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THE INCIDENCE OF FRAUD POST SARBANES OXLEY ACT: A REALITY CHECK

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ABSTRACT

The Sarbanes–Oxley Act (SOX) became law in 2002 after the discovery of significant fraudulent activity on the part of officers of several corporations (Enron, WorldCom, Adelphia, etc.). The goal of the law was to stem the tide of continuing fraudulent behavior, tighten governance and make it more costly for individuals if they were involved in frauds. Unfortunately, it doesn't look like the goals of SOX were achieved, and the spate of significant frauds have continued with frauds involving major banks and corporations (HealthSouth, Lehman Brothers, AIG, Madoff Securities, etc.). These continuing significant frauds led to the passage of additional regulations, in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 (Dodd-Frank Act). This paper discusses SOX, subsequent frauds and the Dodd-Frank Act. In conclusion, it points to the inability of laws and regulations, by themselves, to prevent fraudulent behavior. It suggests that we need to focus on the dangers of unbridled greed and on preventing the invention of fancy derivative investment instruments that few people understand but many trade since no one wants to be left behind in the often believed unlimited profit potential of the markets.

KEYWORDS

Corporate Governance, Fraud, Sarbanes-Oxley Act.

INTRODUCTION

The Sarbanes–Oxley Act (SOX) became law in 2002 after the discovery of significant fraudulent activity on the part of officers of several corporations (Enron, WorldCom, Adelphia, etc.) (Public Law 107-202, 2002). The goal of the law was to stem the tide of continuing fraudulent behavior, tighten governance and make it more costly for individuals if they were involved in frauds. Its goal was to create an environment that would reduce the incentive for individuals to engage in fraud, with greater oversight, more accountability and meaningful penalties for illegal behavior.

Unfortunately, while SOX included a long list of regulations and requirements, it did not stem the tide of 'significant' frauds. Unbridled greed and creative financial instruments, with a belief that the only way the economy could go was up, led to another wave of significant financial debacles, leading to the worst economic downturn in the U.S. since the great depression. This, in turn, led to further regulations being passed, through the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Public Law 111-203, 2010).

This paper flows as follows. The next section is a review of literature which discusses the Sarbanes-Oxley Act, including a brief discussion of its eleven titles. Following that, there will be a discussion of a few significant frauds that occurred in post SOX years. The section after that discusses the Dodd-Frank Act and its sixteen titles. The final section of the paper is the conclusion section, which discusses the dangers of unbridled greed and the consequences of inventing fancy derivative instruments that most people don't understand but trade just so they don't get left behind with the hope of making a quick profit.

REVIEW OF LITERATURE

SARBANES-OXLEY ACT

The Sarbanes-Oxley Act of 2002 (SOX), known as the Public Company Accounting Reform and Investor Protection Act in the Senate, and the Corporate and Auditing Accountability and Responsibility Act in the House, was signed into law on July 30, 2002. The law was in reaction to significant fraudulent activity that was reveled in major corporations including, Adelphia, Enron, Tyco International and WorldCom, in the late 1990s and early 2000s. These frauds, along with others, revealed a corporate environment that was riddled with systemic problems, some of which are detailed below.

ISSUES

External Audit Firm Issues: The external auditing profession had prided itself in self-governance. Leaders within the profession convinced regulators that its self-regulation was effective, that members were ethical and independent in their decision-making and that there was no conflict of interest when the same firm offered consulting as well as audit services. Lawmakers, based on the evidence, felt that self-regulation had not worked and the same firm offering audit as well as consulting services was a problem that needed to be fixed.

Board of Director Issues: Companies where fraud was discovered had Boards lacked independence, expertise or both. Competence and independence are of primary importance since the Board is responsible for governance at the highest level, one example being that the audit committee of the board has to understand the complexities of the audit function and be competent to communicate with both the audit firm and upper management.

Executive Compensation Issues: Stock and bonus options for upper management were initially celebrated as ideas that would minimize agency costs and put manager incentives and behavior in line with those of owners (Jensen and Meckling 1976). However, given significant stock price movement, for insignificant earnings shortfalls, and since stock options were not considered to be expenses, managers were extremely aggressive when it came to 'cooking the books' to meet their target numbers.

Security Analyst Issues: In addition to audit firms' conflicts arising from them offering audit and consulting services, security analysts were in an awkward position since their banks' investment banking division's business depended on their recommendations of the client company's stock. They faced pressure to recommend the stock, even if they had concerns, because it had an impact on whether or not the investment banking division got business or not.

SOX TITLES (Public Law 107-202, July 2002)

SOX has eleven titles that cover a wide range of issues that were identified as weaknesses in the frauds before its passage.

Title I (Public Company Accounting Oversight Board) discusses the creation of the Public Company Accounting Oversight Board (PCAOB). The title discusses the process of audit firm registration with the Board; auditing, quality and standards and rules related to independence; inspection of and investigation and disciplinary proceedings against accounting firms; foreign public accounting firms; SEC oversight over the Board and accounting standards.

Title II (Auditor Independence) addresses auditor independence. It addresses, among other things, reporting requirements, partner rotation, new auditor approval requirements and establishes standards for external auditor independence. It also addresses the restriction that external audit companies cannot provide non-audit services to their clients.

Title III (Corporate Responsibility) addresses corporate responsibility. It covers issues related to public company audit committees, to what would be construed as improper influence when completing audits; the forfeiture of certain bonuses and profits; officer and director bars and penalties; professional responsibilities for attorneys and fair funds for investors. One significant requirement in this title is that it mandates that the CEO and CFO need to sign the financial statements to ensure accountability and responsibility.

Title IV (Enhanced Financial Disclosures) addresses internal controls, among other issues. It addresses disclosure of periodic reports; conflict of interest provisions; disclosures which relate to management and principal stockholder transactions; the need to audit management assertions of internal controls; senior financial officer code of ethics; review of real time and periodic disclosures by issuers. The title discusses issues such as off balance sheet financing and the timely disclosure of material changes in financial position.

Title V (Analyst Conflicts of Interest) discusses analyst conflict of interest.

Title VI (Commission Resources and Authority) discusses the appearance and practice before the SEC; conduct of securities analysts; penny stock bar imposed by federal courts; and associated person qualifications of brokers and dealers.

Title VII (Studies and Reports) discusses a Government Accountability Office report on the consolidation of public accounting firms; SEC reports on credit rating agencies; and a variety of studies and reports on enforcement actions and on investment banks.

Title VIII (Corporate and Criminal Fraud Accountability) addresses penalties for alteration of documents; the statute of limitations for securities fraud; federal sentencing guidelines for extensive criminal fraud and for obstruction of justice; whistle-blower protection; and criminal penalties for defrauding shareholders of public traded companies.

Title IX (While-Collar Crime Penalty Enhancements) discusses penalties for committing fraud including those for conspiracies to commit criminal fraud offences, mail and wire frauds, violations of Employee Retirement Income Security Act of 1974; and corporate responsibilities for financial reports.

Title X (Corporate Tax Returns) discusses the requirement that that chief executive officers needs to sign the company tax return. Finally,

Title XI (Corporate Fraud and Accountability) discusses implications of tampering with a record or impeding an official proceeding; changes to the federal sentencing guidelines; SEC authority to prohibit people from serving as officers or directors; increased criminal penalties under the SEC act and retaliation against informants.

As is evident from the discussion of the SOX titles above, the sweeping legislation addressed issues that had emerged as being significant as they related to the major frauds at the end of the twentieth and beginning of the twenty-first centuries. However, unfortunately, the detailed legislation did not deter from individuals in organizations from committing fraud. The next section includes a discussion of an organization and an individual that were caught committing fraud. The result, of these and other frauds, led to the most significant recession since the Great Depression.

SIGNIFICANT FRAUDS, POST SOX

Despite the passage of SOX, significant, expensive frauds continued to take place in the United States investment sector. Two frauds are discussed next. The first one was committed by individuals in an organization (Lehman Brothers) while the second one was allegedly committed by one individual (Madoff Investment Securities). The purpose of the discussion is to show that legislation and regulation, by themselves, have never been enough to prevent self-interested behaviors on the part of individuals. It also shows how expensive fraudulent behavior can be, both for individuals and their future, as well as for the United States and world economies.

LEHMAN BROTHERS

Lehman Brothers was a global financial service powerhouse before its bankruptcy in 2008. When it filed for bankruptcy, on September 15, 2008, it had about $700 billion in assets, making it the largest corporate bankruptcy in the United States (Knapp 2013). It was ranked number four in investment banks and had an impressive array of products that it sold to its varied clients. Lehman had significant exposure to the sub-prime mortgage investment securities which led to it using creative off-balance sheet devices (Repo 105 and Repo 108). They used the sections to create a financial position that looked a lot better than it really happened to be. They 'fixed' ratios that analysts and investors were most interested in and continued until its exposure was so significant that it could not sustain itself.

Lehman Brothers started doing business as a small retail store in the mid-1800s, but by early twentieth-century the firm became an investment bank. It ended up underwriting several major corporations, including Macy and Company and Sears, Roebuck and Company (Knapp 2013). By the end of the twentieth-century Lehman Brothers found itself being a major organization and player in the financial derivatives market. The company had experience with different types of derivatives and profited from them. This gave them the confidence to trade in residential mortgage-backed securities (RBMS); making them the largest producer of this instrument by 2004 (Knapp 2013). The United States economy was growing rapidly and the housing market was booming (1995 to 2005), causing the RMBS market to being robust and profitable. However, once housing prices began to fall, in late 2007, the value of RBMS securities plunged precipitously. The result was that, at the end of 2007, Lehman Brothers owned almost four times in this asset, as it had in stockholders' equity (Knapp 2013).

Lehman had strong earning for a handful of years, leading up to 2007. Officers of the company enjoyed big bonuses and the company received positive press for its strong results. Financial officers in the company recognized the particular ratios that analysts were focused on and they decided to 'manage' them in order to keep the sham of strong financial results (Knapp 2013). They turned their attention to repurchase or 'repo' transactions to do this. These were complicated transactions and their accounting treatment wasn't very clear. Lehman faced difficulty in getting law firms in the United States to agree on the treatment that would be to their benefit; so they reached out to the United Kingdom where they found a law firm that agreed to see the transactions their way (Knapp 2013).

The bankruptcy showed that, while SOX was law with a lot of titles, it was possible for an organization to be creative and to commit fraud that would have an impact on the economy of the United States and of the world. It showed that various parties involved in corporate governance were in a bubble and acted in a self-interested manner. It also showed that complex rules, which are open to interpretation, have the potential to lead to expensive lessons.

MADOFF INVESTMENT SECURITIES

Bernie Madoff was a respected investment expert on Wall Street. He used his leadership position to setup and run a Ponzi scheme which ended up costing trusting investors tens of billions of dollars. He promised and delivered unrealistic and untenable results which no one else could replicate, even in theory. Madoff was helped in his fraud by an ineffective accounting firm that supposedly audited his books and certified his statements. It also helped that Madoff had contacts in the Securities and Exchange Commission, since this helped him keep the regulators and investigators away from the company and its transactions (Knapp 2013).

Bernie Madoff had one goal, and that was to be rich (Maccabee 2009). Madoff started with a nest egg of about $5,000 and by the time his fraud was exposed, he had accumulated about one billion dollars (Knapp 2013). Madoff started small but was disturbed by the control and power that large firms had on Wall Street. He wanted to democratize the trading process and he spent significant resources to use technology to help with trading. He was also recognized as one of the founders of the NASDAQ stock exchange, serving three one-year terms as its chairman (Knapp 2013).

In the early 60s Madoff added investment advisory services to his portfolio and this led to him courting investors so he could manage their investments. He managed to provide consistent returns of 10 to 15% each year which led to his assets under management to around $65 billion by 2008. There were a number of concerns raised about Madoff's returns but, given Bernie's connection and respect, nothing was done to question his returns and tactics (Knapp 2013). In the end it was revealed that Madoff investments was a Ponzi scheme and it lead to several investors and pension funds losing their entire savings.

These two examples show that frauds remain a very real part of the United States economy and that they have the potential to significantly impact the financial stability and structure of the entire financial system (across the world). As a result of the financial crisis, the United States Congress swung into action and worked on and passed the Dodd-Frank Act (discussed next).

REACTION TO FRAUDS AND THE GREAT RECESSION

DODD-FRANK ACT

The Dodd-Frank Act of 2010, known as the Dodd-Frank Wall Street Reform and Consumer Protection Act, was passed in the Senate on May 20, 2010 and was passed by the House of Representatives on June 30, 2010. It was signed into law on July 21, 2010 by President Obama. The Act represents financial reform with its goal being to regulate financial markets and to reduce the likelihood of another economic crisis. The Act addressed a number of issues, some of which are detailed below.

ISSUES (Amadeo 1.)

Lack of Oversight of Credit Cards, Loans and Mortgages: The Consumer Financial Protection Bureau was created under the U.S. Treasury Department. Its goals include overseeing credit reporting agencies, credit and debit cards and a number of types of loans (except auto loans); it requires borrower's to understand risky mortgage loans, and banks to verify mortgage borrower's job status, income and credit history. The lack of such regulation led to sub-prime mortgages being issued.

Lack of Oversight of Wall Street: The Financial Stability Oversight Council was created which is chaired by the Treasury Secretary and has nine members. Its goals include overseeing hedge funds and other non-bank financial firms and to recommend that the Federal Reserve regulate organization if they get too big. Such oversight did not exist and it ended up creating organizations there were deemed 'too big to fail.'

Banks Gambled with Depositors' Money: A conflict of interest played a role in causing the Great Recession. Banks used their funds on deposit to own hedge funds for their own profit. The Volker Rule (Amadeo 2.) prevents banks from owning or investing in hedge, private or other proprietary funds for their own profit. The Act gave banks up to seven years to divest the funds, while still allowing them to keep the funds if they are less than 3% of revenue.

Unregulated Risky Derivatives: The financial debacle happened because a number of investors did not understand the risk they were taking that was attached to investments in risky derivatives (e.g. credit default swaps). The Act recommends that the Securities Exchange Commission or the Commodity Futures Trading Commission regulate these instruments so policy makers are aware if significant risk is being taken by investor and in advance of a crisis.

Lack of Transparency of Hedge Fund Trades: In part, the financial crisis was a result of the lack of regulation of hedge funds. No one knew where and how much hedge fund managers were investing in risky credit default swaps. This prevented analysts, regulators and policy makers from determining the risk and exposure that the market faced. The Act requires hedge funds to register with the Securities and Exchange Commission and to information on trades and portfolios. The goal, in this part too, is to help policy makers have a better idea of market risk and to have the ability to better assess which sectors of the economy might be affected.

Lack of Oversight of Rating Agencies: Ratings were called into question with the financial crisis. The reason was that risky derivative instruments and mortgage backed securities were given strong and positive ratings when, in fact, they were worthless because the underlying asset lost value. The Act created an Office of Credit Ratings at the Securities and Exchange Commission to help regulate ratings agencies. Such agencies are required to present their methodologies and the Office can actually deregister an agency if it provides faulty or wrong ratings.

Lack of Effective Supervision of Insurance Companies: The term, "too big to fail" was coined and used during the financial crisis. One company for which it was used was AIG (American International group). They had significant exposure to the risky derivative instruments which led to the U.S. Government stepping in and bailing them out through a takeover (Karnitschnig, et al., 2008). The Act created a new office, called the Federal Insurance Office as a part of the Treasury Department. Its goal is to help identify significant insurance companies that end up creating risk to the system, given their practices or exposure. Another goal of the office is to ensure that minorities and underserved communities have access to affordable insurance.

Federal Reserve Transparency: While the Government Accountability Office did audit Federal emergency loans during the financial crisis, it continues to have the power to audit the Federal Reserve's emergency loans in the future too, if necessary. In the future, the Treasury Department will need to get Federal Reserve approval before being able to make a loan to any one single significant organization. Additionally, loans made through the Troubled Asset Recovery Program will have to be transparent, in terms of which banks receive those funds.

DODD-FRANK TITLES (Public Law 111-203)

The Act has sixteen titles. The purpose of the Act is to help minimize the occurrence of another financial crisis. It aims to provide future financial stability to the markets and economy; to provide for orderly liquidation; to provide for orderly transfer of powers to various bodies, including currency comptroller, the corporation and the board of governors; to regulate hedge fund advisers; to reform insurance; to improve bank and savings organizations' regulations as well as transparency and accountability of Wall Street; to supervise payments, clearing and settlement; to better protect investors and security regulation; to create the Bureau of Consumer Financial Protection; to review the emergency lending process; to improve consumer access to mainstream financial institutions; and to reform the mortgage industry and to minimize predatory lending. Additional details, as they relate to the various titles, are discussed next.

Title I discusses financial stability. It discusses the creation of the Financial Stability Oversight Council with authority to supervise and regulate some nonbank financial companies and to have supervisory authority over disputes among member agencies. The title also created the Office of Financial Research which discusses the creation and operations of the Financial Stability Oversight Council, a body that is tasked with identifying risks that might impact the financial stability of the U.S. and to respond to those threats and to promote discipline in the financial markets. Finally, the title also provides increased authority to the Board of Governors as it relates to some nonbank financial companies and bank holding companies.

Title II discusses orderly liquidation of financial companies and brokers and dealers who are covered by the Act. It discusses the powers and duties of the Corporation as well as prevention of conflict of interest and bans on some senior executive and director activities. Finally, it commissions a number of studies on topics including nonbank financial and financial institution bankruptcy processes and international coordination of bankruptcy process for nonbank financial institutions.

Title III discusses the transfer of powers to the comptroller of the currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve.

Title IV discusses the regulation of advisers to hedge funds and others. It creates the requirement to collect risk information, on a systematic basis. However, it exempts venture capital fund advisers and of private equity fund advisers.

Title V tackles insurance. It discusses the Federal Insurance Office and focuses on state based insurance reform as well as on the regulation of non-admitted insurance. Finally, it discusses the regulation of credit for reinsurance and reinsurance agents.

Title VI discusses improvements to regulation of banks, savings association holding companies and other depository institutions. This comprehensive title tackles a number of issues including requirements to ensure financial holding companies are well capitalized and managed; limiting the lending of insiders and purchasing of assets from insiders; regulating capital levels; among others.

Title VII tackles transparency and accountability of Wall Street. It discusses the limits on the Federal Government bailing out swap entities; the regulation of swap markets; and the regulation of security-based swap markets.

Title VIII discusses payment, clearing and settlement supervision including a detailed discussion of financial market utilities.

Title IX discusses investor protection and improvements to the regulation of securities. Its goals are to increase the protection of investors; to increase the enforcement and remedies as they relate to regulation; to improve asset-backed securitization process; to address executive compensation and accountability; to improve the management of the Securities and Management Commission; to strengthen corporate governance; and to regulate municipal securities.

Title X discusses the creation of the Bureau of Consumer Financial Protection, including the Consumer Advisory Board. It discusses the supervisory authority over non-depository covered persons and of very large banks, savings associations and credit unions along with overall regulatory improvements.

Title XI addresses Federal Reserve systems provisions. It discusses emergency lending authority amendments, public access to information, emergency financial stabilization and other Federal Reserve Act amendments.

Title XII discusses improving access to mainstream financial institutions by expanding access, providing low-cost alternatives to payday loans and grants to help establish loan-loss reserve funds.

Title XIII is the pay it back act which includes an amendment to reduce TARP authorization, and also amends the Housing and Economic Recovery Act of 2008.

Title XIV discusses the Mortgage Reform and Anti-Predatory Lending Act. This important title addresses standards as they relate to residential mortgage loan origination; high-cost mortgages; the office of Housing Counseling; mortgage servicing; appraisal activities; mortgage provisions, among others.

Title XV discusses miscellaneous provisions including the restrictions on using United States funds for foreign governments, protecting American taxpayers, and other sections that discuss minerals, coal and mine safety and the disclosure of payments by resource extraction issuers.

Title XVI is the last section and it discusses Section 1256 contracts.

As is clear from the discussion of the Dodd-Frank Act, the United States Congress is quite adept at reacting to major weaknesses that lead to significant crises. It remains to be seen what role the Dodd-Frank Act will play in detecting, deterring, or preventing future financial crises in the United States. The Dodd-Frank Act is relatively recent and it is expected that there will be some modifications in time, based on user challenges and the results of the numerous studies sanctioned by it.

CONCLUSION

This purpose of this article was to address the issue of continuing frauds despite the passage of the Sarbanes-Oxley Act in 2002. It discussed the issues that led to, and the titles within, SOX. Next it highlighted two significant frauds which contributed, in part, to the United States facing the most significant financial crisis since the Great Depression. The last part of the article discussed the issues that led to, and the titles within, the Dodd-Frank Act. In conclusion, the article points to the importance of having a broad and sweeping discussion of the dangers of greed and the dangers of inventing financial instruments which are poorly understood but heavily traded. The hope is that there will be a combination of a constructive dialogue, along with appropriate legislation and regulation, that will help the United States of America clean-up its financial house, before it is too late.

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