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# ST. JOHN'S LAW REVIEW

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## SYMPOSIUM ENRON AND ITS AFTERMATH

### ENRON'S LEGISLATIVE AFTERMATH: SOME REFLECTIONS ON THE DETERRENCE ASPECTS OF THE SARBANES-OXLEY ACT OF 2002

MICHAEL A. PERINO<sup>†</sup>

#### INTRODUCTION

Since Enron's implosion, an astounding string of accounting scandals have stunned the securities markets. Global Crossing, WorldCom, Adelphia, and a host of other companies have seen plummeting share prices and SEC and criminal investigations. Congress's reaction has been equally stunning and surprisingly swift. It passed with near unanimity the Sarbanes-Oxley Act of 2002 (the "SOA" or the "Act"),<sup>1</sup> and President Bush quickly signed it into law. The President billed the Act as one of the "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."<sup>2</sup> While the SOA is certainly lengthy, with eleven titles and nearly 150 pages of text,

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<sup>1</sup> Pub. L. No. 107-204, 116 Stat. 745.

<sup>2</sup> Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1.

its importance and impact are far from certain.

This Article is not intended as a complete overview of the Act; instead, it focuses primarily on those provisions designed to deter securities fraud. Before analyzing whether Congress is likely to achieve its deterrence goals with these reforms, three more general comments about the Act are in order. Admittedly, none fall into the category of stunningly original insights into the legislative process, but they do appear to be considerations that Congress ignored in its headlong rush to get tough on corporate crime.

In fact, the first is simply that haste makes waste. The SOA moved with lightening speed through the legislature and only seemed to pick up momentum with the revelation of each new accounting restatement. Unfortunately, the Act reflects that speed. The original bill that Senator Sarbanes sponsored appears to have been, for the most part, well thought out. But as the political firestorm increased and the Dow Jones Average plunged, there was clearly a sense in Washington that Congress had to do something (anything) and do it fast.<sup>3</sup> And so in the end a number of other pending bills were simply engrafted wholesale onto the Sarbanes bill.

The result was, at a minimum, a disorganized law. For example, the Act's criminal provisions are scattered randomly over three separate titles. Separate provisions, such as those directing the United States Sentencing Commission (the "Sentencing Commission") to review sentencing guidelines for fraud and obstruction offenses, seem largely duplicative. More significantly, other aspects of the Act, especially the changes to the statute of limitations for private securities claims, are inconsistent with current law.<sup>4</sup> Other aspects of the Act, like the new certification requirements, are internally inconsistent, although at least not totally contradictory.<sup>5</sup> Legislation billed as being this important deserved more careful attention.

Second, an election year is a poor time to overhaul a complicated area like securities regulation. Politicians with

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<sup>3</sup> Richard A. Oppel, Jr., *G.O.P. in Congress Moving Past Bush on Business Fraud*, N.Y. TIMES, July 12, 2002, at C4 (quoting Senator Phil Gramm as saying, "In the environment we are in, virtually anything can pass," and that "[e]verybody is trying to outdo everybody else").

<sup>4</sup> See *infra* Part III.

<sup>5</sup> See *infra* Part II.A.2.

their eyes on November ballots may opt for easy fixes that look good in thirty-second television commercials rather than taking the time to analyze the merits of proposed policy changes, a fact that one congressman candidly acknowledged.<sup>6</sup> Much of the Act simply follows headlines from Enron and other corporate scandals, with little appreciation for whether those headlines highlight systemic problems that need legislative attention. Many other provisions, particularly the vaunted criminal provisions, represent little more than political grandstanding and are unlikely to have any real deterrent effect. In the effort to show that it was doing something, Congress seemingly ignored the efforts that the SEC, the self-regulatory organizations, and others had already undertaken—efforts that might make portions of the legislation unnecessary.<sup>7</sup> In other words, there was little appreciation that markets still work and can right themselves.

Third, as always, the devil is in the details. Many provisions of the Act are simply delegations of authority to the SEC to adopt rules.<sup>8</sup> Often these involve areas in which the SEC or the self-regulatory organizations had already undertaken rulemaking initiatives, again raising the question of whether legislation was truly necessary.<sup>9</sup> While the Act contains quite specific rulemaking directives, in many areas the true effect of the Act will not be known until regulations are drafted and in

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<sup>6</sup> Richard A. Oppel, Jr., *Negotiators Agree on Broad Changes in Business Laws*, N.Y. TIMES, July 25, 2002, at A1 (“The bill reflects a ‘stampede by members to get something done, regardless of what it is, to cover them politically,’ Representative John Boehner of Ohio, one of the Republican negotiators on the final bill, said earlier today. ‘Trust me,’ he added, ‘this isn’t about policy.’”).

<sup>7</sup> For example, the Act requires the SEC to adopt rules directing the national securities exchanges to adopt rules that, among other things, require the audit committee to be directly responsible for the appointment, compensation, and oversight of the outside auditors. Sarbanes-Oxley Act § 301 (to be codified at 15 U.S.C. § 78j-1(m)(2)). Before the SOA was passed, the NYSE had proposed to make virtually the identical amendment to its listing standards. N.Y. STOCK EXCH., CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMM. 13 (June 6, 2002), available at [http://www.eoa.org/images/corp\\_govreport.pdf](http://www.eoa.org/images/corp_govreport.pdf).

<sup>8</sup> See, e.g., Sarbanes-Oxley Act § 307 (to be codified at 15 U.S.C. § 7245) (delegating authority to SEC to promulgate rules requiring attorneys to report certain improper or illegal activity to board of directors).

<sup>9</sup> Compare Sarbanes-Oxley Act § 302 (to be codified at 15 U.S.C. § 7241) (requiring SEC to promulgate rules requiring CEOs and CFOs to certify the issuer’s financial statements), with Certification of Disclosure in Companies’ Quarterly and Annual Reports, Exchange Act Release No. 46,079, Fed. Sec. L. Rep. (CCH) ¶ 86,702, at 85,808 (proposed June 14, 2002) (same).

place. Much of this rulemaking is required to be completed very quickly, in most cases in substantially less than a year. To meet these ambitious deadlines, the SEC will most likely have to rely heavily on those pending rulemaking proposals. Again, the end result may be that many provisions of the Act add very little to the ongoing reform process.

To be sure, these criticisms do not apply to the entire Act. Some of its provisions may well have a substantial and lasting impact on our securities markets, although it is reasonable to expect, as with other recent securities legislation, that significant unintended consequences will arise.<sup>10</sup> In short, it is far too early to proclaim the Act as the second coming of the New Deal.

This Article proceeds as follows. Part I briefly sketches the economic theory of deterrence. Part II discusses the Act's new criminal sanctions and penalties. Part III focuses on private civil liability for securities fraud, primarily the new longer statute of limitations for certain securities claims. Part IV discusses the SOA provisions that increase SEC resources and enforcement authority.<sup>11</sup> Brief concluding remarks follow.

## I. ECONOMIC THEORY OF DETERRENCE

Although deterrence theories can be traced back to Jeremy Bentham's work in the late eighteenth century, Gary Becker is generally credited with providing the first rigorous economic model of crime and optimal penalties.<sup>12</sup> Since Becker's pioneering 1968 article, a staggeringly large body of theoretical

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<sup>10</sup> See Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, U. ILL. L. REV. (forthcoming 2003).

<sup>11</sup> Increased criminal penalties and more vigorous SEC enforcement are not the only deterrence mechanisms the SOA creates. The Act also attempts to reinvigorate various private monitoring mechanisms—ranging from the company's outside auditors to audit committees, outside counsel, market analysts, and whistleblowers. By enhancing these private monitoring mechanisms, the Act is seeking to increase the likelihood that inappropriate or illegal activity will be detected. Some of these provisions, for example those limiting the ability of the issuer's outside auditor to provide non-audit consulting services, are attempts to eliminate conflicts that may have prevented vigorous, independent monitoring. See Sarbanes-Oxley Act § 201 (to be codified at 15 U.S.C. § 78j-1). Others, such as the requirement that counsel report evidence of wrongdoing to the board of directors, represent potentially substantial extensions of traditional roles. See Sarbanes-Oxley Act § 307 (to be codified at 15 U.S.C. § 7245).

<sup>12</sup> See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

and empirical literature has emerged.<sup>13</sup> Like other economic models, the crime model starts from the simple premise that individuals are willing to commit crimes if the expected benefits of the crime exceed the expected benefits of engaging in lawful activity.<sup>14</sup> In other words, the decision to commit a crime is simply another type of decision-making under conditions of uncertainty. It thus involves the same kind of calculus that a rational utility-maximizing individual would apply to the decision to engage in any activity. In this model, penalties are necessary for prohibited activities so that individuals internalize the cost of those activities.<sup>15</sup>

Specifically, under Becker's model the individual compares the expected utility to be gained from engaging in risky criminal behavior to that of riskless legitimate employment.<sup>16</sup> Three components determine the expected utility from engaging in criminal behavior—the subjective probability of being caught and convicted,<sup>17</sup> the monetary equivalent of the punishment if convicted, and the gain from committing the crime.<sup>18</sup>

Under this model, expected utility to the individual of committing the crime is negative if, for example, the monetary equivalent of the punishment is greater than the gain from

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<sup>13</sup> Broad overviews of this literature can be found in *The Encyclopedia of Law and Economics*. See A. Mitchell Polinsky & Steven Shavell, *Public Enforcement of Law*, in 5 ENCYCLOPEDIA OF LAW & ECONOMICS 307 (Boudewijn Bouckaert & Gerrit de Geest eds., 2000); Erling Eide, *Economics of Criminal Behavior*, in 5 ENCYCLOPEDIA OF LAW & ECONOMICS, *supra*, at 345; John R. Lott, Jr., *Corporate Criminal Liability*, in 5 ENCYCLOPEDIA OF LAW & ECONOMICS, *supra*, at 492.

<sup>14</sup> RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 242 (5th ed. 1998).

<sup>15</sup> Michael K. Block, *Optimal Penalties, Criminal Law and the Control of Corporate Behavior*, 71 B.U. L. REV. 395, 397 (1991).

<sup>16</sup> This assumption, that acting legitimately is without risk, is obviously problematic for the executive contemplating securities fraud. For example, suppose that the executive knows that if he does not engage in accounting fraud, his company will miss its forecasted earnings. That may result in a significant drop in stock price, a significant decrease in the executive's compensation, possible loss of employment, as well as loss of reputation. If these risks from legitimate activity are added to the model, however, they do not materially affect the outcome. See DAVID J. PYLE, *THE ECONOMICS OF CRIME AND LAW ENFORCEMENT* 11 (1983).

<sup>17</sup> The individual's risk preference will play a role here. A risk-averse individual would likely believe that detection and conviction were more likely than a risk-preferring individual.

<sup>18</sup> Becker's model assumed that if caught and convicted, the criminal would forfeit all gains from the crime. This may not be the case when it comes to corporate criminals if they can effectively place their gains beyond the reach of enforcement officials.

committing the offense, but only if the probability of being caught and convicted are sufficiently high. In other words, expected utility can still be positive even for crimes with severe punishments if the probability of detection and conviction are low. Likewise, as the gains from criminal activity increase the utility of criminal activity increases as well.<sup>19</sup> Quite clearly, an increase in the loss if caught or an increase in the probability of detection and conviction should reduce the expected utility of criminal activity and also reduce the number of crimes.<sup>20</sup> The normative question for legislatures looking to reduce the amount of a particular type of crime is to choose the optimal mix of enforcement resources (i.e., the risk of detection) and the severity of punishment that maximizes social welfare.<sup>21</sup> The SOA takes both approaches.

The SOA's primary deterrence mechanism comes in the form of several new crimes and enhancements to existing criminal sanctions. Indeed, most press attention on the SOA has centered on these aspects of the Act. Politicians have also trumpeted the Act's tougher criminal penalties—when President Bush signed the SOA he claimed that there would be “[n]o more easy money for corporate criminals, just hard time.”<sup>22</sup> But will these provisions really deter fraudulent conduct? A careful analysis of what these provisions actually do and application of the lessons from deterrence theory suggest that these provisions are unlikely to have much deterrent effect.

## II. CRIMINAL SANCTIONS & PENALTIES UNDER THE SOA

### A. *New Crimes*

Some things are inevitable. The sun rises in the morning,

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<sup>19</sup> See Michael K. Block & Robert C. Lind, *An Economic Analysis of Crimes Punishable by Imprisonment*, 4 J. LEGAL STUD. 479, 486 (1975).

<sup>20</sup> See PYLE, *supra* note 16, at 13.

<sup>21</sup> Polinsky & Shavell, *supra* note 13, at 309; see also JAMES Q. WILSON & RICHARD J. HERRNSTEIN, *CRIME AND HUMAN NATURE* 397 (1985) (“To increase the expected disutility of crime for people in general, society must increase either the speed, the certainty, or the severity of punishment, or some combination of all three.”). There has been little if any research “that estimates the effect of changes in the speed of punishment on the probability of crime.” *Id.* at 397. Such a connection is, however, intuitively plausible. See *id.* at 49–56 (analyzing the interaction of delay and uncertainty).

<sup>22</sup> Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1.

the tides ebb and flow, and Congress passes new crime legislation in an election year.<sup>23</sup> So we should not be surprised that this year's version of the crime bill focuses on the recent parade of corporate scandals. When scandals erupt or horrific crimes capture public attention, Congress wants to show that it is doing something about it. There is a long and sometimes ignominious history in Congress of either federalizing crimes that were typically subject to state jurisdiction or addressing public outcry over some recent event through new criminal laws, often in areas in which there appeared to be little need for new federal legislation.<sup>24</sup> When stories about a new "date-rape" drug hit the press,<sup>25</sup> Congress responded with a new federal crime prohibiting drug-induced rape.<sup>26</sup> Congress has even turned car-jacking into a federal crime.<sup>27</sup>

Given the public outcry over seemingly widespread corporate malfeasance, it is easy to see why politicians would want to demonstrate that they are just as tough on corporate crime as they are on street crime. Politicians have competed over who was the most willing to put CEOs "in the pokey."<sup>28</sup> As debate in Congress over the SOA intensified, one representative even quipped, "Summary executions would get about 85 votes in the Senate right now."<sup>29</sup> While this year's batch of new corporate crimes does not raise the federalism concerns of past

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<sup>23</sup> See Michael A. Simons, *Prosecutorial Discretion and Prosecution Guidelines: A Case Study in Controlling Federalization*, 75 N.Y.U. L. REV. 893, 906 (2000) ("Since 1984, every national election year has seen the creation of new federal crimes.").

<sup>24</sup> See *id.* at 902-07. See generally LAWRENCE M. FRIEDMAN, CRIME AND PUNISHMENT IN AMERICAN HISTORY 71-73, 134-39, 261-76, 339-41 (1993).

<sup>25</sup> See, e.g., David Kidwell & Connie Piloto, *Parents, Officials Are Alarmed Over Sedative's Use: Roofies' Blamed in Many Rape Cases; Hypnotic Drug Hard to Trace*, DALLAS MORNING NEWS, Feb. 18, 1996, at 12A; Jean Seligmann & Patricia King, *'Roofies': The Date-Rape Drug*, NEWSWEEK, Feb. 26, 1996, at 54.

<sup>26</sup> Drug-Induced Rape Prevention and Punishment Act of 1996, Pub. L. No. 104-305, 110 Stat. 3807 (codified in scattered sections of 21 U.S.C.).

<sup>27</sup> See Anti-Car Theft Act of 1992, Pub. L. No. 102-519, 106 Stat. 3384 (codified as amended at 18 U.S.C. §§ 2119, 2322).

<sup>28</sup> See Stephen Labaton, *Handcuffs Make Strange Politics, You Say? But Not in Washington*, NY TIMES, Aug. 2, 2002, at C5 (quoting White House Press Secretary Ari Fleischer as saying, "The president is determined that people who break America's laws and engage in corporate practices that are corrupt will be investigated and will be held liable, will be held accountable and will likely end up in the pokey, where they belong").

<sup>29</sup> Richard A. Oppel, Jr., *G.O.P. in Congress Moving Past Bush on Business Fraud*, NY TIMES, July 12, 2002, at C4 (quoting Rep. Michael G. Oxley).



congressional lawmaking efforts, there are serious questions about the manner in which these provisions were drafted and whether they substantially increase deterrence of corporate wrongdoing. By and large the new criminal provisions address two hot-button issues—obstruction of justice and securities fraud.<sup>30</sup>

### 1. Obstruction of Justice

With an eye clearly on the Arthur Andersen document destruction prosecution,<sup>31</sup> Congress created three new obstruction-related offenses, which appear in two different titles of the SOA. Section 1102 of the SOA amends 18 U.S.C. § 1512 to create a maximum twenty-year sentence for efforts or attempts to tamper with records or otherwise obstruct official proceedings.<sup>32</sup> Section 802 of the SOA contains the other two new obstruction statutes. Under new 18 U.S.C. § 1519, individuals that knowingly destroy, alter, or falsify records “with the intent to impede, obstruct, or influence” a federal investigation or bankruptcy proceeding are subject to fines and potential imprisonment of up to twenty years.<sup>33</sup> The second

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<sup>30</sup> The Act also prohibits retaliation against informants. Any individual that takes a harmful action against any person in retaliation for that person “providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense” is subject to fines and imprisonment of up to ten years. Sarbanes-Oxley Act §1107 (amending 18 U.S.C. § 1513(e) (2000)).

<sup>31</sup> See Ken Brown et al., *Paper Trail: Andersen Fires Partner It Says Led Shredding Of Enron Documents*, WALL ST. J., Jan. 16, 2002, at A1.

<sup>32</sup> Sarbanes-Oxley Act § 1102 (to be codified at 18 U.S.C. § 1512(c)). The section provides:

Whoever corruptly—(1) alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding; or (2) otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so, shall be fined under this title or imprisoned not more than 20 years, or both.

*Id.*

<sup>33</sup> *Id.* § 802(a) (to be codified at 18 U.S.C. § 1519). This section, entitled “destruction of records in federal investigations and bankruptcy proceedings,” provides:

Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.

provision relates to the destruction of corporate audit paper and mandates accountants that conduct audits required under the Securities Exchange Act of 1934 (the "Exchange Act") to maintain all audit or review workpapers for five years.<sup>34</sup> Individuals that knowingly and willfully violate this requirement, or any rule or regulation promulgated thereunder, are subject to fines and potential imprisonment of up to ten years.<sup>35</sup>

One of the more glaring examples of the SOA's drafting problems is this document retention requirement. In Title One of the SOA, Congress established a new self-regulatory organization for the accounting industry—the Public Company Accounting Oversight Board (the "Board").<sup>36</sup> In delegating authority to the Board to establish accounting standards,<sup>37</sup> the Act directs the Board to require accountants to maintain audit workpapers for seven, not five, years.<sup>38</sup> Reading these provisions together suggests that an auditor that willfully destroys workpapers in years six and seven is only subject to disciplinary action by the Board or enforcement action by the SEC, but not criminal prosecution under this new provision. Of course the

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*Id.*

<sup>34</sup> *Id.* (to be codified at 18 U.S.C. § 1520(a)(1)). Additionally, the SEC is required to promulgate rules and regulations:

[R]elating to the retention of relevant records such as workpapers, documents that form the basis of an audit or review, memoranda, correspondence, communications, other documents, and records (including electronic records) which are created, sent, or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit or review.

*Id.* (to be codified at 18 U.S.C. § 1520(a)(2)).

<sup>35</sup> *Id.* (to be codified at 18 U.S.C. § 1520(b)).

<sup>36</sup> *Id.* § 101(a) (to be codified at 15 U.S.C. § 7211).

<sup>37</sup> *Id.* Specifically, the Board, subject to SEC oversight, is required to: (i) register public accounting firms that prepare audit reports for "reporting companies"; (ii) establish auditing, quality control, ethics, and independence standards for audits; (iii) inspect registered public accounting firms; (iv) conduct investigative and disciplinary proceedings of public accounting firms and associated persons; (v) enforce compliance with the SOA, the Board's rules, professional standards, and the securities laws relating to the preparation and issuance of audit reports; and (vi) promote high professional standards and improve the quality of audit services. *Id.* § 101(c).

<sup>38</sup> The legislative history of § 1520 recognizes this inconsistency, but does not explain why the time periods applicable under these two provisions are different. See 148 CONG. REC. S7419 (daily ed. July 26, 2002) (discussing five-year retention period in criminal statute and noting "regulatory portion of the Act requires a 7 year retention period").

auditor might, depending on the context, still be criminally liable under existing obstruction provisions. And that is the point—like other recent federal crime legislation, these new crimes do very little to criminalize conduct that was not already criminal.

To be sure, it is possible to read these provisions much more broadly. Indeed, one could easily view them as significant extensions of obstruction law. For example, new §§ 1512(c) and 1519 allow actions against individuals that knowingly obstruct justice, not just those who corruptly persuade or intimidate others to do so.<sup>39</sup> Second, unlike § 1512, § 1519 has no “official proceeding” requirement.<sup>40</sup> As a result, § 1519 could cover any document destruction involving any matter within the jurisdiction of a federal agency. Senator Leahy, who was primarily responsible for drafting § 1519, has argued that it “imposes broad prohibitions on evidence tampering” beyond those found in current law.<sup>41</sup>

But how significant are these changes? Simple proof issues dictate that most obstruction cases are likely to involve more than one individual. For example, if I secretly shred a document in my possession, how likely is it that the government would ever have sufficient evidence to convict me? Courts have broadly defined corrupt persuasion to encompass a wide variety of activities, including non-coercive attempts to tamper with witnesses.<sup>42</sup> Thus, finding a corrupt persuader may not present significant difficulties for a prosecutor. Likewise, under § 1512, “official proceedings” are broadly defined and need not be pending at the time of the offense.<sup>43</sup> While § 1519 technically applies to the destruction or alteration of documents in violation of any federal regulatory function, it is unlikely, both as a matter of prosecutorial discretion and of proving criminal intent, that indictments will involve tampering that is not at least in contemplation of an investigation. Finally, it is worth noting that the Justice Department did not petition Congress for these changes. If the Justice Department saw real loopholes in

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<sup>39</sup> See 18 U.S.C. § 1512(b) (2000); see also *United States v. Khatami*, 280 F.3d 907, 911–14 (9th Cir. 2001).

<sup>40</sup> 18 U.S.C. § 1519.

<sup>41</sup> See Letter from Sen. Leahy to Attorney General Ashcroft (Aug. 5, 2002).

<sup>42</sup> See, e.g., *Khatami*, 280 F.3d at 912–13 (citing additional cases).

<sup>43</sup> See 18 U.S.C. §§ 1512(f)(1), 1515(a)(1); see also *United States v. Davis*, 183 F.3d 231, 248 (3d Cir. 1999); *United States v. Frankhauser*, 80 F.3d 641, 652 (1st Cir. 1996).

existing statutes, it is reasonable to anticipate that it would be first to lobby for reforms. Thus, as a practical matter, it seems that these provisions criminalize very little new conduct and therefore carry very little, if any, additional deterrence benefit.

## 2. Securities Fraud

The same criticisms apply to the new securities fraud crime. Securities fraud has been a federal crime since 1933.<sup>44</sup> Both the Securities Act of 1933 (the "Securities Act") and the Exchange Act make it a criminal offense to willfully violate any of their provisions or any SEC rules promulgated thereunder.<sup>45</sup> In addition, the Exchange Act criminalizes false filings if they are made willfully and knowingly.<sup>46</sup>

The new provision is intended to make it easier to win a securities fraud prosecution and is modeled on the mail and wire fraud statutes,<sup>47</sup> as well as more recent provisions aimed at bank and health care fraud.<sup>48</sup> Under new 18 U.S.C. § 1348, any individual who knowingly executes or attempts to execute a scheme or artifice: (i) to defraud any person in connection with any security of a registered or reporting company; or (ii) to obtain by means of false or fraudulent pretenses, representations, or promises any money or property in connection with the purchase or sale of any registered or reporting company is subject to fine and imprisonment up to twenty five years.<sup>49</sup>

This provision probably does make it marginally easier to prosecute individuals for securities fraud than would be true under Rule 10b-5 because it eliminates a number of elements.<sup>50</sup>

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<sup>44</sup> See 15 U.S.C. § 77x.

<sup>45</sup> See 15 U.S.C. §§ 77x, 78ff.

<sup>46</sup> *Id.* § 78ff(a).

<sup>47</sup> See 18 U.S.C. §§ 1341, 1343.

<sup>48</sup> See *id.* §§ 1344, 1347.

<sup>49</sup> Sarbanes-Oxley Act § 807(a) (to be codified at 18 U.S.C. § 1348).

<sup>50</sup> See 148 CONG. REC. S7421 (daily ed. July 26, 2002):

This bill, then, would create a new 25 year felony for securities fraud—a more general and less technical provision comparable to the bank fraud and health care fraud statutes in Title 18. . . . The provision should not be read to require proof of technical elements from the securities laws, and is intended to provide needed enforcement flexibility in the context of publicly traded companies to protect shareholders and prospective shareholders against all the types [sic] schemes and frauds which inventive criminals may devise in the future.

*Id.*

For example, a prosecution under this new provision would not require proof of fraud in connection with the purchase or sale of a security.<sup>51</sup> The statute may also make it marginally easier for prosecutors to present their case to the jury because, unlike mail and wire fraud, the name of the crime now matches the underlying offense. Nonetheless, it is unclear how much benefit this provision really provides prosecutors or how much it really increases the odds of obtaining a conviction. Prosecutors have typically relied heavily on the mail and wire fraud statutes to address securities fraud, and there is no indication that juries were reluctant to convict defendants under those provisions. The real difficulty prosecutors have always had in complex corporate fraud cases is proving criminal intent—something the new securities fraud statute does nothing to change.

Some of the same criticisms can be made with respect to section 906 of the SOA, which requires CEOs and CFOs of reporting companies to certify in writing for each periodic report containing financial statements that the report fully complies with the requirements of section 13(a) and 15(d) of the Exchange Act and that “information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.”<sup>52</sup> Officers that certify statements knowing that the periodic reports do not comport with all these requirements are subject to fines of up to \$ 1 million and potential imprisonment of up to ten years.<sup>53</sup> Willful violations increase the maximum penalties to \$5 million and twenty years.<sup>54</sup>

While the certification requirement is new, CEOs or CFOs that make knowingly false certifications would have been subject to prosecution for making false statements to the federal government without section 906.<sup>55</sup> Section 906 is another instance of the hurried drafting of the SOA. The primary certification requirements of the Act are contained in Title III,

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<sup>51</sup> See *United States v. O'Hagan*, 521 U.S. 642, 651 (1997). The new securities fraud provision is in other ways narrower than Rule 10b-5. Rule 10b-5 applies to any security, whereas the new statute applies only to the securities of reporting companies.

<sup>52</sup> Sarbanes-Oxley Act § 906 (to be codified at 18 U.S.C. § 1350(a), (b)).

<sup>53</sup> *Id.* (to be codified at 18 U.S.C. § 1350(c)(1)).

<sup>54</sup> *Id.* (to be codified at 18 U.S.C. § 1350(c)(2)).

<sup>55</sup> 18 U.S.C. § 1001(a) (2000).

and require more extensive certifications by the signing officer.<sup>56</sup> Any willfully false certification on these other aspects would still be criminal, but prosecution would be for making a false statement and not under the SOA.

The novel aspect of the criminal certification provision is not that it criminalizes false statements, but rather it is in the nature of the certification itself. Executives are not required to certify that the financial statements comply with GAAP—they must certify that they fairly present the issuer's financial condition and results of operations. Conceivably, financials could paint a misleading picture of the financial condition of the issuer even if they comply with GAAP. Any executive that knowingly signed a certification under these circumstances could be criminally liable. The effect of this provision is to codify Judge Friendly's decision in *United States v. Simon*,<sup>57</sup> which held that an accountant could be convicted of securities fraud even if the accounting practice at issue complied with GAAP.<sup>58</sup>

It is difficult to predict the long-term effect of this codification, but it is possible that Congress may have indirectly worked a significant change in accounting doctrine. In essence this criminal provision may move United States accounting policy away from its traditional rule-based focus to the more standard-based focus of European accounting rules.<sup>59</sup> While a

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<sup>56</sup> Section 302 directs the SEC to promulgate rules requiring CEOs and CFOs to certify the issuer's quarterly and annual reports. See Sarbanes-Oxley Act § 302 (to be codified at 15 U.S.C. § 7241). Pursuant to this directive, SEC rules now require these officers to certify the following:

[That] they are responsible for establishing, maintaining and regularly evaluating the effectiveness of the issuer's internal controls; they have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and they have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation.

Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 57,276 (Sept. 9, 2002) (to be codified at 17 C.F.R. pts. 228, 229, 232, 240, 249, 270, 274).

<sup>57</sup> 425 F.2d 796, 798 (2d Cir. 1969).

<sup>58</sup> Even in *Simon*, however, the court was careful to observe that compliance with GAAP is persuasive although not necessarily conclusive proof that the defendant acted with good faith. *Id.* at 805-06.

<sup>59</sup> See *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Hearing Before the Senate Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. (2002) (prepared statement of Sir David Tweedie, Chairman,

number of commentators argue that such a shift in United States accounting policy is warranted, serious questions abound as to whether criminal law provides the appropriate vehicle for doing so.<sup>60</sup>

### B. *Enhanced Criminal Penalties*

In addition to creating new crimes, the SOA beefs up the penalties for certain existing crimes. Maximum penalties for mail and wire fraud are increased from five to twenty years.<sup>61</sup> Section 902(a) provides that any person who attempts or conspires to commit mail, wire, securities, or any other fraud shall be subject to the same penalties as for a substantive violation of those provisions.<sup>62</sup> Maximum criminal penalties under the Exchange Act are increased for individuals from fines of \$1 million and imprisonment of ten years to fines of \$5 million and imprisonment of twenty years.<sup>63</sup> Fines for organizations are increased from \$2.5 million to \$25 million.<sup>64</sup> Section 904 increases penalties for criminal ERISA violations. For individuals, the maximum sentence is increased from one to ten years, and maximum fines are increased from \$5,000 to \$100,000. For organizations, maximum fines are increased from \$100,000 to \$500,000.<sup>65</sup>

A number of provisions of the SOA direct the Sentencing Commission to review and amend the Federal Sentencing Guidelines (the "Sentencing Guidelines"), where appropriate.<sup>66</sup> Like the other criminal provisions, these directives are scattered throughout the SOA and are often duplicative. The Sentencing Commission must review whether "the base offense level and existing enhancements . . . relating to obstruction of justice are sufficient."<sup>67</sup> In addition, it is required to review several aspects

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Int'l Accounting Standards Bd.).

<sup>60</sup> See John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—And What Can Be Done About It*, 101 YALE L.J. 1875, 1881–82 (1992).

<sup>61</sup> Sarbanes-Oxley Act § 903 (amending 18 U.S.C. §§ 1341, 1343).

<sup>62</sup> *Id.* § 902(a) (amending 18 U.S.C. § 1349).

<sup>63</sup> *Id.* § 1106 (amending 15 U.S.C. § 78ff(a)).

<sup>64</sup> *Id.*

<sup>65</sup> *Id.* § 904 (amending 29 U.S.C. § 1131).

<sup>66</sup> The Sentencing Commission is directed to complete this review not later than 180 days after the SOA was enacted. *Id.* § 805(b).

<sup>67</sup> *Id.* § 805(a)(1). This review includes an assessment of whether the enhancements and specific offense characteristics are adequate for cases in which

of sentencing related to fraud claims,<sup>68</sup> to review whether the guidelines that apply to organizations are sufficient,<sup>69</sup> and to engage in a more general review of the Sentencing Guidelines in light of the new crimes added under the SOA and “the growing incidence of serious fraud offenses.”<sup>70</sup>

These penalty enhancements seem unlikely to deter corporate crime to any greater degree than current provisions. One reason is because it is unlikely that these provisions actually change expected penalties in criminal prosecutions. Maximum statutory sentences play a relatively small role under the Sentencing Guidelines—they simply set an outside limit to the sentence a court may impose.<sup>71</sup> Consequently, even if a guidelines calculation yields a maximum penalty of fifteen years, a defendant convicted of crime with a statutory maximum of ten years may only be sentenced to ten years. In practice, however, prosecutors can easily evade that restriction. They have enormous flexibility to increase or decrease the potential sentence through their charging and plea bargaining decisions and can even exceed statutory maximums by charging multiple counts.<sup>72</sup> So, if a prosecutor wanted to increase sentence length,

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the obstruction involves the destruction of a large amount of evidence, or of particularly probative or essential evidence, involved more than minimal planning, or involved an abuse of a special skill or position of trust. *Id.* § 805(a)(2). The Sentencing Commission must also review whether the guideline offense levels and enhancements are sufficient for cases in which documents or other physical evidence is actually destroyed, *id.* § 1104(b)(4), and for the new obstruction-related crimes (destruction of records in federal investigations and bankruptcies and destruction of corporate audit records), *id.* §§ 802, 805(a)(3).

<sup>68</sup> The Sentencing Commission is directed to ensure that (i) sentencing guidelines and policy statements “reflect the serious nature of securities, pension, and accounting fraud and the need for aggressive and appropriate law enforcement action to prevent such offenses”; (ii) an enhancement exists for fraud offenses that endanger the financial solvency or financial security of a substantial number of victims; and (iii) guideline offense levels and enhancements are sufficient for fraud offenses when the number of victims is significantly greater than fifty. *Id.* § 1104(b).

<sup>69</sup> *Id.* § 805(a)(5).

<sup>70</sup> *Id.* § 905(b).

<sup>71</sup> U.S. SENTENCING GUIDELINES MANUAL § 5G1.1(c)(1) (2002) [hereinafter U.S.S.G.].

<sup>72</sup> Under the U.S.S.G., if the defendant is convicted of multiple counts, then sentences are required to run consecutively so that the combined sentences equal the guidelines calculation. U.S.S.G. § 5G1.2(d). For discussions of prosecutorial discretion and its effect on Guideline determinations, see Stephen J. Schulhofer & Ilene H. Nagel, *Plea Negotiations Under the Federal Sentencing Guidelines: Guideline Circumvention and Its Dynamics in the Post-Mistretta Period*, 91 NW. U. L. REV. 1284 (1997).



it would be relatively easy in most financial frauds to charge the defendant with multiple counts of mail, wire, and securities fraud.

White-collar crime was also one of the only areas in which the drafters of the Sentencing Guidelines sought to increase the severity of pre-Guidelines sentences.<sup>73</sup> Indeed, one of the goals was to send serious white-collar criminals to prison instead of just giving them probation.<sup>74</sup> To some degree the drafters achieved that goal—in post-Guidelines cases a greater proportion of individual white-collar defendants serve prison time instead of probationary sentences,<sup>75</sup> although organizational fines do not appear to have increased significantly.<sup>76</sup>

In fraud cases, the key component to sentence length is the financial harm the fraud caused.<sup>77</sup> Large financial frauds, like those that Congress focused on in the debate on the SOA, already yield substantial prison terms.<sup>78</sup> The enhancements that Congress asked the Sentencing Commission to review add comparatively little to those sentences. Oddly enough, they may have their greatest impact not in large frauds like Enron, but in smaller ones because they may mean the difference between probation and jail time.<sup>79</sup> It also remains to be seen how much

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<sup>73</sup> U.S.S.G. ch. 1, pt. A(3) (noting that empirical data demonstrated that "economic crime" was punished "less severely than other apparently equivalent behavior").

<sup>74</sup> Stephen Breyer, *The Federal Sentencing Guidelines and the Key Compromises Upon Which They Rest*, 17 HOFSTRA L. REV. 1, 22 (1988).

<sup>75</sup> See Theresa Walker Karle & Thomas Sager, *Are the Federal Sentencing Guidelines Meeting Congressional Goals?: An Empirical and Case Law Analysis*, 40 EMORY L.J. 393, 416 (1991) (concluding that a greater proportion of white-collar defendants were imprisoned but that prison terms had not increased). *But see* Michael S. Gelacak et al., *Departures Under the Federal Sentencing Guidelines: An Empirical and Jurisprudential Analysis*, 81 MINN. L. REV. 299, 352-53 (1996) (finding that white-collar defendants benefited disproportionately from downward departures from the sentencing guidelines).

<sup>76</sup> Jeffrey S. Parker & Raymond A. Atkins, *Did the Corporate Criminal Sentencing Guidelines Matter? Some Preliminary Empirical Observations*, 42 J. LAW & ECON. 423, 423 (1999).

<sup>77</sup> See Frank O. Bowman III, *Coping with "Loss": A Re-Examination of Sentencing Federal Economic Crimes Under the Guidelines*, 51 VAND. L. REV. 461, 464 (1998).

<sup>78</sup> U.S.S.G. § 2B1.1(b)(1).

<sup>79</sup> At the lowest levels of the Sentencing Guidelines, a two-point change in offense level can move the defendant into a different "zone," which could significant

the Guidelines will change as a result of the SOA. The Sentencing Commission has already reviewed much of what Congress asked it to review in the SOA,<sup>80</sup> and it seems unlikely that another review will result in substantial changes to the Guidelines.

More fundamentally, economic analyses of crime and punishment strongly suggest that enhanced criminal penalties like these do comparatively little to deter crime.<sup>81</sup> In part this is because complex white-collar crimes likely have a low probability of detection. Even if they are detected, cases like the Andersen obstruction trial teach that successful convictions are difficult—only increasingly so when it comes to complex financial crimes. These low probabilities tend to swamp any increase in deterrence from enhancing sanctions. For example, assume that a defendant faced a ten percent chance of detection and successful prosecution for securities fraud. Prior to the SOA, securities fraud had a ten-year maximum sentence, which meant that at most the defendant's expected sentence was one year. The SOA doubled the maximum sentence to twenty years, but assuming that the Act had no effect on the probability of detection and successful prosecution, that ten-year maximum sentence increase yields only a one-year increase in expected sentence.

Another theoretical explanation for the relatively small benefit from increasing punishment severity rests on the notion

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change the defendant's conditions of confinement. *See* U.S.S.G. ch. 5, pt. A, § 5C1.1. If the defendant's offense level falls within Zone A (the lowest zone), the defendant may be sentenced to probation. *See id.* § 5C1.1(b). In Zone B, the defendant may be sentenced to home detention or a half-way house. *See id.* § 5C1.1(c). In Zone C, the defendant must serve half of the sentence in prison, but may do the other half at home or in a half-way house. *See id.* § 5C1.1(d). In Zone D, the defendant must serve the entire sentence in prison. *See id.* § 5C1.1(f). Thus, the minimum sentence for a defendant with a offense level of twelve is five months imprisonment and five months home confinement. The minimum sentence for a defendant with a offense level of fourteen is fifteen months imprisonment. *See id.* at ch. 5, pt. A.

<sup>80</sup> For example, the Sentencing Commission had already convened an ad hoc advisory group to examine the organizational sentencing guidelines. *See* Press Release, United States Sentencing Commission, Sentencing Commission Convenes Organizational Guidelines Ad Hoc Advisory Group (Feb. 21, 2002), at <http://www.ussc.gov/PRESS/rel0202.htm>.

<sup>81</sup> *See* Eide, *supra* note 13, at 360 (reviewing literature and noting "that in some studies the effect of an increase in the severity of punishment is not statistically different from zero, and a statistically positive effect has also occasionally been obtained").

that individuals either discount the future disutility of imprisonment or that initial imprisonment is associated with the greatest amount of disutility as compared to future years in prison. That disutility might decline over time makes some sense—"stigmatization of the prisoner (which lowers earning capacity and status) may be primarily due to having been in prison at all, and it may not increase much with the number of years spent there."<sup>82</sup> Indeed, stigmatization occurs even earlier, with wall-to-wall press coverage and the ritual "perp walk."

With respect to white-collar criminals, extra-criminal justice penalties associated with loss of future economic earning power may be particularly severe. One study found that "the highest income criminals suffer reductions in legitimate income of between eighty and ninety-five percent as a result of conviction."<sup>83</sup> Similarly, if potential white-collar defendants systematically underestimate the disutility of prison, increasing sentence length may not yield large decreases in deterrence.<sup>84</sup> Although popular stories about "Club Fed" may be inaccurate,<sup>85</sup> the prevalence of those accounts may fuel misperceptions that imprisonment, even if imposed, may not be too onerous.

As a result, longer sentences do not appear to be the answer to deterring securities fraud. Harsher sentences may sell well in elections, but they appear unlikely to have large deterrence benefits. That is not to say that we should rely exclusively on civil penalties as a deterrence strategy. There is clearly a role for criminal enforcement in the federal securities markets. For example, fines will be inadequate to deter fraudulent activity where the optimal fine exceeds the defendant's ability to pay. Under those circumstances, imprisonment can increase the punishment sufficiently to create effective deterrence.<sup>86</sup> It is precisely because criminal sanctions have such a powerful

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<sup>82</sup> A. Mitchell Polinsky & Steven Shavell, *On the Disutility and Discounting of Imprisonment and the Theory of Deterrence*, 28 J. LEG. STUD. 1, 3 (1999). See generally Dan M. Kahan & Eric A. Posner, *Shaming White-Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines*, 42 J. L. & ECON. 365 (1999); J.R. Lott, Jr., *Do We Punish High Income Criminals Too Heavily?*, 30 ECON. INQUIRY 583 (1992).

<sup>83</sup> John R. Lott, Jr., *Optimal Penalties Versus Minimizing the Level of Crime: Does It Matter Who Is Correct?*, 71 B.U. L. REV. 439, 442 (1991).

<sup>84</sup> Polinsky & Shavell, *supra* note 82, at 13.

<sup>85</sup> Russ Mitchell, *White-Collar Criminal? Pack Lightly for Prison*, N.Y. TIMES, Aug. 11, 2002, § 3, at 4.

<sup>86</sup> POSNER, *supra* note 14, at 222.

impact on reputation and future earnings capacity that they should be part of the deterrence toolkit. The important point to remember is that longer jail times, like most simple solutions, are inadequate.

### III. STATUTE OF LIMITATIONS IN PRIVATE SECURITIES ACTIONS

While new crimes and enhanced penalties have captured most public and press attention, it is possible to increase deterrence by increasing the likelihood that private parties will bring successful securities fraud actions or by increasing the damages available in such suits. Such an approach, however, would amount to a significant about-face for Congress, which in 1995 passed the Private Securities Litigation Reform Act (the "PSLRA")<sup>87</sup> to address perceived abuses in securities class actions.<sup>88</sup> Although several commentators suggested rolling back provisions of the PSLRA, in the end, Congress changed only one aspect of private securities fraud suits—section 804 lengthens the statute of limitations for certain claims under the federal securities laws. Specifically, the SOA amends 28 U.S.C. § 1658 to provide that private rights of action under the federal securities laws involving "fraud, deceit, manipulation, or contrivance" be brought not later than the earlier of two years after the discovery of the facts constituting the violation or five years after the violation.<sup>89</sup>

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<sup>87</sup> Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

<sup>88</sup> See MICHAEL A. PERINO, SECURITIES LITIGATION AFTER THE REFORM ACT 1013-14 (2000).

<sup>89</sup> Sarbanes-Oxley Act § 804(b). In 1991, the United States Supreme Court in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), determined that the statute of limitations for Rule 10b-5 actions is one year after the discovery of the facts constituting the violation and within three years after such violation—the same limitation period that applies to several express causes of action in the Exchange Act and the Securities Act. *Id.* at 364. Prior to *Lampf*, most courts borrowed limitations periods from state law, creating a patchwork of inconsistent limitation periods in Rule 10b-5 actions ranging from one to ten years. 10 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4506 (3d ed., 1999). *Lampf* adopted a uniform limitations period to eliminate these inconsistencies, to reduce forum shopping, and to avoid "complex and expensive litigation over what should be a straightforward matter." *Lampf*, 501 U.S. at 357 (quoting Agency Holding Corp. v. Malley-Duff & Assocs., Inc., 483 U.S. 143, 154 (1987)). The *Lampf* Court adopted the one-three year rule used elsewhere in the Exchange Act because it could "imagine no clearer indication of how Congress would have balanced the policy considerations implicit in any limitations provision than the balance struck by the same Congress in limiting similar and related provisions." *Id.* at 359.

The rationale Congress offered for extending the statute of limitations is that a longer period will permit defrauded investors a greater opportunity to recoup losses in cases where those perpetrating the fraud have concealed it.<sup>90</sup> In deterrence terms, a longer statute of limitations theoretically makes it somewhat more likely that investors (or, more accurately, lawyers) will detect improper behavior, assuming that such behavior is difficult to conceal for long periods. Whether a longer statute of limitations will achieve positive deterrence benefits is then an empirical question. Under the old statute of limitations, were potential defendants able to externalize part of the cost of fraudulent activity because they were able to conceal those frauds?

As I have argued elsewhere,<sup>91</sup> there is little empirical evidence supporting an increase in the statute of limitations. In fact, when passing the PSLRA seven years ago Congress expressed exactly the opposite concern—it found that actions were often brought too quickly with little apparent pre-filing investigation.<sup>92</sup>

In connection with a recently completed study of the effectiveness of the PSLRA,<sup>93</sup> I have examined in detail a sample of 160 securities fraud class actions filed from July 1998 through June 2001. Of those cases, 146 involved the kind of Rule 10b-5 actions that appear to be the primary focus of the SOA. On average, these cases were brought within fifty-five days of the end of the class period, i.e., the time when the alleged misrepresentation or omission was disclosed. Median filing time in the cases was even shorter—just eleven days. As Figure 1 demonstrates, 89% of the actions in the sample were filed within six months of disclosure of the alleged misconduct. Only 4.79% of the cases studied were brought within three days of the one-year limit.

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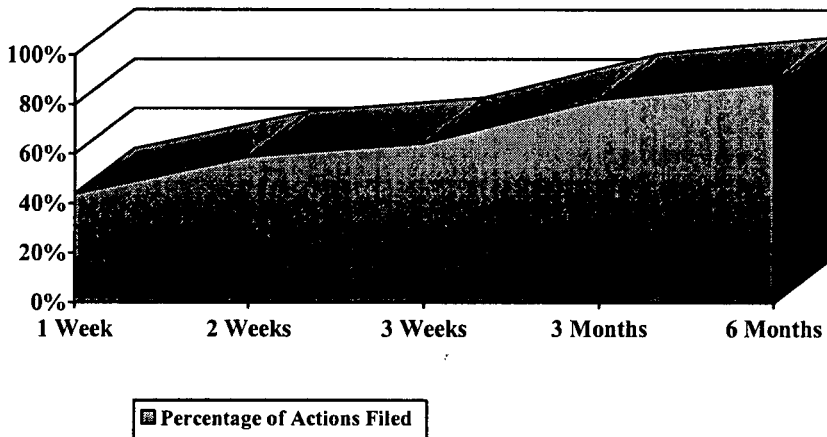
<sup>90</sup> 148 CONG. REC. S6437 (daily ed. July 9, 2002) (statement of Sen. Daschle).

<sup>91</sup> See Michael A. Perino, *Statutes of Limitations Under the Newly Passed Sarbanes-Oxley Act*, N.Y.L.J., Aug. 2, 2002, at 4.

<sup>92</sup> S. REP. NO. 104-98, at 8 (1995) (“A complaint alleging violations of the Federal securities laws is easy to craft and can be filed with little or no due diligence.”).

<sup>93</sup> Perino, *supra* note 10.

Figure 1  
Time to Filing in Securities Class Actions



This evidence demonstrates that plaintiffs' lawyers, the driving force behind this type of litigation, are more than capable of bringing actions within a year of discovery. Indeed, in both Enron and WorldCom, class actions were brought within days of the company's accounting restatements.<sup>94</sup> This incentive to investigate and file actions quickly is not derived from fear that a limitations period will run; rather, it is because earlier filings appear to give attorneys a competitive advantage in securing the lucrative lead counsel position.<sup>95</sup>

In fact, the one-year discovery rule already addresses the problem of fraudulent concealment that Congress purported to address—the time period does not begin to run until the plaintiff discovered or should have discovered through reasonable diligence the facts necessary to assert a claim.<sup>96</sup> In a fraud case, the time period does not begin to run until the plaintiff knows or should know that the defendant made a knowingly false misrepresentation or omission.<sup>97</sup> There is simply no empirical or legal basis for altering the one-year discovery rule.

<sup>94</sup> See *Wolf Haldenstein Adler Freeman & Herz LLP Commences a Class Action Litigation Against WorldCom, Inc.*, Bernard J. Ebberts, Scott D. Sullivan, And Arthur Anderson, LLP, PR NEWSWIRE, JUNE 27, 2002; *Milberg Weiss Announces Class Action Suit Against Enron Corp.*, BUSINESS WIRE, Oct. 22, 2001.

<sup>95</sup> See Perino, *supra* note 10.

<sup>96</sup> See *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 363 (1991); see also *Law v. Medco Research, Inc.*, 113 F.3d 781, 785–86 (7th Cir. 1997).

<sup>97</sup> *Law*, 113 F.3d at 786.

There is also little support for lengthening the three-year statute of repose to five years. There is little or no evidence of completed frauds that only came to light after the three-year period had run. Nonetheless, even if plaintiffs can commence actions quickly after discovery, it is possible that a three-year limit might cut-off some potential recovery in a fraud that existed for a significant amount of time.

From a policy perspective then, the relevant empirical question concerns the frequency of such long-term frauds. Longer-term frauds have received significant press coverage<sup>98</sup> but also appear to be relatively infrequent. One way to analyze this issue is to look at the class periods alleged in securities fraud complaints since the class period typically starts when the fraud allegedly commences. If such frauds were prevalent, we should expect to see a significant number of class periods that approach three years in length. The data reveal no such pattern. The average class period in the actions studied is about 243 days, a little over eight months. Median class periods are an even shorter 199 days, just over six months. Less than 3% of the actions studied involved class periods longer than 2.5 years.

Even if long-term frauds are relatively rare, one might ask what the harm is in extending the statute of limitations to five years? To be sure, such an extension might assist some investors who have been harmed by long-term frauds, but it will also likely impose significant costs on our capital markets as well. When Congress passed the PSLRA it was concerned with the problem of non-meritorious class actions brought for their settlement value. While the PSLRA has given defendants significant tools to fight non-meritorious cases, these cases have not been completely eliminated. Corporations may still have strong incentives to settle such cases, in part because of the large theoretical damages generated in open-market securities fraud cases and the reluctance of defendants to risk an adverse jury verdict that could potentially bankrupt the company. Extending the statute of limitations increases this settlement pressure because it creates even larger theoretical damages. These error costs also reduce deterrence and decrease social welfare.<sup>99</sup>

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<sup>98</sup> See Barnaby J. Feder & Seth Schiesel, *WorldCom Finds \$3.3 Billion More in Irregularities*, N.Y. TIMES, Aug. 9, 2002, at A1 (reporting accounting irregularities dating back to 1999).

<sup>99</sup> Polinsky & Shavell, *supra* note 13, at 318.

Even if a longer limitations period were warranted, the provision is poorly drafted. It is inconsistent with express statutes of limitation already contained in the federal securities laws and is likely to create significant interpretational difficulties for courts.

Although the drafters' primary aim appears to be to extend the statute of limitations for Rule 10b-5 actions, the SOA has a much broader effect because it applies to all causes of action under the Securities Act and the Exchange Act. There are a number of express private rights of action in those statutes, each of which is already governed by an explicit statute of limitations. The new limitations period does not contain an exception for acts of Congress with their own limitations periods.<sup>100</sup> Thus, if one of the express causes of action involves a claim of fraud, deceit, manipulation, or contrivance, two statutes of limitations will apply to it—the express provision of the federal securities laws and 28 U.S.C. § 1658(b). This appears to be the case for at least three provisions of the Exchange Act: (1) manipulation claims under section 9(e);<sup>101</sup> (2) misleading statement claims under section 18;<sup>102</sup> and (3) certain insider trading claims under section 20A.<sup>103</sup>

The SOA may also present significant problems for causes of action that do not require proof of scienter. For example, claims under sections 11 and 12(a)(2) of the Securities Act do not require that the plaintiff prove fraud, but a number of courts have found that such claims may still “sound in fraud.”<sup>104</sup> Courts applying the SOA may have to determine whether these claims sound in fraud before determining the appropriate limitations period to apply. Thus, different claims under the same express liability provisions may be governed by different statutes of limitations. Different courts are likely to reach different

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<sup>100</sup> See *Lampf*, 501 U.S. at 364 n.10.

<sup>101</sup> See 15 U.S.C. § 78i(e) (2000) (manipulation claims must be brought within one year after the discovery and within three years after violation).

<sup>102</sup> See *id.* 78r(c) (2000) (claims for false or misleading SEC filings must be brought within one year after discovery and within three years after cause of action accrued).

<sup>103</sup> See *id.* § 78t-1(b)(4) (contemporaneous insider trading claims may not be brought more than five years after the date of the last transaction that is the subject of the violation).

<sup>104</sup> See, e.g., *Anderson v. Clow*, 89 F.3d 1399, 1405 (9th Cir. 1996); *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1223 (1st Cir. 1996).



conclusions on this issue, thereby creating uncertainty for potential plaintiffs and defendants as to the viability of a particular claim. Such inconsistencies may encourage forum shopping and increase the costs of securities fraud actions as litigants clash over whether the limitations period has run—precisely the kinds of problems the Supreme Court sought to avoid when it adopted a uniform limitations period.<sup>105</sup>

#### IV. STRENGTHENING THE COP ON THE BEAT: COMMISSION RESOURCES AND AUTHORITY

For years the SEC has been on a starvation diet. The SEC (with a staff of about 3,000) oversees nine national securities exchanges, the over-the-counter market, seventy alternative trading systems, twelve registered clearing agencies, 8,000 registered broker-dealers that employ over 700,000 registered representatives, 8,000 transfer agents, 5,000 investment companies, 7,400 investment advisers, and 14,000 issuers.<sup>106</sup> Throughout the 1990s, as the securities markets became larger, more complex, and increasingly global, the SEC's resources lagged increasingly farther behind its workload. For example, from 1990 through 2000 the SEC's enforcement staff grew by 16% while the number of complaints grew 100%.<sup>107</sup> The percentage of corporate filings that received a full or partial review dropped from 21% percent in 1990 to 8% in 2000.<sup>108</sup> The SEC has also been hampered by substantial staff turnover, driven in part by large pay differentials between the SEC and other financial regulators. Although President Bush signed a pay-parity law to address these concerns,<sup>109</sup> his initial 2003 budget did not fund it.

The SOA seeks to reverse this trend. It significantly increases the SEC's resources, increasing SEC appropriations for fiscal year 2003 to \$776 million, a 66% percent increase from the \$466.9 million in President Bush's original budget proposal. About 30% of that increase is earmarked to add 200 employees

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<sup>105</sup> See *Lampf*, 501 U.S. at 357.

<sup>106</sup> U.S. GEN. ACCOUNTING OFFICE, REP. NO. GAO-02-302, SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES 3 (March 2002).

<sup>107</sup> *Id.* at 13.

<sup>108</sup> *Id.* at 22.

<sup>109</sup> Investor and Capital Markets Fee Relief Act, Pub. L. No. 107-123, 115 Stat. 2390 (2002) (to be codified in scattered sections of 15 U.S.C.).

for auditor oversight and to improve the SEC's "investigative and disciplinary effort[s]."<sup>110</sup> Another third is slated to raise the pay of SEC employees to levels commensurate with other financial regulators.<sup>111</sup>

Even with these funding increases, the SEC is likely to be resource-constrained over the short-term. It will take some time to add and train new staff. The SOA gives the SEC substantial rulemaking responsibilities over the course of the next year.<sup>112</sup> The SOA also directs the SEC to review publicly traded issuers' periodic disclosures "on a regular and systematic basis for the protection of investors."<sup>113</sup> Still, these budget increases, if maintained in the future, may well provide more substantial deterrence than the more publicized criminal provisions of the SOA. A large body of empirical literature suggests that increasing the risk of detecting crimes (which is primarily what this budget increased does) has a more substantial deterrent effect than increasing sanctions.<sup>114</sup>

The SOA not only increases the SEC budget, it also

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<sup>110</sup> Sarbanes-Oxley Act § 601 (amending 15 U.S.C. § 78kk).

<sup>111</sup> The SEC is to use the remaining increase for technology and security enhancements and for expenses related to September 11th.

<sup>112</sup> The Act also directs the SEC to undertake a number of studies. The Commission is required to study: (i) its enforcement actions over the preceding five years that have included civil penalties or disgorgement "to identify areas where such proceedings may be utilized to efficiently, effectively, and fairly provide restitution for injured investors," *id.* § 308(c)(1)(A), (ii) "the role and function of credit rating agencies," *id.* § 702, (iii) securities law violations among professionals practicing before the Commission for the period 1998 to 2001, *id.* § 703, (iv) all enforcement actions over the previous five years "to identify areas of reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management," *id.* § 704, (v) the extent that issuers use off-balance sheet transactions and special purpose entities and whether current GAAP rules make the accounting for such transactions sufficiently transparent, *id.* § 401(c), and (vi) whether it is appropriate for the United States to adopt a principles-based accounting system, *id.* § 108(d)(1)(a).

<sup>113</sup> *Id.* § 408(a) (to be codified at 15 U.S.C. § 7266). At a minimum, the SEC is required to review an issuer's filings at least once every three years. *Id.* § 408(c). In scheduling reviews, the Sarbanes-Oxley Act directs the SEC to consider, among other factors, whether the issuer: (i) issued a material restatement; (ii) has significant stock price volatility; (iii) has a large market capitalization; (iv) is an emerging company with a disparity in price to earnings ratio; and (v) is in a material sector of the economy. *Id.* § 408(b).

<sup>114</sup> See JAMES Q. WILSON & RICHARD J. HERRNSTEIN, CRIME AND HUMAN NATURE 398 (1985); Eide, *supra* note 13, at 359; Jeffrey Grogger, *Certainty vs. Severity of Punishment*, 29 ECON. INQUIRY 297, 304 (1991). See generally Isaac Ehrlich, *Participation in Illegitimate Activities: A Theoretical and Empirical Investigation*, 81 J. POL. ECON. 521 (1973).

enhances the enforcement tools at the SEC's disposal. These provisions are important for deterrence to the extent that they increase the probability of a successful enforcement action and increase the loss if caught (and therefore the severity of the punishment).<sup>115</sup> The most significant enforcement change for officers and directors is the expansion of the SEC's authority to bar individuals from serving as officers and directors of reporting companies if those individuals have violated section 17(a)(1) of the Securities Act or section 10(b) of the Exchange Act. Previously, the SEC could only obtain so-called O&D bars in a federal court action by showing that the person was "substantially unfit" to serve as an officer or director.<sup>116</sup> The SOA amends this standard from "substantial unfitness" to "unfitness."<sup>117</sup> This change flowed from SEC arguments "that the 'substantial unfitness' standard for imposing bars is inordinately high, causing courts to refrain from imposing bars even in cases of egregious misconduct."<sup>118</sup>

It remains to be seen how courts will interpret this provision. Most courts interpreting the "substantial unfitness" standard followed the six-factor analysis established in *SEC v. Patel*.<sup>119</sup> Courts have most frequently focused on the likelihood of recurrence as the determining factor in granting or denying the bar order.<sup>120</sup> Even under an "unfitness" standard, courts are

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<sup>115</sup> PYLE, *supra* note 16, at 13.

<sup>116</sup> 15 U.S.C. §§ 77t(e), 78u(d)(2) (2000).

<sup>117</sup> Sarbanes-Oxley Act § 305.

<sup>118</sup> See *SEC v. Patel*, 61 F.3d 137, 141 (2d Cir. 1995) (reversing district court imposition of bar order because SEC had not sufficiently demonstrated likelihood of future misconduct).

<sup>119</sup> *Patel*, 61 F.3d at 141. The *Patel* court held that the court should consider: "(1) the 'egregiousness' of the underlying securities law violation; (2) the defendant's 'repeat offender' status; (3) the defendant's 'role' or position when he engaged in the fraud; (4) the defendant's degree of scienter; (5) the defendant's economic stake in the violation; and (6) the likelihood that misconduct will recur." *Id.* (quoting Jayne W. Barnard, *When Is a Corporate Executive "Substantially Unfit to Serve"?*, 70 N.C. L. REV. 1489, 1492-93 (1992)).

<sup>120</sup> See, e.g., *SEC v. First Pac. Bancorp*, 142 F.3d 1186, 1193-94 (9th Cir. 1998) (affirming bar order against recidivist defendant); *Patel*, 61 F.3d at 142 (suggesting that "loss of livelihood and the stigma attached to permanent exclusion from the corporate suite" should in most cases require substantial evidence before imposing permanent bar); *SEC v. Posner*, 16 F.3d 520, 521-22 (2d Cir. 1994) (holding bar order appropriate because defendants' "high degree of scienter" and "... past securities law violations... demonstrated that such violations were likely to continue"); *SEC v. Chester Holdings, Ltd.*, 41 F. Supp. 2d 505, 530 (D.N.J. 1999) (permanently barring defendant who had "been restrained, censured, fined, and

likely to continue to insist on a showing of potential future violations.

Any such continuing reluctance may make very little practical difference to the SEC because section 1105 of the SOA now permits the SEC to impose O&D bars in cease-and-desist proceedings under sections 8A of the Securities Act<sup>121</sup> and 21C of the Exchange Act.<sup>122</sup> Thus, the SEC may now obtain O&D bars in administrative actions without a federal court order. Cease-and-desist proceedings employ the same "unfitness" standard as court actions,<sup>123</sup> but the SEC is not typically required to show likelihood of repetition in cease-and-desist proceedings.<sup>124</sup>

As a result, it is reasonable to expect more frequent imposition of such bars,<sup>125</sup> although it is unclear how much additional deterrence such orders provide. For example, consider the most recent high profile bar order involving Al Dunlap, formerly Chairman of Sunbeam Corporation. Mr. Dunlap acquired a reputation as an effective, if brutal, leader of troubled companies, earning him the sobriquet "Chainsaw Al." That reputation suffered substantially when he was implicated in the accounting scandal at Sunbeam and when media reports linked him to other similar accounting scandals earlier in his career.<sup>126</sup> While the SEC's bar order officially closes the door on Mr. Dunlap's colorful career, was it terribly likely that he was going to serve as an officer and director of a publicly traded company in the future? If such service were unlikely, does prohibiting it create much deterrence for future officers bent on fraud? It is certainly possible that a well-publicized O&D bar might impose additional reputational loss, but the real benefit of the bar seems to be in preventing the particular wrongdoer from committing additional acts—precisely the standard courts used in reviewing request for such relief.

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even imprisoned for prior securities violations").

<sup>121</sup> Sarbanes-Oxley Act § 1105(b) (amending 15 U.S.C. § 78u-3).

<sup>122</sup> Sarbanes-Oxley Act § 1105(a) (amending 15 U.S.C. § 77h-1).

<sup>123</sup> 15 U.S.C. §§ 77h-1, 78u-3 (2000).

<sup>124</sup> See 10 LOSS & SELIGMAN, *supra* note 89, at 4989.

<sup>125</sup> Even prior to passage of the Sarbanes-Oxley Act, the SEC increasingly sought bar orders in its actions. See Michael Schroeder, *Dunlap Settles Fraud Charges With the SEC*, WALL ST. J., Sept. 5, 2002, at C14 (noting that in this fiscal year, SEC has sought 93 bar orders, almost twice as many as it sought in fiscal year 2001).

<sup>126</sup> See Floyd Norris, *An Executive's Missing Years: Papering over Past Problems*, N.Y. TIMES, July 16, 2001, at A1.

In any event, although one may raise questions about the legitimate scope of SEC enforcement powers, it is certain that the SEC has its work cut out for it. While it has been given substantial additional resources, it has also been given substantial new responsibilities. It also has an enormous amount of rulemaking to accomplish in a relatively short time. Nonetheless, the increase in SEC resources and enforcement authority may prove to be one of the most important changes that the SOA makes.

#### CONCLUSION

Congress said it was getting tough on corporate crime when it passed the SOA. It trumpeted its new crimes and new enhanced penalties as providing significant deterrence for securities fraud. In reality, these provisions are unlikely to have much real impact on deterrence. They criminalize little additional conduct and do little to enhance real penalties. Even if they did meaningfully increase penalties, economic literature suggests that such increases have comparatively little impact on increasing deterrence. Likewise, the lengthened statute of limitations creates an enhanced detection risk, but empirical data suggest that the previous limitations periods were sufficient. Far more significant than these reforms are the increased resources and enforcement authority at the SEC. In particular, the increased enforcement resources (especially if maintained in the future) may significantly increase the likelihood that securities fraud is detected. Increasing detection may well have a much greater long-term impact on deterrence than enhanced penalties.