Sarbanes-Oxley Turns Six: An Enforcement Perspective

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Sarbanes-Oxley Turns Six: An Enforcement Perspective***

I. INTRODUCTION

Nearly six years ago Congress passed the Sarbanes-Oxley Act (the “Act” or “SOX”), which has been widely touted as the most sweeping federal securities law reform in nearly seventy years. The Senate and the House both were anxious to pursue corporate fraud reform after the collapse and late 2001 bankruptcy of the Enron Corporation, followed shortly by the accounting fraud at WorldCom, as well as multi-billion dollar financial frauds at Global Crossing, Adelphia, Xerox and Tyco, among others. SOX amends both the civil and the criminal securities laws. The Act makes sweeping changes to the regulation of the accounting industry and the reporting requirements of public companies. In addition, SOX significantly adds to the wide array of tools that the Securities and Exchange Commission (the “Commission” or SEC) has to enforce the securities laws and regulations. This Article briefly will set forth the circumstances under which the Act was passed. It then will outline the substance of SOX. Finally, it will discuss key new enforcement tools that the Act gives the Commission and how these tools have impacted the Commission’s enforcement program.

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*** The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any Commission employee or Commissioner. This Article expresses the Authors’ views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.

The story behind SOX begins with the fraud at Enron Corporation, which led to its December 2001 filing of what was then the largest bankruptcy in U.S. history. Prior to its demise, Enron was listed on the New York Stock Exchange, employed more than 22,000 people, and had claimed revenues of $111 billion in 2000. For six consecutive years, from 1995 to 2000, Fortune magazine named Enron “America’s Most Innovative Company.” At the end of 2001, it was revealed that Enron’s reported financial condition was no more than fraudulent accounting. The Enron fraud resulted in the loss of billions in investor dollars, as well as the complete loss of thousands of employee pensions. It was in this environment that Congress began deliberating two separate bills, which ultimately became the Sarbanes-Oxley Act.

The first bill, the Public Company Accounting Reform and Investor Protection Act of 2002, was introduced in the Senate after the Senate Committee on Banking, Housing, and Urban Affairs ("Banking Committee") held a series of hearings from February 12 to March 21, 2002. Five former Chairmen of the Commission, then-Chairman Harvey Pitt, Former Chairman of the Federal Reserve, Paul Volcker, and Chairman of the International Accounting Standards Board, Sir David Tweedie, among others, testified at these hearings. On June 25, 2002, after a series of mark-
ups and amendments in Committee, Senator Paul Sarbanes, then-Chairman of the Banking Committee, introduced the bill to the full Senate as original bill S. 2673.  

The bill was debated on the floor of the Senate from July 8 through July 15, 2002, when it was passed, as amended, by a vote of 97–0.  

Shortly after the Senate Committee on Banking began its Enron-related hearings, the House Committee on Financial Services ("Financial Services Committee") commenced its own hearings on increased oversight of the accounting industry in general. On February 14, 2002, then-Chairman of the Financial Services Committee, Representative Michael Oxley, introduced H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002. After a series of hearings in March and April, Oxley's bill emerged from the Financial Services Committee and was passed by the full House on April 24, 2002 by a vote of 334 to 90.

On June 25, 2002, while the bills introduced by Senator Sarbanes and Representative Oxley were percolating through their respective channels, news broke that an internal audit at WorldCom had uncovered a multi-billion dollar accounting fraud involving underreporting of expenses and inflation of revenues concealed by bogus accounting entries. The Commission launched a formal investigation the same day and took the extraordinary action of filing a complaint against WorldCom in federal district court just one day later, on June 26, 2002.

While there were substantial differences between the House and Senate reform bills, the heightened public pressure after news of the WorldCom scandal broke led to a prompt and short conference that resulted in a single bill. The consolidated legislation was passed by the full House and the full Senate by a vote of 423–3 and 99–0, respectively. President George W. Bush signed H.R. 3763, commonly

known as the Sarbanes-Oxley Act, into law on July 30, 2002, with varying effective dates beginning on the date of enactment.\textsuperscript{18}

III. SOX OVERVIEW

Before turning to the new enforcement tools granted to the Commission by the Act, it is worth providing a broad overview of SOX. The Act is divided into eleven titles, the most significant of which are summarized in this section.

A. Public Company Accounting Oversight Board

Title I of SOX establishes the Public Company Accounting Oversight Board (PCAOB or “Board”), which, under the Commission’s oversight,\textsuperscript{19} is charged with setting auditing standards to be used by registered public accounting firms in the preparation of audit reports\textsuperscript{20} and with periodically inspecting all registered audit firms.\textsuperscript{21} The Act prohibits accounting firms that are not registered with the Board from preparing or issuing audit reports on U.S. public companies.\textsuperscript{22} Notably, SOX makes foreign public accounting firms that prepare audit reports with respect to any U.S. issuer subject to the Act in the same manner and to the same extent as U.S. public accounting firms, unless specifically exempted by the Commission or Board.\textsuperscript{23} Additionally, foreign registrants are deemed to have consented to procedures for the Commission and the Board to obtain their audit work papers.\textsuperscript{24} SOX requires auditors to maintain all audit or review work papers for seven years from


\textsuperscript{19} The Commission’s general oversight of the Board includes, among other things, the power and duty to approve Board rules and to review Board disciplinary and other actions. Sarbanes-Oxley Act § 107, 15 U.S.C. § 7217 (2006). The Board is structured as a private-sector, non-profit organization.

\textsuperscript{20} Id. § 103, 15 U.S.C. § 7213.

\textsuperscript{21} Section 104 of the Sarbanes-Oxley Act specifically requires the Board to inspect annually all registered public accounting firms that provide audit reports for more than 100 issuers for compliance with the Act, the rules of the Board, the rules of the Commission, and professional standards. Id. § 104, 15 U.S.C. § 7214. The Act requires inspection at least tri-annually for all firms that provide audit reports for fewer issuers. Id.

\textsuperscript{22} Id. § 102, 15 U.S.C. § 7212. On September 13, 2007, the Commission filed thirty-nine administrative actions charging sixty-nine audit firms and partners for issuing audit reports on the financial statements of public companies while the firms were not registered with the PCAOB. Press Release, SEC, SEC Charges 69 Audit Firms and Partners for Issuing Audit Reports While Not Registered with the PCAOB, SEC Release No. 2007-183 (Sept. 13, 2007).


\textsuperscript{24} Foreign audit work papers traditionally have been beyond the reach of the Commission unless they were produced by a U.S. issuer. For an in-depth discussion of the potential significance of sections 105 and 106, see David M. Stuart & Charles F. Wright, The Sarbanes-Oxley Act: Advancing the SEC’s Ability to Obtain Foreign Audit Documentation in Accounting Fraud Investigations, 2002 COLUM. BUS. L. REV. 749.
the end of the fiscal period in which an audit or review is concluded. One thousand, eight-hundred, forty-six accounting firms currently are registered with the Board. The Board also has the authority to conduct investigations and impose disciplinary or remedial sanctions upon registered public accounting firms and their associated persons if they violate the Act, the rules of the Board, or other provisions of the securities laws related to preparing and issuing audit reports. The Board has brought sixteen disciplinary actions against more than two-dozen auditing firms and/or accountants.

B. Auditor Independence

Title II of SOX adds new substantive and procedural requirements that enhance auditor independence. The Act specifies eight categories of services that an auditor may not provide to an audit client contemporaneously with the audit: (1) bookkeeping or other services related to the accounting records or financial statements of the issuer; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker, dealer, investment adviser, or investment banking services; and (8) legal services and expert services unrelated to the audit.


27. Sarbanes-Oxley Act § 105, 15 U.S.C. § 7215. The constitutionality of the Board’s inspection and disciplinary powers was challenged recently by two auditors who were the subject of an ongoing Board investigation and non-profit trade association, the Free Enterprise Fund. Free Enter. Fund v. PCAOB, No. 06-0217, 2007 WL 891675 (D.D.C. Mar. 21, 2007). The United States District Court for the District of Columbia rejected petitioners’ challenge and granted summary judgment for the Board in March 2007. Id. at *6.


C. Corporate Responsibility

Title III of the Act addresses the responsibilities of audit committees and senior management. Section 301 requires all audit committee members to be independent of the issuer. It further requires audit committees to have complaint procedures in place to address allegations of corporate wrongdoing and gives audit committees the authority to engage advisers.

Section 302 requires both the chief executive officer (CEO) and chief financial officer (CFO) to certify in each quarterly and annual report that they have reviewed the filing and to the best of their knowledge it is complete and accurate and internal accounting controls are effective. Section 304 requires CEOs and CFOs to reimburse their companies for all bonuses and other equity-based compensation received within twelve months of materially noncompliant financial statements that are subsequently restated as a result of misconduct.

Audit committees now must establish whistleblower procedures that allow employees to report anonymously concerns about questionable accounting or auditing. Corporate attorneys now have an affirmative duty to report any “evidence of a material violation” of the securities laws to the chief legal officer or the CEO, and ultimately to the audit committee if there is not an appropriate response.

Section 308 of the Act gives the Commission the authority to add civil monetary penalties, which previously were returned to the U.S. Treasury, to disgorgement funds to be distributed to harmed investors.


31. Id.
34. Id. § 301, 15 U.S.C. § 78j-1(m)(4). Committees also must have procedures for reviewing and retaining any such reports. A common response to this requirement has been for audit committees to contract with independent hotline companies to receive the reports. Terry Morehead Dworkin, SOX and Whistleblowing, 105 Mich. L. Rev. 1757 (2007) (citing Jennifer Bjorhus, Hot Lines Hot: Watchdog Law Has Companies Scrambling to Line Up Off-site Sites to Record Anonymous Employee Comments, ST. PAUL PIONEER PRESS, Oct. 12, 2004, at D1).
D. Enhanced Financial Disclosures

Title IV of the Act requires the Commission to prescribe rules to enhance financial disclosures in periodic reports and to require management to make and report on an assessment of internal controls on an annual basis. These disclosures must be “on a rapid and current basis” and “in plain English.” Additionally, issuers are required to disclose in their annual report whether their audit committee contains at least one “financial expert.”

E. Corporate Fraud Accountability: Enhanced Criminal and Civil Remedies

Titles VIII, IX and XI of the Act add substantive criminal provisions to the securities laws and enhance the maximum criminal penalties that can be imposed on violators.41 For individuals, SOX extended the maximum jail terms for securities violations from ten to twenty years and increased the maximum fines from $1 million to $5 million.42 For corporations, SOX increased the maximum fine from $2.5 million to $25 million.43 In addition to increased penalties for existing violations, SOX creates a new federal felony for securities fraud and two new criminal anti-shredding penalties.44

SOX prohibits issuers from discharging or otherwise retaliating against employees who report securities law violations or participate in an investigation or proceeding related to alleged violations. Prior to SOX, private sector retaliation suits generally were governed by state law. The whistleblower protection provisions of

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39. Id.

40. Id. § 407, 15 U.S.C. § 7265. A designated audit committee financial expert must have an understanding of GAAP; either actual experience in preparing, auditing, analyzing or evaluating financial statements of a complexity similar to that expected to be raised by the company’s actual financial statements, or experience actively supervising persons with such experience; an understanding of internal controls for financial reporting; and an understanding of audit committee duties and obligations. Id. Commission rules also require that if the requisite attributes are not obtained by certain specified formal education and/or specified experiences, the issuer is required to disclose specifically what qualifies the individual as a “financial expert.” Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8,177A, Exchange Act Release No. 47,235A (Mar. 31, 2003) (codified at 17 C.F.R. pts. 228, 229, 249).


43. Id.


45. Id. § 806, 18 U.S.C. § 1514A.
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SOX create a federal securities law cause of action for acts of employer retaliation. In addition, SOX gives the Department of Justice jurisdiction to impose criminal penalties on companies or individuals that knowingly and willfully retaliate against whistleblowers.

Section 1105 gives the Commission authority to seek officer and director bars in an administrative hearing, without petitioning a federal court. The Act also reduces the standard to obtain an officer and director bar from “substantially unfit” to “unfit.”

IV. NEW ENFORCEMENT TOOLS

In addition to the prophylactic provisions of SOX intended to increase the accuracy of audits and financial disclosure, SOX adds to the array of enforcement tools the Commission has within its authority. Key among these new tools are extraordinary payment freezes, clawbacks of executive compensation in the event of a restatement for “material noncompliance,” fair funds, executive certifications of financial statements, and enhanced remedies. The remainder of this Article will address these various new tools.

A. Extraordinary Payment Freezes

Section 1103 of SOX authorizes the Commission to seek a temporary order freezing “extraordinary payments” by a publicly-traded company to its “directors, officers, partners, controlling persons, agents or employees,” while the company is under a lawful Commission investigation. Section 1103 is intended to stop the corporation from inappropriately compensating individuals who participated in fraudulent conduct and to preserve assets that potentially can be returned to harmed inves-

46. Id. § 806, 18 U.S.C. § 1514A(b). Before filing a civil action under section 806, an employee must file a complaint with the Secretary of Labor, who then refers it to the Occupational Safety and Health Administration for investigation. Id. § 806(b), 18 U.S.C. § 1514A(b). A Department of Labor administrative law judge hears the evidence resulting from the investigation and renders a decision. 14 GUY P. LANDER, U.S. SECURITIES LAW FOR FINANCIAL TRANSACTIONS § 6:168 (2d ed. 2007).
50. Id.
51. Id. § 1103, 15 U.S.C. § 78u-3(c)(3)(A)(i). Section 1103 provides in relevant part: Whenever, during the course of a lawful investigation involving possible violations of the Federal securities laws by an issuer of publicly traded securities or any of its directors, officers, partners, controlling persons, agents, or employees, it shall appear to the Commission that it is likely that the issuer will make extraordinary payments (whether compensation or otherwise) to any of the foregoing persons, the Commission may petition a Federal district court for a temporary order requiring the issuer to escrow, subject to court supervision, those payments in an interest-bearing account for 45 days.
tors. If granted, a section 1103 freeze is valid for forty-five days. If the Commission charges an executive subject to a section 1103 freeze before the freeze expires, the freeze remains in effect until the conclusion of the litigation.

The Commission has had the authority to seek temporary restraining orders, asset freezes and injunctions (permanent and preliminary) since its inception. What makes section 1103 distinct is that it gives the Commission authority to seek a temporary freeze before the Commission files an action. The Act does not set forth any specific factual showing that the Commission is required to make in order to obtain a section 1103 order. Rather, the statute states that the Commission must demonstrate that it is conducting a “lawful investigation” of potential securities violations by a publicly-traded company or any of its officers, directors, or employees, and that it appears “likely” that the “extraordinary payment” will be made. The Act is also silent as to what constitutes an “extraordinary payment.”

To date, the Commission has sought to freeze extraordinary payments to the executives of three companies: HealthSouth Corporation (“HealthSouth”), Vivendi Universal (“Vivendi”) and Gemstar-TV Guide International (“Gemstar”).

"to strengthen the ability of SEC investigators to temporarily freeze improper payments to corporate executives"; 148 Cong. Rec. H4685 (daily ed. July 16, 2002) (Representative Sensenbrenner stating that section 1103 authority will prevent "top executives [from] pilfer[ing] the assets of the company by giving themselves huge bonuses and other extraordinary payments if the company is subject to an SEC investigation."); 148 Cong. Rec. S6545 (daily ed. July 10, 2002) (Senator Trent Lott stating that section 1103 would "ensur[e] that corporate assets are not improperly taken [for] an executive's personal benefit.").

53. The Impact of the Sarbanes-Oxley Act: Hearing Before the H. Comm. on Fin. Serv., 109th Cong. 43–61 (Apr. 21, 2005) (statement of William H. Donaldson, SEC Chairman) (describing section 1103 as one of the “[t]wo . . . most powerful tools that the Act gave the Commission”); see also SEC v. Gemstar-TV Guide Int'l, Inc., 401 F.3d 1031, 1035–36 (9th Cir. 2005) ("Faced with one cataclysmic corporate accounting scandal after another, . . . Congress' purpose in enacting Section 1103's escrow measure could not be clearer. . . . [T]he intent of Congress . . . was to provide a strong shield for third-party creditors and corporate investors once the SEC begins an investigation of corporate malfeasance."); Brief of the SEC, Appellee at 35, SEC v. Gemstar-TV Guide Int'l, Inc., No. 03-56129 (9th Cir. Aug. 28, 2003) ("Section 1103 is a prophylactic provision, which seeks to preserve corporate assets during a Commission investigation and subsequent enforcement action.").

54. Sarbanes-Oxley Act § 1103(a)(3)(A)(i)-(iv), 15 U.S.C. § 78u-3(c)(3)(A)(i)-(iv). If the Commission has not filed charges at the end of the initial freeze period, it can petition the court for a single forty-five-day extension. Id.


57. Gilchrist, supra note 56, at 880–82.

58. Id. at 882–83.

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1. HealthSouth

On March 19, 2003, during the course of a financial fraud investigation involving HealthSouth, the Commission sought a section 1103 order requiring HealthSouth "to escrow . . . all extraordinary payments (whether compensation or otherwise) to any director, officer, partner, controlling person, agent, or employee." The Commission’s request was filed as part of a complaint that also sought injunctive relief, disgorgement and civil penalties against both HealthSouth and its CEO, Richard Scrushy, as well as an officer and director bar and asset freeze against Scrushy. Notably, the Commission did not identify any particular payments that it believed would be made improperly absent the freeze. Rather, the Commission pleadings stated:

"Scrushy remains in control of [HealthSouth] and continues to have the ability to direct extraordinary payments to himself and others who may have participated in the violations alleged in the complaint. [HealthSouth] is likely to make extraordinary payments, as it has in years past, as its financial results for fiscal year 2002 are finalized." 61

The district court entered the section 1103 payment freeze (with the consent of HealthSouth). 62 The freeze was dissolved after HealthSouth removed Scrushy from his positions as Chairman of the Board and CEO. 63

2. Gemstar

In May 2003, during a financial fraud investigation of Gemstar, the Commission sought a section 1103 freeze of severance payments to the former CEO and CFO of Gemstar. 64 The Commission’s investigation of Gemstar began a year earlier, in April 2002, when Gemstar filed its Annual Report and Form 10-K for the year 2001. The filing revealed that Gemstar had overstated its revenue by more than $107 million. 65 The following day Gemstar’s stock plummeted 37%. 66 Four months later, on August 14, 2002, Gemstar issued a Form 8-K announcing that it would

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65. SEC v. Gemstar-TV Guide Int’l, Inc. (Gemstar II), 401 F.3d 1031, 1036 (9th Cir. 2005) (en banc).
66. Id.
restate its 2001 financial results. In conjunction with the Form 8-K, both CEO Henry Yuen and CFO Elsie Leung submitted signed sworn statements that they were unable to certify the accuracy of Gemstar’s financials.

On September 25, 2002, Gemstar announced that it was unable to file its Form 10-Q for the quarter ending June 30, 2002 and was subject to delisting because of an unresolved dispute with its independent auditor. Less than two weeks later, on October 8, 2002, Gemstar announced that Yuen and Leung agreed to resign from their respective positions as CEO and CFO in exchange for combined cash “restructuring payments” totaling nearly $38 million, plus additional stock and stock option compensation. At the request of the Commission staff, Gemstar voluntarily placed the “restructuring payments” into escrow for six months.

On May 5, 2003, days before Gemstar’s voluntary six-month payment delay expired, the Commission petitioned the district court for the Central District of California to temporarily freeze the cash payments to Yuen and Leung pursuant to section 1103. Gemstar did not oppose the freeze application. However, both Yuen and Leung intervened to oppose the freeze, arguing that the phrase “extraordinary payments” was unconstitutionally vague and in the alternative, the specific “restructuring payments” at issue in the freeze application were not “extraordinary.” Yuen and Leung argued that the payments were neither extraordinary when compared to their own outstanding compensation and termination agreements nor when compared to compensation and termination agreements of top executives of other public companies. The district court disagreed with Yuen and Leung and ordered Gemstar to escrow the payments. The court found that the payments were “extraordinary payments” given the circumstances surrounding the termination, the lengthy negotiation of the payments, the size of the payments, and the ongoing Commission investigation. Yuen and Leung appealed the district court

67. Id.
68. Id. at 1036–37.
69. Id. at 1037.
71. SEC v. Gemstar-TV Guide Int’l, Inc. (Gemstar I), 367 F.3d 1087 (9th Cir. 2004), vacated, 384 F.3d 1090 (9th Cir. 2004).
72. Id. at 1089–90.
74. Id. at 34 (“[T]here was no] evidence adduced that the payments were unduly large as compared to severance payments paid to similarly situated departing CEOs and CFOs.”).
75. SEC v. Gemstar-TV Guide Int’l, Inc., 2003 U.S. Dist. LEXIS 8707 (C.D. Cal. May 12, 2003), vacated, 384 F.3d 1090 (9th Cir. 2004). The court summarily rejected Yuen and Leung’s constitutional challenge based on the fact that section 1103 freezes, by their terms, provided for notice and hearing, were limited to short time periods, and were not punitive because the funds would be returned with interest in the event fraud charges were not filed within the strict statutory time prescriptions. Id. at *3.
76. See Gemstar I, 367 F.3d at 1092–95.
order granting the section 1103 freeze to the Ninth Circuit Court of Appeals, which reversed and remedied the case for a determination of whether the payments were extraordinary compared to termination payments made to CEOs and CFOs of other publicly-held companies.\textsuperscript{77}

Shortly thereafter, the Ninth Circuit granted the Commission’s petition for rehearing, and on March 22, 2005, an \textit{en banc} panel of the Ninth Circuit issued its opinion (\textit{Gemstar II}).\textsuperscript{78} In \textit{Gemstar II}, the court affirmed the district court order granting the Commission’s petition to freeze the severance payments under section 1103.\textsuperscript{79} The court found that the components of the payments should not be considered in isolation, but rather in the context of the surrounding events and circumstances.\textsuperscript{80} The court endorsed a “fact-based and flexible” test to determine whether payments were “extraordinary payments” under the statute.\textsuperscript{81} The court enumerated a number of factors as potentially relevant to, but not dispositive of, the analysis, including: the circumstances under which the payment is made; the size and purpose of the payment; whether there is a nexus between the suspected wrongdoing and the payment; and evidence the payment deviated from an “industry standard.”\textsuperscript{82} In finding the payments at issue in \textit{Gemstar II} were “extraordinary payments,” the court found significant: the five-month negotiation resulting in the payments; that the payments were conditioned on the resignation of two top executives; the apparent nexus between the payments and the alleged financial fraud; and that the payments were equivalent to five to six times the executives’ annual base salaries.\textsuperscript{83} In support of its decision, the court also noted that “[section 1103’s] purpose is to temporarily protect corporate funds and the investing public and creditors against theft, fraud, and dissipation.”\textsuperscript{84}

In May 2003, after the termination payments first were frozen, Yuen had filed an arbitration demand against Gemstar with the American Arbitration Association alleging that Gemstar breached the termination agreement by withholding the pay-

\textsuperscript{77} \textit{Id.} at 1095.
\textsuperscript{78} \textit{SEC v. Gemstar-TV Guide Int'l, Inc. (Gemstar II)}, 401 F.3d 1031, 1036 (9th Cir. 2005) (\textit{en banc}).
\textsuperscript{79} \textit{Id.} at 1048.
\textsuperscript{80} \textit{Id.} at 1045–47.
\textsuperscript{81} \textit{Id.} at 1045.
\textsuperscript{82} \textit{Id.} Two Judges concurred in the result, but not the reasoning. The concurring opinion would have adopted a bright line rule that all termination packages for top executives are by definition “extraordinary payments” because terminating top executives is not “part of the regular day-to-day business of the company.” \textit{See id.} at 1048–51 (Reinhardt, J., concurring). Judge Bea, who wrote the initial Ninth Circuit opinion, which the court reversed \textit{en banc}, dissented from the majority opinion. \textit{Id.} at 1051 (Bea, J., dissenting). Judge Bea would have remanded the application to the district court for a determination as to whether the payments were “extraordinary” in comparison to severance payments made to other top executives of public companies. \textit{Id.} at 1060. Judge Bea criticized the majority opinion for interpreting “extraordinary payments” as “payments made under extraordinary circumstances.” \textit{Id.}
\textsuperscript{83} \textit{Id.} at 1046.
\textsuperscript{84} \textit{Id.} at 1035.
ments. In June 2003, the Commission filed a contested complaint alleging Yuen and other former Gemstar officers and directors had committed financial fraud. On May 8, 2006, the district court of the Central District Court of California issued a final judgment against Yuen. On June 14, 2007, the arbitration panel issued a final order, finding that Yuen was in breach of the termination agreement when he signed it, Gemstar was not obligated to make the termination payments, and Yuen owed Gemstar various other damages. Subsequently, Gemstar filed an action in New York state court to confirm the arbitration award. Yuen filed a motion to vacate the arbitration order regarding the payments. On November 27, 2007, the New York state court affirmed the arbitration order.

On February 15, 2008, Gemstar filed a motion to dissolve the section 1103 order. On March 27, 2008, the district court granted Gemstar’s motion and dissolved the freeze, effectively returning the frozen termination payments to the company.

3. Vivendi

The Commission next sought a section 1103 freeze on September 16, 2003, during its financial fraud investigation of U.S.-listed French media company, Vivendi Universal, and its former Chairman and CEO, Jean-Marie Messier.

On July 2, 2002, under intense pressure created by the company’s plummeting stock price, Messier resigned from his position as Chairman and CEO of Vivendi. Prior to resigning, however, Messier negotiated a severance package worth approximately $23 million. Vivendi’s new management refused to pay Messier, arguing that the severance package had not been approved by the Board. Consequently,

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87. See Former Chairman and CEO of Gemstar-TV Guide International, Inc. Ordered to Pay Over $22 Million for Role in Accounting Fraud, Litigation Release No. 19,694 (May 10, 2006). Yuen appealed the district court judgment, which was subsequently affirmed by the Ninth Circuit Court of Appeals on April 1, 2008. SEC v. Yuen, No. 00-55857 (9th Cir. April 1, 2008).
89. Id.
90. Id.
91. Id.
93. Id.
95. See Nicola Clark, Vivendi Gets New Boss in Management Shake-up, HERALD TRIB., July 4, 2002, at 1 (Messier’s resignation came at the end of “another punishing day for Vivendi’s stock, which plunged €3.90, or 22 percent, to a new low of €13.90 ($13.70), wiping out a further €4 billion in market value.”).
Messier sought to enforce the agreement, which was governed by New York law and subject to arbitration. On June 27, 2003, the arbitration panel ruled unanimously that Vivendi was obligated to pay the $23 million. To further complicate matters, on July 10, 2003, at the request of France’s securities market regulator, the Commission des Operations de Bourse, a Paris court froze the severance package pending approval by Vivendi’s shareholders. Messier filed an action in New York state court to confirm the arbitration decision. Vivendi filed a motion to dismiss Messier’s state court petition and to vacate the arbitration award. On September 11, 2003, the New York state court affirmed the arbitration panel’s decision for Messier.

Against this backdrop, the Commission petitioned the United States District Court for the Southern District of New York, pursuant to section 1103, to temporarily freeze the pending twenty-three million dollar severance payment to Messier. Vivendi did not oppose the Commission’s application for a section 1103 freeze. On September 24, 2003, the district court granted the Commission’s application to prohibit Vivendi from paying the state court judgment and to require Vivendi to place the payments into escrow. Messier intervened and filed a motion to vacate the freeze order. Messier argued that there was nothing extraordinary about his negotiated severance and that payments due under both a valid arbitration decision and a valid state law judgment could not be “extraordinary payments.” The district court rejected Messier’s arguments.

98. Id.
99. Id.
102. Id.
103. Id.
105. Id.
108. Id.
Three months later, on December 23, 2003, the Commission filed a settled action against Vivendi, Messier, and the company’s former CFO, Guillaume Hannezo. Pursuant to the final settlement, Messier agreed to pay a $1 million penalty and to relinquish any claim to the approximately $23 million previously placed in escrow pursuant to the Commission’s section 1103 freeze. In settlement, Vivendi paid a fifty million dollar penalty, and Hannezo paid disgorgement and penalties of approximately $268,000. The penalties and disgorgement paid by Vivendi, Messier and Hannezo, totaling over $76 million, were placed in a fair fund to be distributed to investors harmed by the Vivendi fraud.

Temporary Restraining Orders (TROs) and preliminary injunctions, accompanied by ancillary asset freezes, remain the Commission’s most often used method of securing the status quo and preserving the assets of harmed investors. Nevertheless, the authority to freeze extraordinary payments under section 1103 significantly supplements the Commission’s ability to act quickly to preserve assets in unique situations. In HealthSouth, the Commission was able to proactively prevent a sitting CEO, who was himself subject to Commission investigation for fraud, from making extraordinary payments to himself or others during the Commission’s investigation. In both Gemstar and Vivendi, the Commission was able to act quickly to prevent the payment to top executives of tens of millions of dollars in severance payments, which were negotiated after allegedly fraudulent acts.

B. Bonus and Stock Compensation Clawbacks

In addition to authorizing the prevention of extraordinary payments, SOX gives the Commission the related authority to require top executives to reimburse issuers for bonuses and other incentive-based compensation paid based on faulty financial statements, later restated as a result of misconduct. Section 304, more commonly known as the “clawback” provision, provides:

If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for – (1) any

111. Id.
112. Id. Vivendi also paid $1 in disgorgement, which enabled its penalty monies to be added to a fair fund pursuant to section 308 of SOX, 15 U.S.C. § 7246.
113. Id.
114. Id.
115. From fiscal year 2003 through fiscal year 2007 the Commission sought three extraordinary asset freezes under section 1103. During the same time period, the Commission sought more than 200 asset freezes. See SELECT SEC AND MARKET DATA FISCAL 2003-2007, available at http://www.sec.gov. Traditional asset freezes are broader powers than $1103 because they allow the Commission to freeze assets already in the hands of defendants, and not just “extraordinary payments” about to be made. See Gilchrist, supra note 56, at 875–76.
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bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period.116

To date, the Commission has sought to clawback bonuses and stock-based compensation granted by two issuers: Mercury Interactive and UnitedHealth Group.

I. Mercury Interactive

The Commission filed its first section 304 claim on May 31, 2007.117 In this pending, contested action the Commission is seeking to “clawback” bonuses and stock compensation, among other relief, relating to options backdating charges filed against the former CEO, Amnon Landan, and the former CFO, Douglas Smith, of Mercury Interactive.118

The Commission’s clawback claims originate from Mercury Interactive’s July 3, 2006 restatement of its financial results for fiscal years 2002–2004.119 The restatement reflected that the company failed to disclose more than $258 million in compensation expenses associated with backdated stock options from 2000–2004.120 In its complaint, the Commission alleges that: Landan and Smith each reviewed and certified each of the Annual Reports on Form 10-K for fiscal years 2003–2005; “[b]oth Landan and Smith had ample information at the time they signed the certifications that they were not true”;121 and both Landan and Smith “obtained significant cash bonuses . . . at least in part related to the financial performance of the company during the period of the fraud, which resulted in material GAAP expenses being omitted from the company’s financial reports.”122 The Commission’s complaint against Landan and Smith seeks injunctive relief, disgorgement, penalties, officer and director bars, and reimbursement of bonuses and profits from stock sales pursuant to section 304.123

118. Id. §§ 145–89. Mercury Interactive, which was acquired by Hewlett-Packard Company after the alleged misconduct, settled related charges with the Commission. In settlement, the company paid a twenty-eight million dollar civil penalty and agreed to be permanently enjoined from further violations of the securities laws. Press Release, SEC, SEC Settles With Mercury Interactive and Sues Former Mercury Officers for Stock Option Backdating and Other Fraudulent Conduct, SEC Release No. 2007-108 (May 31, 2007). The Commission’s contested action against the four former officers is pending. Id.
120. Id.
121. Id. § 104.
122. Id. § 81.
123. Id. at Prayer for Relief, §§ I–V.
On October 1, 2007, Defendant Smith filed a motion to dismiss the section 304 claims, among others. The Commission filed its opposition to Smith’s motion to dismiss on December 3, 2007, and Smith filed a reply on January 15, 2008. Smith makes two substantive arguments that the section 304 claims should be dismissed.

First, Smith argues that the Commission’s claim of forfeiture of bonuses and profits pursuant to section 304 amounts to an improper retroactive application of SOX, because the alleged options backdating misconduct, which ultimately resulted in the restatements at issue, all predated enactment of SOX. In response, the Commission argues that while misconduct is a necessary element of section 304, it was the filing of the materially noncompliant financial statements, and not the underlying misconduct itself, that triggered the restatement and consequent repayment obligation under section 304. Each of the later-restated financial statements that the Commission cites as a basis for its section 304 claims was filed after the effective date of section 304. In further support of its argument that it is the filing date of the later-restated financials and not the date of the underlying misconduct that is determinent of the statute’s applicability, the Commission notes that “by the language of Section 304, neither the CFO nor CEO need be personally responsible for, or even aware of, the misconduct itself.”

Smith’s second argument is that section 304 only mandates repayment of bonuses and other compensation received “during the 12-month period following the first public issuance or filing with the Commission” and that none of the later-restated filings alleged by the Commission as bases for its section 304 claims is a “first public issuance or filing.”

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124. Defendant Douglas Smith’s Notice of Motion and Motion to Dismiss Complaint Pursuant to F.R.C.P. 12(B)(6) and 9(B) or, in the Alternative, to Strike Pursuant to F.R.C.P. 12(F) at 4–9, SEC v. Mercury Interactive LLC, No. 5:07-cv-02822 (N.D. Cal. Oct. 1, 2007) (on file with authors). Defendant Landon moved to dismiss a number of the Commission’s other charges, but did not address the Commission’s section 304 claims.

125. Plaintiff’s Opposition to Landan’s, Abram’s, Smith’s and Skaer’s Motion to Dismiss at 10–14, SEC v. Mercury Interactive LLC, et al., No. 5:07-cv-02822 (N.D. Cal. Dec. 3, 2007) (on file with authors).

126. Defendant Douglas Smith’s Reply Memorandum of Points and Authorities in Support of His Motion to Dismiss Complaint Pursuant to F.R.C.P. 12(B)(6) and 9(B) or, in the Alternative, to Strike Pursuant to F.R.C.P. 12(F) at 2–6, SEC v. Mercury Interactive LLC, No. 5:07-cv-02822 (N.D. Cal. Jan. 15, 2008) (on file with authors).

127. Id. at 2–5.

128. Plaintiff’s Opposition to Landan’s, Abram’s, Smith’s and Skaer’s Motion to Dismiss, supra note 125, at 11.

129. Id. at 12.

130. Id. Senate amendment 4198, proposed by then-Senator Max Cleland, would have limited the clawback provision to officers and directors “with knowledge, at the time of the misconduct, of the material noncompliance of the issuer.” See Arnold & Porter Legislative History: Sarbanes-Oxley Act of 2002, P.L. 107-204, 116 Stat. 745, History 40-C, 2002 WL 32054475. Similarly an earlier version of section 304 proposed in the House would have limited executive bonus and stock compensation disgorgement provisions to instances in which the Commission can “prove misconduct” by the specific officers or directors subject to the clawbacks. See H.R. 3763, 107th Cong. § 12 (2002); H.R. Rep. No. 107-414, at 44 (2002). Notably, no knowledge or actual misconduct requirement is found in the final version of section 304 and the clawback provision applies only to the CEO and CFO, who are required to certify the accuracy of the financial statements.
public issuance or filing."\(^{131}\) The Commission's claim against Smith relies on his review and certification of "eleven Mercury quarterly reports filed with the Commission between November 12, 2002 and May 6, 2005," and Mercury's annual reports for the years 2003, 2004, and 2005.\(^{132}\) Smith argues that because the Commission does not allege any backdating occurred after April 1, 2002, the first public issuance or filing in which the company failed to expense its backdated option grants was Mercury's August 13, 2002 Form 10-Q.\(^{133}\) In response, the Commission argues that each of the Commission filings during the vesting period of the backdated options constitutes a first filing of materially noncompliant financial information because GAAP requires any in-the-money portion of an option to be expensed over the vesting period of the option.\(^{134}\) A hearing on Smith's motion to dismiss is scheduled for April 25, 2008.

2. UnitedHealth Group

The Commission next used its section 304 clawback authority on December 6, 2007, when it filed a settled options backdating action against William McGuire, the former CEO and Chairman of the Board of UnitedHealth Group.\(^{135}\) In addition to paying disgorgement and a seven million dollar penalty, pursuant to section 304, McGuire agreed to reimburse UnitedHealth for approximately $448 million that he received from 2003 through 2006 in cash bonuses, and profits from the exercise and sale of UnitedHealth stock and unexercised UnitedHealth options.\(^{136}\) The Commission's clawback claims against McGuire originate from UnitedHealth Group's March 6, 2007 restatement, which disclosed that the company materially understated its stock-based compensation expenses each year from 1994 through 2005, resulting in a cumulative misstatement of over $1.5 billion.\(^{137}\) Notably, the Commission's settled action was filed only nine months after the restatement that triggered the section 304 claim.

In both Mercury Interactive and UnitedHealth Group, the Commission used its section 304 authority to seek clawbacks of bonuses and equity-based compensation of executives who were alleged either to have been active in, or to have had contem-
poraneous knowledge of, the misconduct leading to the relevant restatements.\textsuperscript{138} The outcome of the pending action against the former certifying executives of Mercury Interactive may help shape how the Commission chooses to use section 304 in the future. UnitedHealth Group demonstrates the utility of section 304 in providing a clear, disciplined basis for calculating disgorgement in order to resolve liability claims quickly.

Significantly, private industry appears to be following both Congress’ and the Commission’s lead, and many Boards independently have chosen to put clawback provisions in their executive employment agreements.\textsuperscript{139} According to one 2007 study that looked at proxies filed by fifty of the 100 largest companies in the United States, 44% had clawback provisions in their executive employee contracts.\textsuperscript{140}

C. Fair Funds

One of the most frequently used tools granted to the Commission in SOX is the ability to create “Fair Funds,” which allow the Commission to add civil penalties collected in enforcement actions to disgorgement funds and distribute the funds to harmed investors.\textsuperscript{141} The practice of returning disgorged funds is not new.\textsuperscript{142} However, prior to SOX, all collected civil penalties were required by law to be sent to the U.S. Treasury.

Since the Commission received Fair Funds authority, it has ordered over $9 billion in penalties and disgorgement to be placed into Fair Funds for distribution to harmed investors. More than $3.5 billion of those funds already have been distributed.\textsuperscript{143} In February 2008, the Commission created a new Office of Collections and Distributions to expedite distribution of funds to harmed investors.\textsuperscript{144}

D. CEO & CFO Certifications

The scandals leading up to SOX focused public attention on personal accountability at the top of the corporate ladder. Congress addressed this concern in section

\textsuperscript{138} Although to date the Commission has not sought to clawback bonuses and other compensation under section 304 in instances in which the CEO or CFO have no knowledge or participation in the underlying misconduct, Congress did not so limit section 304. See supra note 130 and accompanying text.


\textsuperscript{140} Id. (citing study by California-based executive compensation research firm Equilar).


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302, which requires both the CEO and CFO to certify that the company’s quarterly financial statements are complete and accurate and that internal accounting controls are effective.145

“Certification” of financials by top executives is not new. Principal executive officers were required to sign company Annual Reports and Form 10-Ks and could be liable for civil or criminal penalties for malfeasance before SOX.146 However, the specificity of SOX and its new focus on personal accountability are new. SOX requires CEOs and CFOs of public companies to certify that: (1) they have reviewed the financial report; (2) based on their knowledge, the report does not contain any untrue statement of a material fact or any material omissions; (3) based on their 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; and (4) they are aware of their responsibility for, and have taken certain actions and made certain disclosures with respect to, the issuer’s internal controls.147

Now in their sixth year, the certification provisions largely have been accepted.148 Since the enactment of SOX, the Commission has brought more than fifty enforcement actions involving CEO or CFO certifications, including the options backdating actions against former Brocade Communications CEO, President and Chairman, Gregory Reyes, former Converse Chairman and CEO, Jacob “Kobi” Al-


146. Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides: Integration of Securities Acts Disclosure Systems, Securities Act Release No. 6,231, Exchange Act Release No. 17,114, AS-279 (Sept. 25, 1980) (codified at 17 C.F.R. pts. 229, 231, 239, 240, 241 and 249) (explaining that the form 10-K must be signed on behalf of the issuer by the registrant’s principal executive officer or officers, its principal financial officer, its controller or principal accounting officer, and by at least a majority of the board of directors or persons performing similar functions). On June 27, 2002, the Commission issued an Order requiring CEOs and CFOs of publicly traded companies with annual revenues of more than $1.2 billion to file sworn statements attesting to the accuracy, to the best of their knowledge, of certain of the companies’ filings, or alternatively requiring the executives to file a sworn statement describing the facts and circumstances that would make a certification of the filings incorrect. Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, SEC File No. 4-460, OMB No. 3235-0569 (June 27, 2002).

147. Sarbanes-Oxley § 302, 15 U.S.C. § 7241. SOX also provides significantly enhanced criminal penalties for officers who violate the section 302 certification requirements. CEOs and CFOs who certify statements knowing that the periodic report accompanying the statement does not comport with the requirements of section 302 are subject to fines of up to $1 million and up to 10 years in prison. 18 U.S.C. § 1350(c)(1). CEOs and CFOs who willfully certify statements knowing that the periodic reports accompanying the statements fail to comply with section 302 are subject to fines of up to $5 million and up to twenty years in prison. Id. § 1350(c)(2).

148. Some early critics argued that the certification requirements of SOX would require new and unreasonable commitments of time and money and that the new attention on potential personal liability might cause good candidates to shy away from officer positions. See Peter J. Wallison, Blame Sarbanes-Oxley, WALL ST. J., Sept. 3, 2003, at A16 (arguing SOX may lead to increased risk-aversion amongst corporate managers and directors).
exander, and former Converse CFO, David Kreinberg. Notably, these are the same type of fraudulent certification cases against corporate officers that the Commission brought before the Act. The Commission has not sued any officer under the new certification provisions where there was no indication the executive had, or was reckless in not having, some knowledge that the certified financials were materially incorrect. While the new certifications may not have radically altered the legal requirement that top executives take responsibility for the company's filings, the new provisions make it more difficult for corporate officers to plead ignorance as a defense. Moreover, section 302 gives the Commission an added tool in framing its charges, settlements and prayers for relief.

E. Enhanced Remedies

In addition to providing new enforcement charging tools, SOX enhances the remedies available in Commission actions. Most significantly, SOX increases the Commission's authority to bar securities law violators from serving as officers or directors of public companies. Prior to SOX, the Commission had to file an injunctive action in federal court to obtain an officer and director bar. The Commission had to prove that the individual's conduct demonstrated "substantial unfitness" to serve as an officer and director of a public company. SOX amended this authority in two ways.

First, section 1105 gives the Commission authority to request officer and director bars in administrative cease-and-desist proceedings without petitioning a federal court. Second, section 305 of the Act reduces the standard for obtaining an officer and director bar from "substantial unfitness" to "unfitness." Prior to SOX, most federal courts employed a six-prong test, articulated by the Second Circuit in SEC v. Patel, to determine whether the Commission had demonstrated "substantial unfitness." In Patel, the defendant was a first-time securities law offender. The district court summarily concluded that the defendant was likely to commit additional violations if not barred because he abused his position as an officer and


153. Id. § 305, 15 U.S.C. §§ 77t(e), 78u(d)(2).


155. Id.

156. Id.
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director.\textsuperscript{157} The Second Circuit reversed the district court bar and remanded for further consideration of whether there was a likelihood of future violations if the defendant was not barred.\textsuperscript{158} In reaching its holding, the appellate court considered the following six factors: (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 or she engaged in the fraud; (4) the defendant's degree of \textit{sci\textit{ent}}; (5) the defendant's economic stake in the violation; and (6) the likelihood that the misconduct will recur.\textsuperscript{159} In reversing the bar order, the appellate court noted that although past violations were "not essential" to establish "substantial unfitness" to serve as an officer or director, in the absence of past violations the court must articulate a factual basis for concluding there is a likelihood of repeat violations in order to sustain an officer and director bar.\textsuperscript{160}

The reduction of the Commission's burden of proof from "substantially unfit" to "unfit" was first addressed by a federal court in May 2007, in \textit{SEC v. Levine}.\textsuperscript{161} In \textit{Levine}, the Commission brought fraud charges against Gerald and Marie Levine, a husband and wife team who orchestrated a complex scheme using multiple entities to defraud investors.\textsuperscript{162} The Levines were first-time securities law violators.\textsuperscript{163} In its petition for relief, the Commission sought officer and director bars against the Levines based upon their "unfitness" to serve in such capacity.\textsuperscript{164} The district court began its analysis by noting that the legislative history makes clear that in changing the standard from "substantial unfitness" to "unfitness," Congress intended to reduce the government's burden to obtain an officer and director bar.\textsuperscript{165} The court ultimately adopted a "holistic" approach that takes into account a non-exhaustive list of nine factors proposed by Professor Jayne Barnard.\textsuperscript{166} Applying this more flexible approach, the \textit{Levine} court found that the Commission had met its burden of showing the first-time offenders were "unfit" to serve as officers or directors because, among other reasons, the defendants were the "driving or organizing force

\begin{itemize}
  \item \textsuperscript{157} Id.
  \item \textsuperscript{158} Id. at 142.
  \item \textsuperscript{159} Id. at 141.
  \item \textsuperscript{160} Id.
  \item \textsuperscript{161} 517 F. Supp. 2d 121 (D.D.C. 2007).
  \item \textsuperscript{162} Id. at 146.
  \item \textsuperscript{163} Id.
  \item \textsuperscript{164} Id. at 142.
  \item \textsuperscript{165} Id. at 144.
  \item \textsuperscript{166} Id. at 146. Specifically, the court found that the following, non-exhaustive list of factors should be considered: (1) the nature and complexity of the scheme; (2) the defendant's role in the scheme; (3) the use of corporate resources in executing the scheme; (4) the defendant's financial gain (or loss avoidance) from the scheme; (5) the loss to investors and others as a result of the scheme; (6) whether the scheme represents an isolated occurrence or a pattern of misconduct; (7) the defendant's use of stealth and concealment; (8) the defendant's history of business and related misconduct; and (9) the defendant's acknowledgment of wrongdoing and the credibility of his contrition. Id. at 145 (citing Jayne W. Barnard, \textit{Rule 10b-5 and the "Unfitness" Question}, 47 Ariz. L. Rev. 9, 46 (2005)).
\end{itemize}
or 'kingpin’ behind the fraud, and the magnitude of the fraud’s impact was substantial.\textsuperscript{167}

In addition to the specific new remedies discussed above, SOX expressly authorizes the Commission to request, and federal courts to grant, "any equitable relief that may be appropriate or necessary for the benefit of investors."\textsuperscript{168}

\section*{V. CONCLUDING REMARKS}

The Sarbanes-Oxley Act strengthens the reporting requirements for public companies and increases the accountability of top executives, auditors, and internal compliance professionals. In addition, SOX provides the Commission with significant new enforcement tools, including both new causes of action and new remedies. The most significant of these new enforcement tools are extraordinary payment freezes, clawbacks of executive compensation, fair funds, executive certifications of financial statements, and enhanced remedies. To date, the Commission has utilized extraordinary payment freezes and clawbacks sparingly, relying more commonly on its pre-SOX injunctive, TRO and disgorgement authorities to require charged executives to pay back excessive compensation and bonuses. While not the norm, extraordinary payment freezes and clawbacks substantially increase the Commission’s flexibility to proceed quickly and efficiently in enforcement matters. Fair funds, executive certification, and enhanced remedy cases now are common. Consequently, the Commission is returning more money to more harmed investors, and executives are more cognizant than ever that they are accountable for the public statements and filings that they make.

\textsuperscript{167} Id. at 146.