*Enron, Worldcom*), as the subjects of fraudulent transactions were special purpose entities then as well. Transactions through special purpose entities contributed to the forming of the dot-com and subprime bubbles, as the profits deriving thereof were indicated in the financial reports, on the other hand, a great portion of the loss was not. At the same time effective accounting rules were often neglected (or interpreted with excessive flexibility). In this regard, the provisions of the *Sarbanes-Oxley Act* could not prevent history from repeating itself. [74]

[73] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 215.

[74] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 215-216.

The securities issued through special purpose entities were evaluated by the largest credit rating agencies (for example S&P, Moody's, Fitch) with regard to the risks they represented. The rating may not have been very thorough, as they were ready to grant the best qualification to those securities that were based on mortgage claims, which practically could not be enforced once the real estate market crashed. Their evaluations were based on the risk analyses of the issuers which later on proved to be incorrect. The auditors can also be considered liable. The repeated shortcomings of the audit systems are the greatest failure of the practical application of the Sarbanes-Oxley Act, as it succeeded neither in setting up an adequate supervisory system, nor in forecasting problems. Current events allow us to conclude that auditors are still willing to focus on the interests of the issuers they audit if they receive a smashing amount of commission.

Mortgage-based securities were traded on a busy and speculative market, with the participation of several – often unsuspecting – small investors. The summer of 2007 brought changes to the trade of financial instruments on the secondary mortgage market. More and more clients were unable to pay back the loans and ended up bankrupt, therefore the banks had to enforce the mortgages. Selling the acquired real estates, however, reduced the prices due to the sudden expansion of supply.[75]

In order to avoid panic, financial institutions started providing guarantees for securities based on subprime portfolios and offered through the above-mentioned special purpose entities. This decision, however, had a very severe accounting law-related consequence, namely the losses of the special purpose entities had to be consolidated in the financial reports, in other words, the off-balance sheet items were replaced into the balance sheet. This was in fact the repetition of the schemes of the corporate scandals in 2002, which means that the Sarbanes-Oxley Act failed to remedy the problems. (Besides, the financial supervisory system did not work perfectly either.)

The immense spread of derivative transactions meant that the crisis deepened and significantly increased compared to its initial scale. By applying great leverages and carrying out obscure transactions, risks – and eventually, losses – were globally spread.

During the course of the financial-economic crisis, the issue of liability was often raised. Politics was criticised for adopting mild legislation due to corporate lobbying and benefits.

[75] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 216.

This viewpoint however can be questioned as the regulatory reform of 2002 was widely criticised at the time of the enactment for being overly strict. Even strict contents cannot ensure the long-term and stable operation of the corporate sphere. Consequently we can say that the problem does not reside in the contents of the laws, but in their application and enforcement.

This is similar to the repeal of Glass-Steagall Act of 1933 (also known the Banking Act) by the Gramm-Leach Bliley Act in 1999 which enabled the commercial banks to affiliate with securities firms and vice versa. Even though the firewall built by the Glass-Steagall Act had already been weakened by federal authorities in the 1980's by allowing investment banks to acquire commercial banks and vice versa, the whole process was accelerated by Gramm-Leach Bliley Act. This resulted in holding companies with investment, commercial, and mortgage arms which together with the newly created mortgage securities (CDOs)[76] had a key role in creating a mortgage bubble in the US housing market resulting in a full-fledged financial crisis all over the world. In creating the housing market bubble the credit rating agencies have had a major role too. Instead of as being external advising partner –by giving advice to clients how to structure complex financial instruments – they had actually rated the very same products. As a result the rating agencies had an incentive to rate mortgages better than they were in reality and by packaging them in a complicated way so that the clients (even institutional investor from overseas markets like Europe and Asia) who bought these CDOs, could not see the real risk profile of the product.

Therefore we cannot regard unsatisfactory legislation as the *sole* reason of the financial crisis. In order to discover the factors which played a role therein, we should elaborate on the shortcomings of the financial supervisory system in the United States, which were part of the problem regarding the actual application of the laws, and thereby contributed to the financial crisis. As an example we can mention a significant scene of the financial crisis, which was given enormous publicity, the investment scandal related to *Bernard Madoff*. This case can

[76] CDO is a collateralized debt obligation. It involves a special purpose entity (SPE) which buys assets of corporate bonds and loans, commercial real estate bonds and mortgage-backed securities. The SPE separates the payments streams (cash flow) from these assets into a number of buckets called tranches. These tranches rated according to the probability of payment of the debtor, the highest rated called superior the ones that paid the first and have the lowest risk. The lowest rated tranche is the equity tranche; its cash flow is not paid off the underlying asset defaults. A CDO is a bond that pays out the cash flow of a given tranche. The CDO which is backed by non-prime assets called subprime CDO.

increase our concerns regarding the efficient functioning of the financial supervisory system. The significance of the scandal was increased by the fact that many institutional investors suffered losses therein, which obviously resulted in a loss of prestige as well. *Madoff* in fact did not invest the financial assets that he had been entrusted to, but used these assets to pay off his previous clients. By this activity he created the largest Ponzi scheme ever in world history, to the amount of 50 billion dollars. The ability of the supervisory organs to retrace inadequate business conducts in due time does not depend on the legislation on investor protection. It would have been a convenient method to cross-reference the stock of securities against the invested assets in order to reveal how efficient *Madoff's* investments were.

It is not the exclusive shortcomings of legislation (for example of the Sarbanes-Oxley Act) that in this case (and in others) such measures were not taken.[77]

[77] See KECSKÉS András – HALÁSZ Vendel: *Stock Corporations – A Guide to Initial Public Offerings, Corporate Governance and Hostile Takeovers,* (Translated by: Anna Tolnai and the Authors) HVG-ORAC - LexisNexis, Budapest-Wien, 2013. p. 217.