

## Implied Private Actions Under Sarbanes-Oxley

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### INTRODUCTION

The Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley” or “Act”),<sup>1</sup> was enacted in the wake of vast stock market declines and congressional investigations of widespread financial misstatements and other misconduct in American corporations and in American capital markets. In many ways, the Act is the most comprehensive legislation to impact the federal securities laws since the 1930s. Senate Report No. 107-205, which accompanied the Sarbanes-Oxley legislation, stated:

The purpose of the bill [S. 2673, which largely comprised the Act] is to address the systemic and structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility in recent months and years. The bill creates a strong independent board to oversee the conduct of the auditors of public companies, and it strengthens auditor independence from corporate management by limiting the scope of non-audit services that auditors can offer their public company audit clients. . . .

The bill also requires steps to enhance the direct responsibility of senior corporate management for financial reporting and for the quality of financial disclosures made by

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<sup>1</sup> Pub. L. No. 107-204, 116 Stat. 745 (2002).

public companies. The bill establishes clear statutory rules to limit, and expose to public view, possible conflicts of interest affecting securities analysts. Finally, the bill authorizes substantially higher funding for the Securities and Exchange Commission.<sup>2</sup>

The Act also provides that company audit committees are responsible for the appointment, compensation, and oversight of the work of their auditors. The independence of company audit committees is strengthened by prohibiting committee members from accepting consulting fees from the company and by barring committee members from being affiliated persons of the company other than in their capacity as board members. The Act prohibits insider trades during pension blackout periods, requires prompt disclosure of insider trades in company stock, lengthens the limitations period for securities fraud actions, establishes a new federal crime of securities fraud, and enacts into law a number of other provisions designed “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.”<sup>3</sup>

While the Act contains a number of provisions expressly granting private parties the right to sue for violations of the Act, there is an important question as to whether or not private actions may be implied under certain provisions of the Act. In other words, should the courts imply private rights of action where such rights have not been granted expressly by the Act? Conceptually, such implied private actions could be based upon specific existing provisions of the federal securities laws which already sustain implied private actions, such as the Securities Exchange Act of 1934 (“Exchange Act” or “SEA”) section 10(b)<sup>4</sup> and Rule 10b-5<sup>5</sup> or SEA section 14(a)<sup>6</sup> and Rule 14a-9;<sup>7</sup> or such implied private actions could rest solely upon the new statutory provisions of the Act.

We will address the state of the existing law with respect to implying private actions under the federal securities laws, the legislative history of the Act as this legislative history addresses implying private actions under the Act, and, most important, the specific language of the Act itself as that language relates to the issue

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<sup>2</sup> REPORT OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS OF THE UNITED STATES SENATE TO ACCOMPANY S. 2673, S. REP. NO. 107-205, at 2 (2002).

<sup>3</sup> See the preamble to the Act, Pub. L. No. 107-204, 116 Stat. 745, 745 (2002).

<sup>4</sup> 15 U.S.C. § 78j(b) (2000).

<sup>5</sup> 17 C.F.R. § 240.10b-5 (2003).

<sup>6</sup> 15 U.S.C. § 78n(a) (2000).

<sup>7</sup> 17 C.F.R. § 240.14a-9 (2003).

of implying private actions under the Act. We will also examine SEC rules and releases promulgated pursuant to the Act, focusing upon the issue of implied liabilities.

#### BACKGROUND

The expansion and contraction of the application of the concept of implying private actions under the federal securities laws and certain other statutes has been examined elsewhere in considerable detail.<sup>8</sup> In this Section, we will focus briefly upon the high points of that analysis in order to establish the framework for the proper approach to implied private actions under the Act.

In *Cort v. Ash*,<sup>9</sup> the U.S. Supreme Court rejected a stockholder's implied action against directors for violation of a criminal statute that prohibited corporate expenditures in campaigns for federal office. A unanimous Court, per Mr. Justice Brennan, stated:

In determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant. First, is the plaintiff "one of the class for whose especial benefit the statute was enacted"<sup>10</sup>—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one?<sup>11</sup> Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff?<sup>12</sup> And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?<sup>13</sup>

Four years after *Cort*, the High Court changed direction, and in a 6-3 decision in *Cannon v. University of Chicago*,<sup>14</sup> implied a private right of action under section 901(a) of Title IX of the Education Amendments of 1972, which prohibits sex discrimination by universities receiving federal financial assistance. The action had

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<sup>8</sup> See 1 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD AND COMMODITIES FRAUD §§ 2:53 *et seq.* (2d ed. 2003).

<sup>9</sup> 422 U.S. 66 (1975).

<sup>10</sup> *Id.* at 78 (citing *Tex. & Pac. Ry. Co. v. Rigsby*, 241 U.S. 33, 39 (1916)).

<sup>11</sup> *Id.* (citing *Nat'l R.R. Passenger Corp. v. Nat'l Ass'n of R.R. Passengers*, 414 U.S. 453, 458 (1974)).

<sup>12</sup> *Id.* (citing *Sec. Investor Prot. Corp. v. Barbour*, 421 U.S. 412, 423 (1975); *Nat'l R.R. Passenger Corp.*, 414 U.S. 453; *Calhoun v. Harvey*, 379 U.S. 134 (1964)).

<sup>13</sup> *Id.* (citing *Bivens v. Six Unknown Named Agents of Fed. Bureau of Narcotics*, 403 U.S. 388, 394, 395 (1971); *id.* at 400 (Harlan, J., concurring); *J.I. Case Co. v. Borak*, 377 U.S. 426, 434 (1964); *Wheeldin v. Wheeler*, 373 U.S. 647, 652 (1963)).

<sup>14</sup> 441 U.S. 677 (1979).

been brought by a female who was denied admission to medical school at two private universities. For our purposes, however, the most significant element in the Court's opinion, as well as in the concurring and dissenting opinions, was the emphasis upon the importance of the second *Cort* factor—the legislative intent—in comparison to *Cort*'s three other factors.

*Cannon*'s emphasis upon *Cort*'s second factor—legislative intent—was reiterated later in the same year by the Supreme Court in a leading case involving the federal securities laws. In *Touche Ross & Co. v. Redington*,<sup>15</sup> the High Court determined that a broker's customers had no implied action for damages against the broker's auditors for alleged misstatements contained in the reports required under section 17(a) of the Exchange Act.<sup>16</sup> The Court wrote:

It is true that in *Cort v. Ash*, the Court set forth four factors that it considered "relevant" in determining whether a private remedy is implicit in a statute not expressly providing one. But the Court did not decide that each of these factors is entitled to equal weight. The central inquiry remains whether Congress intended to create, either expressly or by implication, a private cause of action. Indeed, the first three factors discussed in *Cort*—the language and focus of the statute, its legislative history, and its purpose—are ones traditionally relied upon in determining legislative intent. Here, the statute by its terms grants no private rights to any identifiable class and proscribes no conduct as unlawful. And the parties as well as the Court of Appeals agree that the legislative history of the 1934 Act simply does not speak to the issue of private remedies under § 17(a). At least in such a case as this, the inquiry ends there: The question whether Congress, either expressly or by implication, intended to create a private right of action, has been definitely answered in the negative.<sup>17</sup>

*Redington*'s focus upon legislative intent as manifested in the language and terms of the statute and to a lesser degree in the legislative history was reemphasized in the Supreme Court's 1994 decision in *Central Bank of Denver v. First Interstate Bank of Denver*.<sup>18</sup> In *Central Bank*, the High Court refused to imply a private right of action for aiding and abetting securities fraud under SEA section 10(b). The Court's analysis concentrated almost exclusively upon the text of the statute.

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<sup>15</sup> 442 U.S. 566 (1979).

<sup>16</sup> 15 U.S.C. § 78q(a) (2000).

<sup>17</sup> *Touche Ross*, 442 U.S. at 575-76 (internal citation omitted).

<sup>18</sup> 511 U.S. 164 (1994).

We have refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute.

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Adherence to the text in defining the conduct covered by § 10(b) is consistent with our decisions interpreting other provisions of the securities Acts. In *Pinter v. Dahl*, for example, we interpreted the word “seller” in § 12(1) of the 1933 Act by “looking first at the language of § 12(1).” Ruling that a seller is one who solicits securities sales for financial gain, we rejected the broader contention, “grounded in tort doctrine,” that persons who participate in the sale can also be deemed sellers. We found “no support in the statutory language or legislative history for expansion of § 12(1),” and stated that “[t]he ascertainment of congressional intent with respect to the scope of liability created by a particular section of the Securities Act must rest primarily on the language of that section.”

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Our consideration of statutory duties, especially in cases interpreting § 10(b), establishes that the statutory text controls the definition of conduct covered by § 10(b).<sup>19</sup>

Our conclusion from the above discussion is that the existence or non-existence of implied private actions under specific provisions of Sarbanes-Oxley must be determined by reference to the legislative intent. And legislative intent is determined primarily through an analysis of the text and language of the statute and to a lesser degree through an analysis of the statute’s legislative history and purpose.

#### LEGISLATIVE HISTORY

For reasons of organization and clarity, it is now appropriate to address the legislative history of Sarbanes-Oxley. We will address the text and language of the statute in subsequent sections. This legislative history roughly divides itself into three phases, and a reasonable conclusion after analysis of these phases is that this legislative history is not supportive of implied private actions under the Act.

The first phase of the legislative history is seen in the hearings on February 4-5, 2002 of the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services. In these hearings Representative Christopher Cox of California, who had been one of

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<sup>19</sup> *Id.* at 173-75 (internal citations omitted).

the most avid and vocal proponents of the Private Securities Litigation Reform Act of 1995 (“PSLRA”),<sup>20</sup> moved swiftly to forestall any attempt to roll back this essentially pro-defendant legislation by spinning it as pro-plaintiff. Mr. Cox stated:

I am also very pleased as we meet here today that as we try and pick up the pieces, as the victims of the Enron debacle try through both civil and ultimately criminal proceedings to gain vindication, that we can rely upon the very pro-shareholder legislation that this Congress enacted some years ago in the form of the Securities Litigation Reform Act, because many of the Members of this subcommittee, given our change in jurisdiction in the Congress, were not present at the birthing and the drafting of that legislation. I just want to bring to the Members’ attention some of what it is going to do for the shareholders of Enron who are now seeking vindication. In the old days it used to be that the first lawyers to the courthouse got to represent you in a class action. We ended that abuse. We ended that process and now the court is going to pick the best class representative.

The Securities Litigation Reform Act gives the court the power to review unconscionable attorneys fees so that the recoveries for abused shareholders will be greater. It imposed new responsibilities on auditors to detect and report illegal acts. It eliminated the professional plaintiffs that used to victimize shareholders in fraudulent and extortionate lawsuits. It strengthened the conflict of interest rules relating to attorneys, ensuring that shareholders are going to get fair representation.

. . . [T]he Securities Litigation Reform Act broadened the SEC’s aiding and abetting enforcement authority, strengthening the ability of the Commission to prosecute those who aid and abet violations of our securities laws.

I also wanted to point out, in conclusion, that far from making it more difficult to bring these kinds of lawsuits, it seems to have advantaged meritorious cases. In the 5 years preceding the enactment of the Securities Litigation Reform Act the average number of securities laws fraud suits filed in our Federal courts was 189. That’s increased now 250 percent, so that for 2001 the actual number of cases filed was 486, and the average settlements have gone way up . . . so that shareholders are getting more as a result of these important reforms.<sup>21</sup>

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<sup>20</sup> Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

<sup>21</sup> *The Enron Collapse: Implications to Investors and the Capital Markets: Hearings on H.R. 3763 Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services*, 107th Cong. (Feb. 4, 2002),

Representative Cox's efforts to prevent any weakening of the provisions of the PSLRA were supported by statements from the American Enterprise Institute, the Securities Industry Association, the Financial Executives International, and others. These supporting statements were made at the outset of the hearings on March 13, March 20, and April 9, 2002, before the full House Committee on Financial Services, which was addressing House Bill 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002. House Bill 3763, together with Senate Bill 2673, was subsequently enacted as the Sarbanes-Oxley Act of 2002.

At this second set of House hearings, however, a second phase of legislative history with respect to Sarbanes-Oxley emerged in the forceful statements of Representatives John La Falce of New York, Melvin Watt of North Carolina, and Brad Sherman of California supporting the enhancement of the rights of private litigants to enforce the securities laws. Representative Watt clearly articulated this position.

So one of the things I particularly feel strongly about is that there is a very important role for private litigants to enforce rights in this context. We can't give responsibility solely to the SEC and say you have got absolute authority to do this, and if you don't do it, then nobody is going to have the authority to do it. Our whole accountability system in this country is based on the rights of individuals to hold corporations and other individuals accountable when they feel like they have been wronged. So, at a minimum, we need to put some of those provisions in the bill to provide for private litigants to protect their own rights, and that I think is a hallmark of the way our system should work.<sup>22</sup>

The majority of the legislators who passed Sarbanes-Oxley, however, did not accept this position articulated by Representative Watt. The third and final phase of the congressional debates regarding Sarbanes-Oxley appeared to militate against the expansion of implied private actions under the Act. This interpretation is supported by the statements of a number of Congressmen on July 25, 2002 during the debate on the conference report on House Bill 3763, a report which essentially comprised the Act.

Representative Watt and others, who had championed the enhancement of the rights of private litigants under the Act and who were now faced with a *fait accompli* in the final version of the Act,

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available at [http://commdocs.house.gov/committees/bank/hba77683.000/hba77683\\_of.htm](http://commdocs.house.gov/committees/bank/hba77683.000/hba77683_of.htm) (last visited Mar. 18, 2004).

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

made resigned statements emphasizing the need for *future* studies regarding civil actions, and stressing that the Act was really “just the first step.”<sup>23</sup> Their conclusion appeared to be that the final version of the Act, whatever else it accomplished, did not do enough to enhance the rights of private plaintiffs in civil litigation. Representative Watt spoke to the need for additional studies, stating:

Let me applaud the chair and ranking member of the House Committee on Financial Services for the job they did starting the process. We had a bill that was a reasonable start, that has been significantly improved upon during the course of the conference, and one of the things that the bill does is ratchet up criminal penalties, but I want to take some time to say that I am not sure that just ratcheting up criminal penalties will do the job.

But there are some things in the conference report which require us and the SEC and GAO to do additional studies and report back to the committees of jurisdiction about either regulatory action that is recommended or legislative action that is recommended, and one of those things is an SEC study of violations and violators and whether we have undermined the ability of individuals to bring claims in civil court to enforce their rights and protect their status as investors.

I do not want to overlook some of those studies that will be reporting back to us because I think this bill is really just the first step, and I applaud us for making that step.<sup>24</sup>

Representative Carson of Indiana stated:

The Conference bill before us today provides the absolute minimum protections to protect investors and restore market confidence.

Still, this measure could be stronger and certainly disgorging the ill gotten gains of these criminals and redistributing profits to the victims must be the next step.

We hear frequently that there is little that Congress should do and limit our interference. However, Congress’ passage of the Private Securities Litigation Reform Act of 1995 got us to where we are today. It repealed the civil RICO, thereby preventing defrauded investors from obtaining triple damages when they bring securities fraud claims.

Mr. Speaker, if we are to restore market confidence, and investors and workers are to be made whole, Congress must pass a strong bill that sets penalties, protects whistleblowers, sends

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<sup>23</sup> 148 CONG. REC. H5465 (daily ed. July 25, 2002).

<sup>24</sup> *Id.*



wrongdoers to jail, and ensures transparency.

Assets acquired through fraud and betrayal of confidence should not be allowed to stand when countless Americans close to retirement must now rethink how they will downgrade their retired lives.<sup>25</sup>

Representative Conyers of Michigan emphasized:

As good as this bill is, it's important to note that the agreement is just a first step toward protecting American investors and workers. We still need to fix the many, many giveaways enacted by Congress in the 1995 Securities Litigation bill. For example, we need to restore civil liability against those that aid and abet securities fraud violators, and make sure that civil RICO applies in full to securities fraud. Measures such as this will make it abundantly clear that we will not tolerate future Enron or WorldCom situations.<sup>26</sup>

Representative Tiahrt of Kansas concluded:

One important area which this bill does not address is the issue of returning ill-gotten corporate gains to investors. I believe Congress must act to ensure that investors are able to reclaim their losses which are due to corporate fraud.<sup>27</sup>

#### THE TEXT OF SARBANES-OXLEY

We concluded above that the U.S. Supreme Court has mandated that the existence or non-existence of implied private actions under Sarbanes-Oxley must be determined by reference to the legislative intent. And legislative intent is determined primarily through an analysis of the text and language of the statute and to a lesser degree through an analysis of the statute's legislative history. We also concluded that the legislative history is not supportive of implied private actions under Sarbanes-Oxley.

We now turn to an analysis of the text and language of certain provisions of the statute. Certain provisions by their terms clearly reject the implication of private actions. Other provisions inferentially reject the implication of private actions. Still other provisions are less clear in such a rejection, but the impact and thrust of the text is toward rejection of implied private actions. We will commence our analysis with those provisions which clearly reject the implication of private actions, and move across the spectrum to those provisions which are less clear in their rejection.

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<sup>25</sup> *Id.* at H5470.

<sup>26</sup> *Id.* at H5478.

<sup>27</sup> *Id.*

There are two additional considerations which are embedded in our analysis. First, any private actions implied under Sarbanes-Oxley may be based upon specific existing provisions of the federal securities laws, which already sustain implied private actions, such as SEA section 10(b) and Rule 10b-5; alternatively, such implied private actions may rest solely upon the new statutory provisions of Sarbanes-Oxley. Second, what weight should be given to SEC releases and rules promulgated under specific provisions of Sarbanes-Oxley *after* the enactment of the statute? In some instances, such as with respect to the professional conduct of lawyers, the Commission has been careful specifically to reject any creation of implied private actions. In other instances, such as new Regulation G<sup>28</sup> addressing pro forma financial statements, the Commission has opined that violations of Regulation G may also be violations of SEA section 10(b) and Rule 10b-5.

#### SPECIFIC STATUTORY REJECTION OF IMPLIED PRIVATE ACTIONS

Section 804 of Sarbanes-Oxley,<sup>29</sup> the new statute of limitations for securities fraud, states clearly and unequivocally:

(c) NO CREATION OF ACTIONS.—Nothing in this section shall create a new, private right of action.<sup>30</sup>

While this statutory language is clear, simple, and unambiguous, the complete section 804 raises complex questions regarding implied private actions.

Section 804(a) of the Act amends 28 U.S.C. § 1658, which now reads in full:

Section 1658—Time limitations on the commencement of civil actions arising under Acts of Congress

(a) Except as otherwise provided by law, a civil action arising under an Act of Congress enacted after the date of the enactment of this section may not be commenced later than 4 years after the cause of action accrues.

(b) Notwithstanding subsection (a), a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), may be brought not later than the earlier of—

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<sup>28</sup> 17 C.F.R. §§ 244.100-102 (2003).

<sup>29</sup> 28 U.S.C. § 1658 (2003).

<sup>30</sup> *Id.*

(1) 2 years after the discovery of the facts constituting the violation; or

(2) 5 years after such violation.<sup>31</sup>

In addition to amending 28 U.S.C. § 1658, section 804 further provides:

(b) EFFECTIVE DATE.—The limitations period provided by section 1658(b) of title 28, United States Code, as added by this section, shall apply to all proceedings addressed by this section that are commenced on or after the date of enactment of this Act.

(c) NO CREATION OF ACTIONS.—Nothing in this section shall create a new, private right of action.<sup>32</sup>

There may be a certain conflict among the sections quoted above. Generally speaking, section 804 extends the pre-Sarbanes-Oxley statutes of limitations applicable to claims of fraud under the federal securities laws from one year after the discovery of the facts constituting the violation but no more than three years after the violation, to two years after discovery but no more than five years after the violation. In addition, section 804 applies to all fraud claims under the federal securities laws commenced after the enactment of Sarbanes-Oxley. Thus, for example, a securities fraud claim which accrued four years prior to the enactment of the statute and was therefore barred at the time of enactment by the three year pre-enactment statute of limitations, could be revived and commenced after enactment unless such revival is deemed to “create a new, private right of action” under 804(c).

Another example of clear statutory rejection of implied private actions under Sarbanes-Oxley appears in section 303,<sup>33</sup> which prohibits improper influence on the conduct of audits. Section 303(b) states unequivocally:

ENFORCEMENT.—In any civil proceeding, the Commission shall have exclusive authority to enforce this section and any rule or regulation issued under this section.<sup>34</sup>

While the above language is clear and unambiguous, the full section may raise questions with respect to implied private actions. Section 303 states in full:

(a) RULES TO PROHIBIT.—It shall be unlawful, in contravention of such rules or regulations as the Commission

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<sup>31</sup> *Id.*

<sup>32</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 804, 116 Stat. 745, 801 (2002).

<sup>33</sup> 15 U.S.C. § 7242(b) (2003).

<sup>34</sup> *Id.*

shall prescribe as necessary and appropriate in the public interest or for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

(b) ENFORCEMENT.—In any civil proceeding, the Commission shall have exclusive authority to enforce this section and any rule or regulation issued under this section.

(c) NO PREEMPTION OF OTHER LAW.—The provisions of subsection (a) shall be in addition to, and shall not supercede or preempt, any other provision of law or any rule or regulation issued thereunder.

(d) DEADLINE FOR RULEMAKING.—The Commission shall—

(1) propose the rules or regulations required by this section, not later than 90 days after the date of enactment of this Act; and

(2) issue final rules or regulations required by this section, not later than 270 days after that date of enactment.<sup>35</sup>

While the SEC may have exclusive authority to enforce this section under subsection (b) above, subsection (c) would appear to allow a private party to initiate an implied private action based upon section 10(b) and Rule 10b-5 to seek redress for conduct denominated as fraudulently manipulative or misleading under subsection (a).

There are two additional points worth noting in addressing specific statutory rejections of implied private actions under Sarbanes-Oxley. First, section 409, which requires real-time disclosure by issuers of material changes in operations, initially provided that only the SEC could enforce section 409 in a civil action.<sup>36</sup> The Sarbanes-Oxley Conference Committee, however, chose to drop this requirement prior to the statute's enactment. Second, section 305 provides that in any action initiated by the SEC "the Commission may seek, and any federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of

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<sup>35</sup> *Id.*

<sup>36</sup> *Id.* § 78m.

investors.”<sup>37</sup> Since this provision would appear to cover financial, as well as other redress, it adds additional strength to the argument that implied private actions are not necessary to make investors whole under Sarbanes-Oxley.

#### EXPRESS ACTIONS NEGATE IMPLIED ACTIONS

Moving across the spectrum from sections 804 and 303 of Sarbanes-Oxley, which by their specific terms reject implied private actions, we address two statutory sections of the Act that provide for express private actions in the event of their violation. The clear inference from the provision of an express statutory private action for the violation of a particular section of the Act is the negation of an implied private action for a violation of that same section.

Section 306 of Sarbanes-Oxley prohibits the directors and executive officers of an issuer from purchasing or selling any equity security of the issuer during a pension plan blackout period that temporarily prevents plan participants from engaging in equity securities transactions through their plan accounts.<sup>38</sup> These restrictions apply if the director or executive officer acquired his security in connection with his services as a director or executive officer. If this prohibition is violated, the statute specifically provides:

(2) REMEDY.—

(A) IN GENERAL.—Any profit realized by a director or executive officer referred to in paragraph (1) from any purchase, sale, or other acquisition or transfer in violation of this subsection shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such director or executive officer in entering into the transaction.

(B) ACTIONS TO RECOVER PROFITS.—An action to recover profits in accordance with this subsection may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer fails or refuses to bring such action within 60 days after the date of request, or fails diligently to prosecute the action thereafter, except that no such suit shall be brought more than 2 years after the date on which such profit was realized.<sup>39</sup>

In addition to the express statutory text, Exchange Act Release No.

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<sup>37</sup> *Id.* § 78u(d)(5).

<sup>38</sup> *Id.* § 7244.

<sup>39</sup> 15 U.S.C. § 7244.

34-47225,<sup>40</sup> which promulgated rules under section 306, gives no hint of any authorization for an implied private action.

Section 806 of Sarbanes-Oxley provides federal protection to employees of public companies when they act lawfully to disclose information about fraudulent activities within their company.<sup>41</sup> If the employer does take illegal action against the whistleblower in retaliation for lawful and protected conduct, section 806 specifically authorizes the whistleblower to file a complaint with the Department of Labor. If the Department does not resolve the matter within 180 days, the whistleblower is authorized to commence an action in federal court. Section 806 specifically sets out the procedure that a whistleblower must follow to institute a federal action, the burden of proof, the statute of limitations, and the permissible damages.

As with respect to section 303 discussed above, however, section 806(d) provides:

(d) RIGHTS RETAINED BY EMPLOYEE.—Nothing in this section shall be deemed to diminish the rights, privileges, or remedies of any employee under any Federal or State law, or under any collective bargaining agreement.<sup>42</sup>

Arguably, this provision may authorize an implied private action under state or federal law for conduct violative of section 806 when such conduct also violates other laws.

#### STATUTORY PROVISIONS ADVERSELY IMPACTING IMPLIED PRIVATE ACTIONS

Continuing our move across the spectrum from statutory provisions of the Act which by their specific terms reject implied private actions, to statutory provisions which provide for express private actions thereby inferentially negating implied private actions, we now address statutory provisions whose thrust and impact is against implied private actions.

Perhaps the most fundamental reform introduced by Sarbanes-Oxley is the creation of the Public Company Accounting Oversight Board. The Board is carefully organized to be both independent of the accounting industry and subject to supervision by the SEC. Congress provided funding for the Board by imposing fees on public companies and granted the Board broad powers to set auditing, quality control, and ethical standards for accounting firms that audit

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<sup>40</sup> Insider Trades During Blackout Periods, Exchange Act Release No. 47225, [2002-2003 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 86,817 (Jan. 22, 2003).

<sup>41</sup> 18 U.S.C. § 1514A (2003).

<sup>42</sup> *Id.*

public companies. In addition, under the Act, the Board has authority to inspect, investigate, and bring disciplinary proceedings against these accounting firms.

As part of its responsibilities, the Board is directed to conduct a continuing program of inspections of registered public accounting firms to assess the degree of compliance by these firms with the Act, the rules of the SEC and the Board, and professional standards in connection with the performance of audits and related matters involving issuers. The Board is directed to prepare a written report of its findings for each inspection and make this report available to the public,

except that no portions of the inspection report that deal with criticisms of or potential defects in the quality control systems of the firm under inspection shall be made public if those criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report.<sup>43</sup>

The thrust and impact of this rather unusual provision will be adverse to the initiation and prosecution of implied private actions because it will deny to plaintiffs' lawyers the very type of official findings adverse to accounting firms which are the lifeblood of their lawsuits.

Another provision of the Act dealing with accounting firms whose thrust and impact is against implied private actions is section 106(a)(1), which states:

(a) APPLICABILITY TO CERTAIN FOREIGN FIRMS.—

(1) IN GENERAL.—Any foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer, shall be subject to this Act and the rules of the Board and the Commission issued under this Act, in the same manner and to the same extent as a public accounting firm that is organized and operates under the laws of the United States or any State, *except that registration pursuant to section 102 shall not by itself provide a basis for subjecting such a foreign public accounting firm to the jurisdiction of the Federal or State courts, other than with respect to controversies between such firms and the Board.*<sup>44</sup>

Since almost all lawsuits asserting implied private actions under the federal securities laws are based upon provisions of the Exchange Act, most particularly section 10(b) and Rule 10b-5, and since, under section 27 of the Exchange Act, the federal courts have exclusive

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<sup>43</sup> Sarbanes-Oxley Act of 2002 § 104(g)(2), 15 U.S.C. § 7214(g)(2) (2003).

<sup>44</sup> *Id.* § 7216(a)(1) (emphasis added).

jurisdiction of these implied private actions,<sup>45</sup> section 106(a)(1) of Sarbanes-Oxley with its limitations upon jurisdiction will make it substantially more difficult to initiate implied private actions against foreign accounting firms.

#### SEC RULES AND RELEASES

In the absence of further manifestations of legislative intent regarding implied private actions in the language and text of specific provisions of Sarbanes-Oxley, we will now address certain SEC rules and releases promulgated under this statute. Clearly, these rules and releases differ from the legislative history and the text of the statute analyzed above because these rules and releases were promulgated after, not before, the enactment of the statute. Therefore, these SEC pronouncements do not constitute manifestations of legislative intent. Rather, they express the SEC's interpretations of legislative intent or, more realistically, what the agency wants the world to believe was the legislative intent. However, as the federal agency with the most direct statutory mandate to protect the investing public through the interpretation, implementation, and enforcement of the federal securities laws, which now include Sarbanes-Oxley, the agency's interpretations of this statute are entitled to substantial analysis and to substantial weight.

As in our analysis of the text of Sarbanes-Oxley, we will first address those SEC rules and releases which clearly reject the implication of private actions, and then move across the spectrum to address those SEC rules and releases which in one instance straddle the issue and in three other instances appear to support implied private actions.

#### IMPLIED PRIVATE ACTIONS AGAINST LAWYERS

Section 307 of Sarbanes-Oxley provides rules of professional responsibility for attorneys.

##### Section 307.—RULES OF PROFESSIONAL RESPONSIBILITY FOR ATTORNEYS.

Not later than 180 days after the enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule—

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<sup>45</sup> Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa (2000).



(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.<sup>46</sup>

The text of the statute is silent regarding implied private actions. Securities Act of 1933 (“Securities Act” or “SA”) Release No. 8150,<sup>47</sup> however, which proposed a rule pursuant to section 307 that would establish standards of professional conduct for attorneys, was unequivocal in its rejection of implied private actions. The SEC release invoked legislative history to buttress its position, stating:

The Commission notes that nothing in Section 307 creates a private right of action against an attorney. Indeed, statements by sponsors of the provision unequivocally demonstrate that there was never an intention to create a right of action by third parties for violation of the rule. Similarly, the Commission does not intend that the provisions of Part 205 create any private right of action against an attorney based on his or her compliance or non-compliance with its provisions.<sup>48</sup>

The SEC’s final release adopting the attorney responsibility rule emphasized that it protected not only attorneys, but law firms and issuers as well.

#### Section 205.7 No Private Right of Action

(a) Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions.

(b) Authority to enforce compliance with this part is vested

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<sup>46</sup> 15 U.S.C. § 7245 (2003).

<sup>47</sup> Attorney Conduct Proposals, Securities Act Release No. 33-8150, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,802, at 85,513 (Nov. 21, 2002).

<sup>48</sup> *Id.* at 86,553 (footnote omitted) (citing 148 CONG. REC. S6552 (daily ed. July 10, 2002) (statement of Sen. Edwards) (“Nothing in this bill gives anybody a right to file a private lawsuit against anybody. The only people who can enforce this amendment are the people at the SEC.”); 148 CONG. REC. S6555 (daily ed. July 10, 2002) (statement of Sen. Enzi) (“[T]his amendment creates a duty of professional conduct and does not create a right of action by third parties.”)).

exclusively in the Commission.

In the proposing release, the Commission expressed its view that: “nothing in Section 307 creates a private right of action against an attorney. . . . Similarly, the Commission does not intend that the provisions of Part 205 create any private right of action against an attorney based on his or her compliance or non-compliance with its provisions.” Nevertheless, the Commission requested comments on whether it should provide in the final rule “a ‘safe harbor’ from civil suits” for attorneys who comply with the rule. Numerous commentators agreed that the final rule should contain such a provision.

Several commentators suggested that the final rule contain a safe harbor similar to that provided for auditors in Section 10A(c) of the Exchange Act, 15 U.S.C. 78j-1(c), which provides that “[n]o independent public accountant shall be liable in a private action for any finding, conclusion, or statement expressed in a report” to the Commission made by an issuer whose auditor has reported to its board a failure to take remedial action. Other commentators recommended that the Commission adopt language similar to that in the Restatement (Third) of Law Governing Lawyers, Standards of Care § 52, which provides that “[p]roof of a violation of a rule or statute regulating the conduct of lawyers . . . does not give rise to an implied cause of action for professional negligence or breach of fiduciary duty. . . .” And others noted that the ABA Model Rules, Scope, & 20, provides that “[v]iolation of a Rule should not itself give rise to a cause of action against a lawyer nor should it create any presumption in such a case that a legal duty has been breached.” Finally, numerous other commentators were of the view that a safe harbor should be created to protect lawyers from liability where they have attempted in good faith to comply with this part.

The Commission is persuaded that it is appropriate to include an express safe harbor provision in the rule, which is set forth in new Section 205.7, No Private Right of Action. Paragraph (a) makes it clear that Part 205 does not create a private cause of action against an attorney, a law firm or an issuer, based upon their compliance or non-compliance with the part. The Commission is of the view that the protection of this provision should extend to any entity that might be compelled to take action under this part; thus it extends to law firms and issuers. The Commission is also of the opinion that, for the safe harbor to be truly effective, it must extend to both compliance and non-compliance under this part.

Paragraph (b) provides that only the Commission may enforce the requirements of this part. The provision is intended

to preclude, among other things, private injunctive actions seeking to compel persons to take actions under this part and private damages actions against such persons. Once again, the protection extends to all entities that have obligations under this part.<sup>49</sup>

IMPLIED PRIVATE ACTIONS AGAINST AUDIT COMMITTEE  
FINANCIAL EXPERTS

Section 407 of Sarbanes-Oxley authorizes rules with respect to “audit committee financial experts.”

Section 407. DISCLOSURE OF AUDIT COMMITTEE  
FINANCIAL EXPERT.

(a) RULES DEFINING “FINANCIAL EXPERT”.—The Commission shall issue rules, as necessary or appropriate in the public interest and consistent with the protection of investors, to require each issuer, together with periodic reports required pursuant to section 13(a) and 15(d) of the Securities Exchange Act of 1934, to disclose whether or not, and if not, the reasons therefore, the audit committee of that issuer is comprised of at least 1 member who is a financial expert, as such term is defined by the Commission.

(b) CONSIDERATIONS.—In defining the term “financial expert” for purposes of subsection (a), the Commission shall consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions—

(1) an understanding of generally accepted accounting principals and financial statements;

(2) experience in—

(A) the preparation or auditing of financial statements of generally comparable issuers; and

(B) the application of such principles in connection with the accounting for estimates, accruals, and reserves;

(3) experience with internal accounting controls; and

(4) an understanding of audit committee functions.

(c) DEADLINE FOR RULEMAKING. — The Commission

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<sup>49</sup> Attorney Conduct Proposals, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 87,097-98 (Jan. 29, 2003) (footnotes omitted).

shall—

(1) propose rules to implement this section, not later than 90 days after the date of enactment of this Act; and

(2) issue final rules to implement this section, not later than 180 days after that date of enactment.<sup>50</sup>

The text of the statute is silent regarding implied private actions. Securities Act Release No. 8177,<sup>51</sup> however, which adopted the rules authorized by section 407, created a safe harbor from liability for audit committee financial experts.

#### 5. Safe Harbor from Liability for Audit Committee Financial Experts

Several commenters urged us to clarify that the designation or identification of an audit committee financial expert will not increase or decrease his or her duties, obligations or potential liability as an audit committee member. A few recommended a formal safe harbor from liability for audit committee financial experts. Unlike the provisions of the Act that impose substantive requirements,[FN34] the requirements contemplated by Section 407 are entirely disclosure-based. We find no support in the Sarbanes-Oxley Act or in related legislative history that Congress intended to change the duties, obligations or liability of any audit committee member, including the audit committee financial expert, through this provision.

In the proposing release, we stated that we did not believe that the mere designation of the audit committee financial expert would impose a higher degree of individual responsibility or obligation on that person. Nor did we intend for the designation to decrease the duties and obligations of other audit committee members or the board of directors. We continue to believe that it would adversely affect the operation of the audit committee and its vital role in our financial reporting and public disclosure system, and systems of corporate governance more generally, if courts were to conclude that the designation and public identification of an audit committee financial expert affected such person's duties, obligations or liability as an audit committee member or board member. We find that it would be adverse to the interests of investors and to the operation of markets and therefore would not be in the public interest, if the designation and identification affected the duties, obligations or liabilities to which any member of the company's audit committee or board is

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<sup>50</sup> 15 U.S.C. § 7265 (2003).

<sup>51</sup> Sarbanes-Oxley Act Disclosures, Securities Act Release No. 33-8177, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,818, at 86,883 (Jan. 23, 2003).

subject. To codify this position, we are including a safe harbor in the new audit committee disclosure item to clarify that:

- A person who is determined to be an audit committee financial expert will not be deemed an “expert” for any purpose, including without limitation for purposes of Section 11 of the Securities Act, as a result of being designated or identified as an audit committee financial expert pursuant to the new disclosure item;
- The designation or identification of a person as an audit committee financial expert pursuant to the new disclosure item does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification; and
- The designation or identification of a person as an audit committee financial expert pursuant to the new disclosure item does not affect the duties, obligations or liability of any other member of the audit committee or board of directors.

This safe harbor clarifies that any information in a registration statement reviewed by the audit committee financial expert is not “expertised” unless such person is acting in the capacity of some other type of traditionally recognized expert. Similarly, because the audit committee financial expert is not an expert for purposes of Section 11, he or she is not subject to a higher level of due diligence with respect to any portion of the registration statement as a result of his or her designation or identification as an audit committee financial expert.

In adopting this safe harbor, we wish to emphasize that all directors bear significant responsibility. State law generally imposes a fiduciary duty upon directors to protect the interests of a company’s shareholders. This duty requires a director to inform himself or herself of relevant facts and to use a “critical eye” in assessing information prior to acting on a matter.<sup>[52]</sup> Our new rule provides that whether a person is, or is not, an audit committee financial expert does not alter his or her duties, obligations or liabilities. We believe this should be the case under federal and state law.

[FN34] For example, the Sarbanes-Oxley Act requires the Commission to direct the self-regulatory organizations by rule to

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<sup>52</sup> See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

mandate the independence of all audit committee members of companies listed on national securities exchanges and associations. See Section 301 of the Sarbanes-Oxley Act. As another example, Section 402 of the Sarbanes-Oxley Act prohibits certain loans made by companies to their directors and executive officers.<sup>53</sup>

There are two points in the above excerpt which bear on the issue of implied private actions under Sarbanes-Oxley. First, the SEC makes the distinction between provisions of the Act that impose “substantive requirements,” which, according to the Commission in footnote thirty-four of the above quote, include prohibitions of certain loans by companies to insiders and self-regulatory rules mandating the independence of all audit committee members, as contrasted to the provisions of section 407 which, according to the Commission in the first paragraph of the above excerpt, are “entirely disclosure-based.” The Commission then opines that Congress did not intend “to change the duties, obligations or liability of any audit committee members, including the audit committee financial expert, through [section 407].” The implication appears to be that Congress did intend to change certain existing duties, obligations, and liabilities through the imposition of the “substantive requirements” of the Act. In the absence of express liabilities, one way to effectuate this change would be through the creation of implied liabilities for violations of these newly imposed “substantive requirements” of the Act.

The second point in the quoted excerpt which bears on the issue of implied private actions under Sarbanes-Oxley is that the SEC’s safe harbor purports to protect the “audit committee financial expert” from liabilities not only under federal law but under state law as well. Query as to whether the SEC, as contrasted to the U.S. Congress, has the power to grant absolution from liabilities under state law.

#### IMPLIED PRIVATE ACTIONS BASED UPON DISCLOSURE OF OFF-BALANCE SHEET TRANSACTIONS

Section 401(a) of Sarbanes-Oxley mandates disclosure with respect to off-balance sheet transactions.

(j) OFF-BALANCE SHEET TRANSACTIONS.—Not later than 180 days after the date of enactment of the Sarbanes-Oxley Act of 2002, the Commission shall issue final rules providing that

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<sup>53</sup> Sarbanes-Oxley Act Disclosures, *supra* note 51, at 86,893-94 & n.34 (footnotes omitted).

each annual and quarterly financial report required to be filed with the Commission shall disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.<sup>54</sup>

Here again, as with respect to lawyers and audit committee financial experts discussed above, the text of the statute is silent regarding implied private actions. Securities Act Release No. 8182,<sup>55</sup> however, which adopted the rules authorized by section 401(a), created “a new safe harbor” to “protect forward-looking statements against private legal actions that are based on allegations of a material misstatement or omission.”<sup>56</sup> The SEC appears to have designed its rule amendments to have a coverage and impact beyond the existing statutory safe harbors contained in Securities Act section 27A<sup>57</sup> and Exchange Act section 21E.<sup>58</sup> The Commission emphasized in Release 8182, which created the new safe harbor via rule amendments:

Because we believe that it would promote more meaningful disclosure, we are invoking rulemaking authority under Sections [SA]27A and [SEA]21E to create a new safe harbor to ensure the application of the statutory safe harbors to the forward-looking statements required under the amendments [to SEC rules adopted by this Release]. The safe harbor is designed to remove possible ambiguity about whether the statutory safe harbors would apply to the forward-looking statements made in response to the amendments. The safe harbor specifies that, except for historical facts, the disclosure would be deemed to be a “forward looking statement” as that term is defined in the statutory safe harbors. In addition, with respect to the MD&A discussion of off-balance sheet arrangements, we are adopting a provision that the “meaningful cautionary statements” element of the statutory safe harbors will be satisfied if a registrant satisfies all of its off-balance sheet arrangements disclosure requirements. Because the new MD&A safe harbor is closely linked to the statutory safe harbors, we urge companies preparing their disclosure to consider the

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<sup>54</sup> 15 U.S.C. § 78m(j) (2003).

<sup>55</sup> Off-Balance Sheet Arrangements, Securities Act Release No. 33-8182, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,821, at 86,969 (Jan. 28, 2003).

<sup>56</sup> *Id.* at 86,985-86.

<sup>57</sup> 15 U.S.C. § 77z-2 (2003).

<sup>58</sup> *Id.* § 78u-5.

terms, conditions and scope of the statutory safe harbors in drafting their disclosure.<sup>59</sup>

#### IMPLIED PRIVATE ACTIONS BASED UPON ANALYSTS' CERTIFICATIONS

Moving across the spectrum from those SEC rules and releases which provide specific safe-harbor protection from implied private actions under provisions of Sarbanes-Oxley for lawyers, audit committee financial experts, and with respect to off-balance transactions, we now address the SEC's attempt to straddle the issue of implied private actions with respect to research analysts' certifications in new Regulation AC.<sup>60</sup>

Section 501(a) of Sarbanes-Oxley authorizes the SEC, or the self-regulatory organizations ("SROs") under the direction of the SEC, to adopt rules "reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances."<sup>61</sup> One important objective of this statutory mandate is for rules to eliminate certain pressures on securities analysts from investment bankers that tend to compromise the objectivity of the analyst's work. Another important goal is for rules to provide disclosure to investors of certain conflicts of interest that could also influence the objectivity of the analyst in preparing a research report. Senator Sarbanes summarized these problems succinctly in the debates preceding the enactment of the statute which bears his name.

[I]f you are an investor and an analyst is making a recommendation and he puts up front in his analysis that he owns the company stock, or that he is receiving compensation from the company, or that his firm has a client relationship with the company, or that he is receiving compensation based on investment banking revenues received from the company, someone is going to look at this and say: wait a second. I have to take his recommendation in the context of his involvement.<sup>62</sup>

The text of the statute is silent with respect to implied private actions, and there is no parroting of 10b-5 language as we see below with respect to officers' certifications and Regulation G.<sup>63</sup> Securities Act Release No. 8193,<sup>64</sup> which adopted Regulation AC<sup>65</sup> pursuant to

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<sup>59</sup> Off-Balance Sheet Arrangements, *supra* note 55, at 86,986 (footnotes omitted).

<sup>60</sup> 17 C.F.R. §§ 242.500-.505 (2003).

<sup>61</sup> 15 U.S.C. § 78o-6 (2003).

<sup>62</sup> 148 CONG. REC. S6333 (daily ed. July 8, 2002) (statement of Sen. Sarbanes).

<sup>63</sup> 17 C.F.R. §§ 244.100-102 (2003).

<sup>64</sup> Regulation Analyst Certification, Securities Act Release No. 33-8193, [2002-



the authority granted in section 501, appears somewhat ambiguous with respect to implied private actions under Regulation AC.

#### I. Regulation AC and Fraud Liability Under Federal Securities Laws

Several commenters requested that the Commission reiterate the position stated in the Proposing Release that Regulation AC does not impose new liability on analysts or their firms.<sup>[66]</sup> Regulation AC formalizes and potentially adds rigor to analysts' responsibilities to express their views truthfully and without guile.<sup>[67]</sup> Regulation AC makes explicit the representations that are already implicit when an analyst publishes his or her views—that the analysis of a security published by the analyst reflects the analyst's honestly held views.<sup>[68]</sup>

Regulation AC does not alter any other existing obligation under the federal securities laws for research analysts or broker-dealers.<sup>[69]</sup> A research report contains an inherent representation that the views expressed in the report are not knowingly false and do not omit material facts necessary in order to make statements made not misleading.<sup>[70]</sup>

Thus, even without Regulation AC, analysts may be found to have violated the anti-fraud provisions of the federal securities laws if they make baseless recommendations or recommendations

2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,833, at 87,233 (Feb. 20, 2003).

<sup>65</sup> 17 C.F.R. §§ 242.500-505 (2003).

<sup>66</sup> Regulation Analyst Certification, *supra* note 64, at 87,241-42 n.52 (listing examples).

<sup>67</sup> *Id.* at 87,242 n.53 (stating that “[a]s the Commission stated in the Proposing Release, Regulation AC is not intended to create new duties under Section 10(b) of the Exchange Act. As a result, no private liability will arise from a broker, dealer, or associated person’s failure to make the required disclosure, or make, keep, and maintain required records. However, Regulation AC is subject to the full range of the Commission’s enforcement authority. With regard to the enforcement of Regulation AC by the SROs, nothing in Regulation AC is inconsistent with Exchange Act Rule 19g2-1,” and citing 17 C.F.R. 240.19g2-1).

<sup>68</sup> *Id.* n.54 (stating “[t]he use of a certification process echoes and is consistent with one approach employed in the Sarbanes-Oxley Act of 2002, which requires certifications by officers of corporations relating to issuers’ financial statements,” and citing Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 302, 906, 116 Stat. 746, 777-78, 806 (2002)).

<sup>69</sup> *Id.* n.55 (citing, as examples, Securities Act § 17(a), (b), 15 U.S.C. 77q; Exchange Act § 10(b), 15 U.S.C. 78j(b); and Exchange Act Rule 10b-5, 17 C.F.R. 240.10b-5).

<sup>70</sup> *Id.* n.56 (citing, as examples, Securities Act § 17(a), 15 U.S.C. 77q(a); Exchange Act Rule 10b-5, 17 C.F.R. 240.10b-5; Exchange Act § 15(c)(1)(A), 15 U.S.C. 78o(c)(1)(A); and Exchange Act Rule 15c1-2(b), 17 C.F.R. 240.15c1-2).

that they disbelieve.<sup>71</sup>

The SROs have been issuing rules with respect to research analysts' certifications that, to some extent, are inextricably intertwined with the text of section 501 of Sarbanes-Oxley and the SEC rules promulgated thereunder.<sup>72</sup> Query as to whether private actions may be implied based upon violations of these SRO rules.<sup>73</sup>

#### IMPLIED PRIVATE ACTIONS BASED UPON CERTIFICATIONS OF FINANCIAL REPORTS

We have examined the safe harbors created by the SEC from implied private actions under certain provisions of Sarbanes-Oxley for lawyers, audit committee financial experts, and with respect to off-balance sheet transactions. We have seen the SEC straddle the issue of implied private actions based upon analysts' certifications. In contrast to these positions, the Commission has promulgated releases which support implied private actions under provisions of Sarbanes-Oxley with respect to officers' certifications, Regulation G, which covers pro forma financial statements, and accountants' retention of audit records. We now address these releases.

Section 302(a) of Sarbanes-Oxley requires chief executive officers and chief financial officers personally to certify certain financial representations of their companies.

#### Section 302. CORPORATE RESPONSIBILITY FOR FINANCIAL REPORTS.

(a) REGULATIONS REQUIRED.—The Commission shall, by rule, require, for each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)), that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that—

- (1) the signing officer has reviewed the report;
- (2) based on the officer's knowledge, the report does

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<sup>71</sup> *Id.* at 87,242 & n.57 (citing Securities Exchange Act Release No. 34-45908 (May 10, 2002); Securities Exchange Act Release No. 34-46301 (Aug. 2, 2002) (Proposing Release); Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969); *In re* Robertson Stephens, Inc., Administrative Proceeding File No. 3-11003 (Jan. 9, 2003)).

<sup>72</sup> See SEC Approval of SRO Analyst Rules, Exchange Act Release No. 34-45908, [2001-2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,639, at 85,457 (May 10, 2002).

<sup>73</sup> For an extended discussion with respect to this issue, see 6 BROMBERG & LOWENFELS, *supra* note 8, §§ 13:62 to :72.

not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

(4) the signing officers—

(A) are responsible for establishing and maintaining internal controls;

(B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.<sup>74</sup>

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<sup>74</sup> 15 U.S.C. § 7241 (2003).

While the language of 302(a) does not expressly authorize private actions, that language does parrot the text of SEA section 10(b) and Rule 10b-5, provisions which have engendered literally thousands of implied private actions during the past fifty years. Moreover, Securities Act Release No. 8124,<sup>75</sup> which promulgated rules as directed by 302(a), offers a roadmap for the express and implied private actions which can be sustained based upon violations of the duties and obligations created by 302(a).

#### 6. Liability for False Certification

An issuer's principal executive and financial officers already are responsible as signatories for the issuer's disclosures under the Exchange Act liability provisions<sup>[76]</sup> and can be liable for material misstatements or omissions under general antifraud standards<sup>[77]</sup> and under our authority to seek redress against those who cause or aid or abet securities law violations.<sup>[78]</sup> An officer providing a false certification potentially could be subject to Commission action for violating Section 13(a) or 15(d) of the Exchange Act and to both Commission and private actions for violating Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5.<sup>79</sup>

### IMPLIED PRIVATE ACTIONS UNDER REGULATION G

Section 401(b) of Sarbanes-Oxley authorizes rules with respect to the proper presentation of pro forma financial information, stating:

#### (b) COMMISSION RULES ON PRO FORMA FIGURES.—

Not later than 180 days after the date of enactment of the Sarbanes-Oxley Act of 2002, the Commission shall issue final rules

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<sup>75</sup> Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Act Release No. 33-8124, [2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,720, at 86,125 (Aug. 28, 2002).

<sup>76</sup> *Id.* at 86,133 n.66 (citing sections 13(a) and 18 of the Exchange Act, 15 U.S.C. §§ 78m(a), 78r).

<sup>77</sup> *Id.* n.67 (citing *Howard v. Everex Systems, Inc.*, 228 F.3d 1057 (9th Cir. 2000), for the proposition that "a corporate officer who signs a Commission filing containing representations 'makes' the statement in the filing and can be liable as a primary violator of Section 10(b) of the Exchange Act").

<sup>78</sup> *Id.* n.68 (citing sections 20, 21, 21C and 21D of the Exchange Act, 15 U.S.C. §§ 78t, 78u, 78u-3, 78u-4).

<sup>79</sup> *Id.* at 86,133 & n.70 (footnote omitted) (noting that "[a] false certification also may have liability consequences under Sections 11 and 12(a)(2) of the Securities Act [15 U.S.C. §§ 77k and 77l(a)(2)] where a quarterly or annual report is incorporated by reference into a registration statement on Form S-3 [17 CFR 239.13] or F-3 [17 CFR 239.33] or into a prospectus filed pursuant to Securities Act Rule 424(b) [17 CFR 230.424(b)]").

providing that pro forma financial information included in any periodic or other report filed with the Commission pursuant to the securities laws, or in any public disclosure or press or other release, shall be presented in a manner that—

(1) does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the pro forma financial information, in light of the circumstances under which it is presented, not misleading; and

(2) reconciles it with the financial condition and results of operations of the issuer under generally accepted accounting principles.<sup>80</sup>

Here again, as with respect to officers' certifications discussed above, the statutory language does not expressly authorize private actions. The statutory language does, however, track the language of SEA section 10(b) and Rule 10b-5 which have been the basis for thousands of implied private actions during the past half century. Moreover, Securities Act Release No. 8176,<sup>81</sup> which adopted Regulation G<sup>82</sup> as directed by 401(b), is quite explicit in stating that a violation of Regulation G may give rise to a violation of 10b-5 "if all the elements for such a violation are present":

#### 4. Liability matters

Rule 102 of Regulation G expressly provides that neither the requirements of Regulation G nor a person's compliance or non-compliance with the requirements of Regulation G shall in itself affect any person's liability under Exchange Act Section 10(b) or Rule 10b-5 thereunder. Disclosure pursuant to Regulation G that is materially deficient may, in addition to violating Regulation G, give rise to a violation of Section 10(b) or Rule 10b-5 thereunder if all the elements for such a violation are present. In this regard, we reminded companies in December 2001 that, under certain circumstances, non-GAAP financial measures could mislead investors if they obscure the company's GAAP results. We continue to be of the view that some disclosures of non-GAAP financial measures could give rise to actions under Rule 10b-5.<sup>83</sup>

Section 3(b) of the Sarbanes-Oxley Act provides that a

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<sup>80</sup> 15 U.S.C. § 78m(b) (2003).

<sup>81</sup> Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 33-8176, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,816, at 86,830 (Jan. 2, 2003).

<sup>82</sup> 17 C.F.R. §§ 244.100-102 (2003).

<sup>83</sup> Conditions for Use of Non-GAAP Financial Measures, *supra* note 81, at 86,836 n.36 (citing Financial Reporting, Release No. 33-8039 (Dec. 4, 2001); *In re Trump Hotels & Casino Resorts, Inc.*, Release No. 34-45287 (Jan. 16, 2002)).

violation of that Act or the Commission's rules thereunder shall be treated for all purposes as a violation of the Exchange Act. Therefore, if an issuer, or any person acting on its behalf, fails to comply with Regulation G, the issuer and/or the person acting on its behalf could be subject to a Commission enforcement action alleging violations of Regulation G. Additionally, if the facts and circumstances warrant, we could bring an action under both Regulation G and Rule 10b-5.<sup>84</sup>

#### ACCOUNTANTS' RETENTION OF AUDIT RECORDS

We noted above that section 104(g)(3) of Sarbanes-Oxley mandates confidentiality regarding certain findings made by the Public Company Accounting Oversight Board as a result of its inspections of accounting firms. We noted further that this confidentiality requirement would adversely impact the prosecution of implied private actions because it would deprive plaintiffs' lawyers of crucial ammunition for their lawsuits.

By contrast, section 802(a) of Sarbanes-Oxley supports implied private actions by mandating that accountants who audit a public company's financial statements "shall maintain all audit or review workpapers for a period of 5 years from the end of the fiscal period in which the audit or review was concluded."<sup>85</sup> The statute also provides:

The Securities and Exchange Commission shall promulgate, within 180 days, after adequate notice and an opportunity for comment, such rules and regulations, as are reasonably necessary, relating 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, which is conducted by any accountant who conducts an audit of an issuer of securities . . . .<sup>86</sup>

The Commission's rules promulgated pursuant to section 802 extend the record retention period from five to seven years. Moreover, the Commission's Release pursuant to section 802 is quite clear in articulating the benefits the new record retention rules will provide for private litigants.

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<sup>84</sup> *Id.* at 86,836.

<sup>85</sup> 18 U.S.C. § 1520(a)(1) (2003).

<sup>86</sup> *Id.* § 1520(a)(2).

Rule 2-06 [of Regulation S-X] requires that accountants retain certain records relevant to an audit or review of an issuer's or registered investment company's financial statements for seven years. To the extent that the rule increases the availability of documents beyond current professional practices, the rule may benefit investigations and litigation conducted by the Commission and others. Increased retention of these records will preserve evidence reflecting significant accounting judgments and may provide important evidence of financial reporting improprieties or deficiencies in the audit process.<sup>87</sup>

#### SUMMARY AND CONCLUSION

In conclusion, there are a number of points worth noting. First, the text and the legislative history of Sarbanes-Oxley do not support implied private actions under that statute. Rather, it is the SEC rules and releases promulgated pursuant to Sarbanes-Oxley that are the main source of support for such implied private actions. Second, these SEC rules and releases, while supportive of implied private actions under Sarbanes-Oxley, are supportive of such actions within the framework of existing implied private actions, primarily 10b-5. There is no support articulated in these SEC rules and releases for implied private actions based *solely* upon the new obligations and duties created by Sarbanes-Oxley. Third, the implied private actions that the SEC supports under Sarbanes-Oxley are the kinds of actions one would expect the SEC to support—to wit: actions based on false and misleading officers' certifications, false and misleading pro forma financial statements, and baseless analysts' recommendations. There is nothing revolutionary here. That being said, however, meaningful additional obligations and duties have been created by Sarbanes-Oxley, and these additional duties and obligations will provide fuel for new implied private actions within the framework of existing anti-fraud provisions. Fourth, one of the most interesting questions with respect to implied private actions under Sarbanes-Oxley is whether the courts will imply private actions under the self-regulatory ("SRO") rules presently being issued under that statute. These SRO rules, which address such matters as audit committee independence and analyst certifications, are being issued either in lieu of, or in conjunction with, SEC rules, and in many cases are inextricably intertwined with SEC rules. Under the language and policies

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<sup>87</sup> Audit Record Retention, Securities Act Release No. 33-8180, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,819, at 86,927 (Jan. 24, 2003).

articulated by such authorities as *Colonial Realty Corp v. Bache & Co.*,<sup>88</sup> and *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,<sup>89</sup> these new SRO rules may well provide a basis for new implied private actions.

As a fifth consideration, it will be interesting to see how the lower federal courts respond to implied private actions under Sarbanes-Oxley. The Supreme Court is presently embedded in the Contraction Era.<sup>90</sup> The lower federal courts, however, have usually been more expansive with respect to implied private actions than the Supreme Court, and there is always the possibility of a change of personnel on the High Court. Sixth, no matter what the Supreme Court eventually decides, however, implied private actions under Sarbanes-Oxley will have a settlement value, often substantial, as they slowly wend their way up the federal appellate ladder.

Finally, the most receptive fora for implied private actions based upon Sarbanes-Oxley may well be the NASD and New York Stock Exchange arbitration panels, which hear and decide almost all customer actions against brokerage firms. Here, the interweaving of the new duties and obligations created by Sarbanes-Oxley with the existing anti-fraud provisions of the federal securities laws, state legal provisions sanctioning fraud and negligence, and the sweeping ethical standards contained in SRO rules mandating that brokers adhere to high standards of commercial honor and just and equitable principles of trade, may prove very effective for plaintiffs, particularly in fora more receptive to equitable arguments than to strict legal contentions.

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<sup>88</sup> 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather, the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law.

*Id.* at 182; *see also* 6 BROMBERG & LOWENFELS, *supra* note 8, § 13:64.

<sup>89</sup> 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969) (“The touchstone for determining whether or not the violation of a particular rule is actionable should properly depend upon its design ‘for the direct protection of investors.’”) (quoting Lewis D. Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12, 29 (1966)); *see also* 6 BROMBERG & LOWENFELS, *supra* note 8, § 13:65.

<sup>90</sup> *See, e.g.*, *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994); *Touche Ross & Co. v. Redington*, 442 U.S. 566 (1979).