# THE SARBANES-OXLEY DEBACLE: HOW TO FIX IT AND WHAT WE'VE LEARNED

Henry N. Butler* & Larry E. Ribstein**

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* James Farley Professor of Economics, Argyros School of Business and Economics, Chapman University

** Richard & Marie Corman Professor of Law, University of Illinois College of Law

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Abstract

The Sarbanes-Oxley Act of 2002 ("SOX") is a colossal failure, poorly conceived and hastily enacted during a regulatory panic. Everyone now concedes that the direct compliance costs of SOX have been much greater than anticipated. While that alone should give any serious policy analyst pause, SOX defenders press the case that SOX was worth it. This paper demonstrates that the SOX supporters are dead wrong in their assessment of SOX – both logic and evidence make it clear that SOX was a costly mistake.

SOX's problems were predictable from the circumstances of its birth. Enron may or may not have helped set off a market panic, but what ensued was clearly a Code Red regulatory panic. Given the efforts of pro-regulatory interest groups and sensationalist news media reports of corporate fraud, it is not surprising that SOX was enacted and that it still has many defenders. Although it was not clear what, if any, problems needed fixing, or how new regulation could solve them, Congress was in no mood for ambiguities. The prevailing regulatory philosophy was "shoot first and ask questions later." We are only now asking the right questions and getting the correct, if depressing, answers.

SOX is ostensibly an anti-fraud, investor-protection statute. This observation provides a good starting point for asking the right questions by considering what investors – SOX's putative beneficiaries – want in anti-fraud regulations. Although investors do not like to be defrauded and would want some regulation, they will find such regulation valuable only if the benefit from reduced fraud is greater than the cost of compliance by the firms they invest in. SOX attempts to create a world with zero fraud. This is wildly unrealistic from any perspective. Moreover, it is well accepted in the financial economics literature that the costs and benefits of securities regulation should be evaluated from the perspective of typical shareholders who can avoid some costs of fraud by investing in diversified portfolios of shares. By imposing the costs of eliminating fraud on all firms in investors' portfolios, the SOX mandates are a terrible deal for the ordinary investors it purports to protect.

SOX's defenders bolster their position by arguing that the direct costs of complying with SOX's most onerous provision –internal controls disclosures under Section 404 – will decline. Yet, while the direct costs are substantial (approximately $600 million per year), they are only the tip of the iceberg. The indirect costs of SOX include, among other things, diverting executives' attention from the hard work of maximizing shareholder value, distorting executives' and directors' incentives and investment decisions, criminalizing corporate agency costs and mistakes, reducing access to capital markets by the entrepreneurs our markets depend on, and crippling the dynamic federalism that has created the best corporate governance structure in the world.

There is striking preliminary evidence of the market's evaluation of SOX. The most extensive and persuasive study of SOX's financial costs estimates that firms' total market value declined by $1.4 trillion around legislative events leading to the passage of SOX. The best estimates of the annual direct costs of complying with SOX indicate the firms will spend a total of $6 billion in 2006. Even if such costs continued in perpetuity,

their present value would amount to "only" about $300 billion of the $1.4 trillion market decline.[1] In other words, the stock market implicitly estimated the net costs of SOX to be much greater than simply the present value of the future direct costs of compliance.

Another major area of SOX's indirect costs that has not received sufficient attention is its impact on litigation. SOX gives litigators the benefit of 20/20 hindsight to identify minor or technical reporting mistakes as the basis for lawsuits against corporations, officers and directors. While the first major market correction will be painful for investors, SOX will surely turn it into a festival for trial lawyers. Such litigation on this scale should not be confused with shareholder protection. SOX has created a ticking litigation time bomb.

SOX's defenders assert that the business world is better off now than before SOX. But the relevant question is whether it is better *because of* SOX. Although SOX's defenders take credit for every positive move in the stock market, the alleged benefits cannot be established by simply asserting that SOX is an anti-fraud law aimed at fraud. Neither Congress nor SOX's defenders give sufficient credence to the historical, institutional strengths of our corporate governance system. For over 100 years, the American corporate governance system has demonstrated its resilience and ability to evolve in response to dramatic structural changes and external shocks. Even if there was a problem that needed solving, existing institutions and the market could have responded without a massive new dose of one-size-fits-all regulation from the federal government. To frame the question of whether SOX was necessary, therefore, we need to consider what would have happened if there had been no SOX. American markets would not have turned into a costly casino with careful investors stuffing their money in mattresses. Existing market and regulatory sanctions have already stepped in to punish pre-SOX frauds and thereby deter future fraud. If new rules were necessary, capital-hungry companies, stock exchanges, states and professional groups had ample incentive to provide them, and thereby to demonstrate their integrity to investors. They also had better information about what to do than politicians and regulators. It is highly unlikely that Congress could outthink this dynamic system, particularly during the frenzied regulatory panic of 2002.

The obvious policy implication of our analysis is that SOX should be repealed. A recently filed lawsuit could provide the leverage to enact some major changes in SOX. On February 8, 2006, the Free Enterprise Fund filed a complaint alleging that the structure SOX established to oversee the firms that audit public companies is unconstitutional because its members are improperly appointed by the SEC instead of the President. This suit has the potential to overturn all of SOX, which lacks a severability clause. If the Free Enterprise Fund prevails, the courts are likely to give Congress a window of opportunity to fix SOX before it disappears. Although political reality suggests that Congress will not abandon SOX, it may respond to the mounting criticism of SOX by fixing its most egregious faults.

Several changes could greatly reduce the burden that SOX imposes on the American economy. First, SOX should be amended to prohibit private lawsuits, thereby defusing the litigation time bomb. Second, SOX should be amended to exempt dual listed securities of foreign corporations. Third, SOX should be amended to exempt all but the largest corporations. Fourth, at least some SOX provisions could be amended to allow shareholder opt-out through shareholder proxy proposals. Finally, the criminal

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[1] *See infra* note 12.

sanctions in SOX should be removed.

The post-SOX era offers sober opportunities to assess what we have learned about policymaking from the SOX fiasco. Given policymakers' tendency to overreact in market panics, doubts about the efficacy and costs of federal regulation, and the availability or other mechanisms for controlling corporate fraud, there is much to be said for careful regulation that recognizes legislators' inherent limitations in reforming corporate governance. Perhaps something can be salvaged from the ruins of SOX.

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# I. INTRODUCTION

The Sarbanes-Oxley Act of 2002 ("SOX") emerged from the spectacular crashes of Enron, WorldCom and other corporations after the bursting of the dot.com stock market bubble. Enron and WorldCom became poster children for the supposed "separation of ownership and control" problems first publicized 70 years earlier by Adolf Berle and Gardiner Means and echoed by generations of corporate scholars ever since. After the millennial frauds, the usual proponents of reform argued for regulation that would restore "investor confidence" in the securities markets. Congress responded with the most sweeping federal securities legislation since the original laws in 1933 and 1934.

Since 2003, the direct costs of SOX have become evident. Despite, or perhaps because of, the significant indications of costs and problems related to SOX, many journalists in prominent magazines,[2] and Representative Michael Oxley himself,[3] have rushed to SOX's defense in its fourth year of life. Their argument goes something like this: there was fraud; SOX was designed to reduce fraud by requiring more honesty and disclosure; therefore, SOX is good. For example, *The New Yorker*'s James Surowiecki acknowledges SOX's significant costs, but emphasizes the social costs of fraud – that WorldCom made its rivals look less efficient than they were, resulting in misallocation of resources. The *New York Times*' Joe Nocera stresses that accountants now have a regulator, the SEC has more money, CEOs must vouch for their firms' financial statements, corporate loans are outlawed, directors must be more independent, and the internal controls disclosures are revealing useful information.[4] Nocera acknowledges the expenses under SOX, but says the costs are starting to drop, and the SEC is working on reducing the burden on smaller companies. *Business Week* blithely asserted that SOX 404 "is enabling businesses to cut costs and boosts productivity." Perhaps Congress should apply its managerial prowess more broadly.[5]

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[2] *Learning to Love Sarbanes-Oxley*, *Business Week*, November 21, 2005, available at http://www.businessweek.com/magazine/content/05_47/b3960113.htm; Joe Nocera, "For All Its Cost, Sarbanes Law is Working," *NY Times*, December 3, 2005, available at http://select.nytimes.com/search/restricted/article?res=F00A1EFA39550C708CDDAB0994DD404482; and James Surowiecki, "SOXed-In?," *The New Yorker*, December 12, 2005, http://www.newyorker.com/talk/content/articles/051212ta_talk_surowiecki. For a response to all of these articles, see William Sjostrom, *Ideoblog*, http://busmovie.typepad.com/ideoblog/2005/12/another_prosox_.html. For a response to the *Business Week* article *see* William Sjostrom, "A Silver Lining in Sarbanes-Oxley," *Business Law Prof Blog*, November 14, 2005, available at http://lawprofessors.typepad.com/business_law/2005/11/silver_lining_i.html. For responses to the Nocera article, see Stephen Bainbridge, "Shedding Light on SOX," December 7, 2005, available at http://www.tcsdaily.com/article.aspx?id=120705G. For a response to the Business Week article, see Dale Oesterle, *Business Law Prof Blog*, "Business Law Professors Square Off over Sarbanes-Oxley," http://lawprofessors.typepad.com/business_law/2005/12/business_law_pr.html (December 3, 2005).

[3] Michael G. Oxley, "In the Wake of the Sarbanes-Oxley Act," 31 *Ohio N. U. L. Rev.* 319 (2005).

[4] *See* Nocera, *supra* note 2.

[5] The assertion that Congress should be in the management consulting business is laughable and brings to mind President Ronald Reagan's famous quote: "The ten most feared words in the English language are 'Hi, I'm from the government and I'm here to help.'"

Praise for SOX is also pouring in from those who participated in creating it. Michael Oxley, who shepherded the House version of SOX and provided its surname, says "the system is much better now… We have come a long way since the economic dark days that are only a couple of years behind us." Investors, once were "losing confidence in the American markets." Now, he says, "[b]oards are working harder, playing more of the role that they were designed for. They are responding to shareholders and increasing dividends and buybacks. Audit committees are more active and more independent. They are using their authority to engage independent counsel. The PCAOB is up and running and is actively reviewing auditing firms." As a result, he says, corporate profits, jobs, stock prices, venture capital and research and development spending are up, bankruptcies are down. In other words, Oxley attributes to SOX the turn in the business cycle. Next, like Lear, he will be crediting it with atmospheric phenomena. While it is understandable that Oxley would overstate the benefits of his namesake, one should be skeptical of his self-serving assessment.

Former SEC Chairman Arthur Levitt, a key proponent of several of SOX's provisions,[6] wrote in the *Wall Street Journal*[7] to oppose SOX exemptions for small public firms proposed in December by an SEC advisory committee.[8] Levitt insists, remarkably, that "the small-business lobby" is seeking changes that "would make it more difficult for smaller companies to attract capital needed for growth and undermine confidence in the markets." In other words, he is so sure of the wisdom of the changes he helped adopt that he is willing to assume that the "small business lobby" is lobbying against its own interests. Levitt ignores the fact that this supposedly powerful lobby was too weak to prevent passage of the Act.[9] Moreover, it is hard to accept that exempting firms constituting only 7% of the capitalization of the market would undermine investor confidence in the entire market.[10]

No one can deny that there have been *some* benefits from SOX, including the increased information revealed by the internal controls disclosures. Moreover, the business world is clearly performing better now than in the chaotic days before SOX. The relevant policy questions are whether the benefits exceed the costs, and whether the business world is better now *because of* SOX.

While SOX's proponents in Congress and the media have been creative in finding social benefits derived from SOX, they have not been equally thorough in understanding its full costs. SOX defenders focus on direct costs such as increased audit fees. But while these are substantial (approximately $600 million per year), they are only the tip of the

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http://www.cfif.org/htdocs/freedomline/current/america/reagan_quotes.htm

[6] As to the role of Levitt and other "policy entrepreneurs" in obtaining passage of SOX, *see infra* Section II.B.5.

[7] Arthur Levitt, Jr., "A Misguided Exemption," January 27, 2006 at A8 available at http://online.wsj.com/article/SB113833559392957970.html?mod=todays_us_opinion%20.

[8] *See infra* text accompanying note 105.

[9] The different positions of the big and small business lobbies on SOX are discussed below in section II.B.4.

[10] *See infra* note 152.

iceberg – with much larger but less obvious costs accruing beneath the surface. Indeed, the best evidence indicates that SOX imposes additional net losses of $1.1 trillion. This paper demonstrates that the SOX supporters are utterly misguided in their assessment of SOX – both logic and evidence make it clear that SOX was a costly mistake.

As discussed in Part II, SOX's problems are unsurprising given the circumstances of its birth. Enron may or may not have helped set off a market panic, but what ensued was clearly a Code Red regulatory panic. When one combines the efforts of pro-regulatory interest groups and the avid news media reports of corporate fraud, it is not surprising either that SOX was enacted or that it still has many defenders. Although there were significant ambiguities about precisely what, if any, problems needed fixing, if any, Congress was in no mood for ambiguities. The prevailing regulatory philosophy was "shoot first and ask questions afterward." We are only now asking the right questions and getting the correct, if depressing, answers.

Part III provides a good starting point for asking the right questions by considering what investors – the putative beneficiaries of SOX – desire in anti-fraud regulations. Clearly, investors do not like to be defrauded. To the extent government regulation can prevent fraud, shareholders benefit. But shareholders will find such regulation valuable only if the benefit from reduced fraud is greater than the cost of regulatory compliance. SOX's attempt to create a perfect world with zero fraud goes too far. Moreover, it is well accepted in the financial economics literature that the costs and benefits of securities regulation should be evaluated from the perspective of typical shareholders who can avoid some costs of fraud by investing in diversified portfolios of shares. By imposing the costs of eliminating fraud on all firms in investors' portfolios, the SOX mandates are a terrible deal for the ordinary investors it purports to protect.

Although SOX's defenders assert that the business world is better off now than before SOX, Part IV makes it clear that the relevant question is whether the business world is better *because of* SOX. The American corporate governance system is incredibly dynamic – for over 100 years, it has demonstrated its resilience and ability to evolve in response to dramatic structural changes and external shocks. Even if there was a problem that needed solving, it is likely that existing institutions and the market could have solved this problem without a massive new dose of one-size-fits-all regulation from the federal government. Moreover, given the dynamism and success of our system, the proponents of massive new regulation logically should bear the burden of justifying it. To frame the question of whether SOX was necessary, we consider what would have happened if there had been no SOX. American markets would not simply have turned into a costly casino with careful investors stuffing their money in mattresses. Existing market devices and regulation have already worked to punish the pre-SOX frauds and thus to deter future fraud. If new rules were necessary, capital-hungry companies, stock exchanges, states and professional groups had ample incentive to provide them, and thereby to demonstrate their integrity to investors. They also had better information about what to do than politicians and regulators. It is highly unlikely that Congress could outthink this dynamic system, particularly during the frenzied regulatory panic of 2002.

The costs of SOX are described in Parts V and VI. In general, SOX's defenders have limited their calculations to the most direct compliance costs. They, like Congress in 2002, ignore indirect and possibly hidden but still quite substantial costs. Part V surveys the mounting evidence on the direct costs of SOX – particularly the costs of complying with the notorious Section 404 internal controls – that have triggered so much interest in the media and then discusses in detail some of the less obvious costs, including interference with business management, distraction of managers, risk aversion by independent directors, overcriminalization of agency costs, reducing access to capital

markets, and crippling the dynamic federalism that has created the best corporate governance structure in the world.

Part VI describes the ticking litigation time bomb SOX has created. The first major market correction will be painful for investors, but it will be a gigantic litigation festival for trial lawyers. SOX gives litigators the benefit of 20/20 hindsight to identify minor or technical reporting mistakes as the basis for lawsuits against corporations, officers and directors. The threat of litigation on this scale should in no way be construed as investor protection.

Part VII compares the small benefits of SOX discussed in Part IV with the large costs discussed in Parts V and VI and concludes that the SOX is a large net cost to the American economy. The best available evidence indicates that SOX imposed a net loss on the economy of $1.4 trillion. A widely cited study of the annual direct costs of complying with SOX indicates that firms will spend a total of $6 billion in 2006.[11] Even if annual direct costs of this magnitude were going to continue in perpetuity, the present value of those direct costs would amount to only a small fraction of $1.4 trillion net loss. A conservative estimate is that the indirect costs of SOX are greater than $1.1 trillion.[12]

Part VIII considers the potential policy implications of our conclusion that SOX is a colossal mistake. A favorable court decision in a recently filed lawsuit could provide the leverage to enact some major changes in SOX. On February 8, 2006, the Free Enterprise Fund filed a lawsuit[13] alleging that the accounting oversight board SOX created violates the Appointments Clause of the Constitution because its members should be appointed by the President or heads of executive branch departments rather than by the SEC.[14] This suit has the potential to overturn all of SOX, which lacks a severability clause. However, if the Free Enterprise Fund prevails, the courts are likely to give Congress a window of opportunity to fix it. Although political reality makes it unlikely that Congress will repeal SOX, it may have the incentive to respond to the increasing criticism of SOX and fix its most egregious flaws.

Several relatively minor changes in the statute could greatly reduce the burden that SOX imposes on the American economy. First, SOX should be amended to prohibit private lawsuits. Second, SOX should be amended to exempt securities of foreign corporations. Third, SOX should be amended to exempt all but the largest corporations. Fourth, SOX should be amended to allow shareholder opt-out of at least some provisions through shareholder proxy proposals. Finally, the criminal sanctions in SOX should be removed.

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[11] *See* AMR Research, "SOX Spending for 2006 To Exceed $6B," November 29, 2005, available at http://www.amrresearch.com/Content/View.asp?pmillid=18967.

[12] Assuming that the $6 billion will continue as an annual payment in perpetuity, and assuming an interest rate of 2%, the present discounted value of the direct costs is "only" $300 billion.

[13] The complaint may be found at http://www.feinstitute.org/pdfs/FEF%20v%20%20PCAOB%20Complaint.pdf. For a discussion of the suit, see "A Matter of Oversight," *The Economist* (US), Feb 18, 2006 at 71.

[14] For analysis of this issue, see Donna M. Nagy, "Playing Peekaboo With Constitutional Law: The PCAOB and its Public/Private Status," 80 *Notre Dame Law Review* 975 (2005), available at http://ssrn.com/abstract=622964.

Part IX takes a longer view. The post-SOX era offers real opportunities to assess what we have learned about policymaking from the Sarbanes-Oxley fiasco. Given policymakers' tendency to overreact in market panics, doubts about the efficacy and costs of federal regulation, and the availability or other mechanisms for controlling corporate fraud, there is much to be said for a careful approach to federal regulation that, among other things, allows for alternatives and limits the scope of regulation. Perhaps something can be salvaged from the SOX fiasco.

Part X contains a summary and brief statement of our conclusions.

## II. FROM ENRON TO SOX: SHOOT FIRST, THEN ASK QUESTIONS

An assessment of SOX should begin with its passage. What did we know about the costs and benefits of regulation and when did we know it? If Congress had known that the costs of SOX were going to be as high as they turned out to be, would Congress have nonetheless passed SOX? This Part shows that Congress knew very little when it acted precipitously, in the midst of a regulatory panic. An understanding of the defects of this process may help us prevent a similar mistake the next time the conditions are ripe for a regulatory panic.

### A. ENRON

The long millennial bull market, which had peaked in March, 2000, had dropped even before September 11, 2001. By late September, trillions in shareholder wealth had evaporated. So the market was in an ugly mood when Enron Corporation disclosed on October 16, 2001 that it was taking a half-billion-dollar after-tax charge against earnings and $1.2 billion reduction of shareholders' equity because it was revising its accounting for transactions with one of its so-called "special purpose entities." This began Enron's collapse into litigation and bankruptcy.

It was a spectacular fall. Enron had been a model for the new economy, pioneering a way to create markets that heralded drastically reduced transaction costs. Enron showed, for example, that utility companies did not have to own energy sources to ensure fuel sources – they could buy the energy through Enron's energy market. Fortune had ranked Enron the most innovative company in America for six straight years, and its chief executive, Jeff Skilling, now known mainly as a criminal defendant, had been named the nation's second best executive (after Microsoft's Steve Ballmer) as recently as six months before the collapse. Business school classes had admired Enron's business model.[15] After October, 2001, they rapidly turned to studying Enron as a classic example of business failure.[16]

As first detailed in the so-called Powers Report, issued in February 2002,[17] Enron

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[15] *See* Samuel E. Bodily et al., "Enron Corporation's Weather Derivatives" (explaining the use of weather derivatives by Enron to hedge risk), available at http:// papers.ssrn.com/sol13/papers.cfm?abstract_id=274195.

[16] *See* Samuel E. Bodily & Robert F. Bruner, "Enron, 1986-2001" (Darden Case, No.UVA-G-0563-M-SSRN, 2002), available at http:// papers.ssrn.com/sol3/papers.cfm?abstract_id=302155.

[17] William C. Powers, Jr. et al., Report of Investigation By The Special Investigative Committee of The Board of Directors of Enron Corp. (Feb. 1, 2002) 2002 WL 198018.

executives had created earnings for the company and its insiders by disguising speculation as hedging, making murky deals with hazy special purpose entities, and claiming as revenues speculative predictions of years of future sales and prepayments on commodities contracts. The Report spread the blame widely. Senior officers were either involved in the transactions or curiously ignorant of what was going on. The Enron board, including its fully independent audit committee, knew of problems, but put its faith in representations by senior officers that they would police the insider deals, and in assurances by the firm's accounting firm, Arthur Andersen. Andersen, in turn, and its partner in charge of the Enron account, failed adequately to scrutinize its major customer of both audit and non-audit services. Meanwhile, despite indications that all was not well at Enron, securities analysts continued to give buy recommendations and the major debt rating agencies rated Enron's debt as investment grade until shortly before the crash.

## B. THE POST-ENRON REGULATORY PANIC

Something had happened to Enron, but it was not clear what. Clearly some corporate executives had been dishonest, but they were being found out and punished under existing law. Companies already had plenty of watchdogs. Enron and WorldCom had independent directors and auditors. Securities analysts seemingly had ample incentives to watch them closely.

As detailed in Roberta Romano's exhaustive study of SOX's legislative history,[18] Congress acted precipitously without anything resembling a balanced consideration of the issues. The House passed a relatively mild bill in April, 2002, after the stock market had recovered somewhat and the public had become calmer. Its bill focused on increased criminal penalties to exact the vengeance against executives the public was demanding, and provided for an accounting industry watchdog. However, by the end of July the Senate had passed, and the House and Senate had agreed to in conference, a much stricter law that included several more consequential corporate governance measures, including a prohibition on executive loans, requiring audit committee independence and executive certification of financial statements. This bill was reported out of the conference committee on July 23 and quickly passed and signed into law July 30, 2002 by President Bush, who described the law as "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."

What happened to propel this law from a modest bill to a far-reaching law through a divided Congress in only three months? The answer to this question reveals much about the source of the problems discussed in this paper. The following are some of the relevant factors. Many are interrelated. Some grow out of unique events in 2002, while others reflect long-term historical trends. The main question is what they tell us about how we might avoid future SOXes.

### 1. Mounting reports of corporate wrongdoing

Between April and July there were reports of numerous additional cases of corporate fraud or bad accounting. Xerox had improperly accelerated revenues from

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[18] *See* Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," 114 *Yale L. J.* 1521, 1549-68 (2005). See also Jayne W. Barnard, "Historical Quirks, Political Opportunism, and the Anti-Loan Provision of the Sarbanes-Oxley Act," 31 *Ohio N. U. L. Rev.* 325 (2005) (also presenting detailed legislative history and background, focusing on executive loan provisions).

long-term equipment leases,[19] Qwest and Global Crossing had manipulated revenues and expenses on fiber optic deals,[20] cable firm Adelphia had apparently been looted by its controlling shareholders, there were reports of excessive spending by Tyco CEO Dennis Kozlowski and, most spectacularly of all, WorldCom collapsed into bankruptcy after disclosing that it had falsely claimed as assets billions of dollars it had paid as ordinary business expenses to use its transmission networks.

But what did all this mean? The media suggested that all of this was connected and indicated a drastic increase in the total amount of fraud. The question is whether this was the reality: were the stories actually connected in a way that called for coherent government action? Looting by executives is a different problem from accounting errors, not least because the former is already well covered by existing law. Moreover, connecting looting, a real problem, with accounting errors, may tend to make the latter look worse than it is.

### 2. The stock market decline

The stock market had been declining since early March 2002 – possibly as direct result of investor concerns over the growing threat of the Iraq War. This market decline created political pressure to do something about mounting corporate fraud in order to "restore confidence" in the market.[21] The market reached a temporary low in late July, around the time of the vote on the conference committee bill. In fact, the Dow Jones Industrial Average dropped 1000 points in July alone. Just as investors' judgment errors may have played a role in the run-up in stock prices prior to 2001, so they may have figured in the post-boom panic.

### 3. The news media's role.

During the first half of 2002 the news media was unrelentingly negative on business: 77% of the 613 major network evening news stories between January and July 2002 concerned corporate scandals, of which 195 connected corporations to Congress, and 188 to the Bush Administration, compared to 11% of 489 business stories about scandals in the same period the prior year.[22] This suggests that corporate crime was quite salient in the public mind during deliberations on SOX. Salience tends to drive the political agenda: people think more about corporate crime than about the potential costs of laws intended to deal with it. Moreover, the news media undoubtedly played a role in creating this salience by deciding what stories are featured prominently, and how they are

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[19] Mark Maremont, "Leading the News: Xerox Overstated Pretax Income By $1.41 Billion, Filing Reveals," *Wall St. Journal*., July 1, 2002, at A3.

[20] Deborah Solomon & Susan Pulliam, "SEC Adopts Tougher Position On Qwest Accounting Methods," *Wall St. Journal*, June 26, 2002, at A3.

[21] For a skeptical analysis of the alleged lack of "investor confidence" leading up to the enactment of SOX, see Peter J. Wallison, "Sarbanes-Oxley As An Inside-the-Beltway Phenomenon," AEI Online (June 1, 2004), http://www.aei.org/publications/filter.all,pubID.20582/pub_detail.asp.

[22] Romano, *supra* note 18 at 1559; Karlyn H. Bowman, "Sarbanes-Oxley and Public Opinion After Enron and WorldCom," Presentation at Sarbanes-Oxley: A Review (May 5, 2004) [hereinafter Bowman], available at http://www.aei.org/events/eventID.809, filter.all/event_detail.asp (follow "Video" link, at 00:13:45) (discussing data compiled by the Media Research Center).

portrayed.

Because the media is obviously an important player in the political process, it is important to examine its incentives. There is evidence of news media's bias toward the left, and that this slant produces more regulation.[23] Moreover, noted financial economist Michael Jensen has characterized the press as producers of entertainment rather than of information.[24] Jensen says that readers want simple answers delivered in an entertaining way. This suggests that the press will tend to colorfully exaggerate market excesses and support simple regulatory solutions that ignore the complexity of the underlying problems. To be sure, readers also demand correct information. But a recent study testing these alternative hypotheses shows significant evidence of sensationalism in coverage of executive compensation.[25]

Applying these insights to SOX, it is clear that the millennial stock market crash created a market for entertaining stories about bad business people. The media saw gains in a continuing saga of corporate fraud that readers or viewers would follow avidly day by day. This conveniently meshed with the media's pro-regulatory bias. All of this negative coverage interacted with the public's anxiety about the economy and the market, its tendency to stress recent prominent news, and general populist sentiments about business discussed further below.

#### 4. The lack of effective political opposition by pro-business interests

There are usually several inherent brakes on enactment of business legislation, particularly laws as sweeping and multifarious as SOX. There are always reformers and business groups that favor regulation that may be socially harmful. But the social costs are often felt by particular firms and interest groups, and these groups are in a position to bear the costs of lobbying against the reform effort.[26] The political process provides ample opportunity for firms and groups to express and organize opposition and slow down legislation. Laws like SOX must wend their way through both houses of Congress, beginning in committee and finally working their way to the floor. Even if a single party dominates both houses, this apparent unity may mask significant disagreement among the relevant business groups. That is particularly so with most business legislation, which rarely pushes galvanizing hot buttons.

In the case of SOX, the houses were controlled by different parties – Republicans had the House, while Democrats had the Senate. This created the conditions for disagreement not only within parties and within legislative bodies but between the houses of Congress. In fact, true to the differing party alignments, the House initially passed a

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[23] David P. Baron, *Persistent Media Bias* (Stanford Graduate Sch. of Bus., Research Paper No. 1845, 2004), available at http:// ssrn.com/abstract=516006.

[24] Michael C. Jensen, "Toward a Theory of the Press," in *Economics and Social Institutions*, Karl Brunner, ed., 1979; available at http://ssrn.com/abstract=94038.

[25] John E. Core, Wayne R. Guay & David F. Larcker, *The Power of the Pen and Executive Compensation* (October 28, 2005), available at http://ssrn.com/abstract=838347.

[26] *See generally* Mancur Olson, *The Logic of Collective Action* (1965); Robert E. McCormick & Robert D. Tollison, *Politicians, Legislation, and the Economy: An Inquiry into the Interest Group Theory of Government* (1981); Robert Tollison, "Public Choice and Legislation," 74 *Va L Rev* 339 (1988).

significantly weaker version of the law that became SOX than did the Senate. Yet it was the Senate's version that eventually became law, and quickly at that. Why did the usual "brakes" of interest groups and the political process apparently fail here? One possible reason, of course, is that the conditions outlined above, as well as others discussed below, created significant public pressure for action. Another is that the Bush administration needed to demonstrate its disapproval of its former political ally, Ken Lay of Enron, who was now a notorious symbol of corporate malfeasance.

Despite these politics, business groups might have stopped the SOX juggernaut. However, they were not united.[27] The U.S. Chamber of Commerce did give battle. Its members included smaller firms that were more sensitive to sharp increases in monitoring costs, were not susceptible to blame for the most public corporate frauds, and did not have to worry as much about a backlash from public shareholders or customers who might be incensed by their opposition to corporate reform. However, the Business Roundtable did not oppose SOX. It represented big business, which in the summer of 2002 was concerned less about regulatory costs than about avoiding the public's ire. These companies might have concluded that it is cheap public relations to support the government's moves against fraud, or at least costly in terms of public relations to oppose them. Moreover, it seemed that no one was representing the interests of foreign issuers, even including the U.S. securities industry that derived significant revenues from trading these shares. And, of course, there was no one to defend the interests of potential future firms stillborn because of high regulatory costs.

There were deeper reasons business interests supported SOX even after its high costs became apparent. Firms might have been particularly willing to support legislation that imposes regulatory costs if the firms that bear the most costs are their competitors. For example, Henry Manne argued that the original federal securities laws helped leading securities firms that underwrote relatively low-risk, high-disclosure securities compete against firms that served a higher-risk clientele.[28] With respect to the costs of SOX, it is significant that bigger companies may have smaller rivals. The biggest worry for all big companies is the next big thing, which will come bubbling up from the venture capital incubator – unless SOX prevents it.

Some of the more vocal business supporters of SOX were the accountants and others in the monitoring and consulting industry who audit, investigate, prosecute and defend fraud as well as prepare disclosure documents.[29] It is ironic that some of the biggest winners from SOX are those whose gatekeeping failures triggered the law in the first place. Joseph Nocera of the *New York Times* views this as

> one of the unintended consequences – that Sarbanes-Oxley has been a financial boon to the profession, since all the big accounting firms have to audit a company's financial controls as well as its books. "In effect, the law is giving the auditors business," Senator Sarbanes said with a chuckle. But so what? Better

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[27] See Romano, *supra* note 18.

[28] See Henry G. Manne, "Economic Aspects of Required Disclosure under Federal Securities Law," in *Wall Street in Transition: The Emerging System and its Impact on the Economy*, Henry G. Manne & Ezra Solomon eds., 1974, 33-36.

[29] See Richard B. Schmitt, "Lawyers' Growth Industry: Corporate Probes," *Wall St. Journal*, June 28, 2002, at B1 (discussing how lawyers specializing in internal corporate investigations are profiting by recent corporate fraud scandals).

> that they make money doing actual auditing work than by selling themselves as consultants.[30]

However, public choice economics suggests that the intent of SOX should be inferred from its consequences. In this view, the accounting lobby – who Nocera says were the "primary opponent of Sarbanes-Oxley" – was pleased with the passage of SOX.[31] As Yale Law Professor Jonathan Macey has said:

> [T]he politicalization of the process of corporate governance has produced massively perverse results. Specifically, those corporate governance institutions that have performed the worst have been rewarded, while those institutions that have performed the best have been hampered by legal rules designed to impede the ability to operate. Rather than producing genuine reform, the wave of corporate governance, accounting and capital markets scandals of the 1990s have generated political responses that benefit narrow interest groups and harm investors. Politics, not economics, determines which corporate governance devices are favored and which are not. As a consequence, the most effective corporate governance devices tend to be disfavored, while the ineffective mechanisms are rewarded in the regulatory process.[32]

Some firms may have supported SOX because it appeased public passion for reform as cheaply as possible. Indeed, firms may continue to believe that SOX's main importance is symbolic. Roberta Romano notes that this may explain at least SOX's increased criminal sanctions, as indicated by the extent to which these were emphasized by legislators in the debates on SOX and in opinion polls on the public's view of SOX.[33] But this does not account for SOX's governance reforms, which were not featured in the debates. Romano believes the symbolism explanation is inconsistent with the high actual costs of governance reforms.

The failure of business to stop the SOX juggernaut also owes something to the Republicans, who normally could be expected to defend business interests. Although the Republicans did slow down the train in the House in April, by the summer they could not longer provide effective opposition. Republicans were facing mid-term elections in November, and as the party controlling the White House, and the party identified with business, stood to lose much more than the Democrats from any public ire about the economy and corporate misconduct. Corporate fraud helped the Democrats discredit Republican deregulatory and anti-tax policies. Republicans therefore risked damaging their agenda by siding with opponents of regulation. The choice between keeping or increasing control and temporarily abandoning some of its constituents might have seemed easy, particularly since those constituents were divided and had their own reasons for wanting the Republicans in power.

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[30] Nocera, *supra* note 2.

[31] The accounting profession, in other words, was "born and bred in the briar patch." *See* Joel Chandler Harris, "Brer Rabbit and the Tar Baby," available at http://www.otmfan.com/html/brertar.htm.

[32] Jonathan R. Macey, "The Politicalization of American Corporate Governance," Conference on Boundaries of SEC Regulation, Claremont McKenna Financial Economics Institute, Friday, February 3, 2006.

[33] *See* Romano, *supra* note 18 at 1586-87.

Moreover, the Republicans had a more significant problem. The press on July 4 had revived a story from twelve years before about how President Bush had failed to file an appropriate notice of his 1990 sale of the stock of Harken Energy while he was a director of that company.[34] Bush held a news conference on July 8, apparently looking like he had been caught with his hand in the cookie jar.[35] The next day the President announced a set of corporate governance reforms, including executive certification of financial statements, stiffer criminal sentences, restrictions on non-audit services by accounting firms, as well as condemning insider loans, though he did not suggest dealing with them by federal or other law.[36]

The political picture was therefore darkening rapidly for the Republicans. They needed corporate reform legislation quickly, or at least could not afford to be seen as obstructing it. This helps explain why the Republicans' consented to a cloture motion in the Senate.[37] Cloture effectively prevented amendments on the floor of the Senate, the main exception being Senator Schumer's executive loan provision discussed below.

The Republicans still might have hoped to avoid a disastrous law through negotiations in conference. But things rapidly got worse for the Republicans when, on July 10, a story appeared about the President's below-market-rate loan from Harken while a director.[38] By July 11, the story was all over the media.[39] Again, politics was being shaped by a combination of actual events and deliberate news media decisions concerning what stories to feature, in this case a decision to investigate President Bush's 12-year-old conduct in the business world just as other corporate fraud stories were emerging.

So as the Senate and House proceeded to conference July 16 over their very different versions of corporate reform – a conference in which Republicans had hoped to modify the more drastic Senate version of the Act that had emerged from the cloture vote – the Republicans were in a political corner. The White House pressured the House Republicans for a quick compromise with the Senate, saying that "the two [chambers] need to get together as quickly as possible and get me a bill that I can sign before the August recess."[40] Among Republicans there was "a mad dash to embrace the Sarbanes bill."[41] This left lobbyists little room to make last minute adjustments. By July 25, 2002

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[34] Elisabeth Bumiller, "Bush Faces Scrutiny over Disclosing '90 Stock Sale Late," *N.Y. Times*, July 4, 2002, at A11. For a discussion of how Bush's political problems related specifically to the adoption of the executive loan provisions in SOX, see Barnard, *supra* note 18.

[35] *See id.* at 336.

[36] *Id.* at 337.

[37] See Romano, *supra* note 18 at 1562.

[38] Joann S. Lublin, "Loans to Corporate Officers Unlikely to Cease Soon," *Wall St. Journal*, July 10, 2002, at A8.

[39] *See* Barnard, *supra* note 18 at 338.

[40] *Id.* at 340.

[41] Carolyn Lochhead, "Bush to Sign Corporate Crackdown: GOP Drops Opposition, Backs

the deal had been made, and the consensus bill passed the House 422-3 and the Senate 99-0.

### 5. The role of policy entrepreneurs

Roberta Romano stresses the role of "policy entrepreneurs" in shaping SOX provisions on executive loans, independent audit committees, executive certification of financial statements and provision of nonaudit services. [42] These influential participants in Congress's deliberations saw a new opportunity to press proposals they had long favored without success. While the witnesses may have been sincere, the one-sidedness of this testimony clearly contributed to Congress's flawed policymaking.

For example, in the Senate committee hearings on the bill that became SOX, former SEC Chairman Arthur Levitt and SEC Chief Accountant Lynn Turner pushed their agendas on independent audit committees and restrictions on non-audit services by auditors. The latter was an initiative Levitt had pushed two years earlier, only to be defeated by the efforts of Harvey Pitt on behalf of the big auditing firms. At the time of the SOX deliberations, Pitt was the SEC Chairman, but was unpopular among Congressional Democrats. Other policy entrepreneurs who testified in the Senate included corporate lawyer and prominent governance reform advocate Ira Milstein, who advocated fully independent audit committees. The witness list in the Senate was shaped by the pro-regulatory committee chair, Senator Paul Sarbanes.

Pro-reform witnesses ignored evidence of which they were aware casting doubt on the wisdom and effectiveness of these proposals. For example, Romano recounts how witnesses including Levitt, testifying on the need to restrict auditors from providing non-audit services, failed to mention that the Panel on Audit Effectiveness, whose creation Levitt himself had suggested,[43] found no evidence that performing non-audit services had actually impaired audit quality.[44] Romano says, referring to the report in 2000 of this Panel and to a 1978 report reaching the same conclusion,

> It should be noted that . . . witnesses who advocated a prohibition, such as Levitt, were, without question, fully aware of both reports, but one would not have known that from their testimony. The lack of candor is embarrassing.[45]

One wonders how Levitt would have treated a comparable lack of candor in SEC disclosure documents.

The opinions expressed at the committee hearings by prominent policy entrepreneurs resonated with the views of academic reformers who, since the 1930s, had urged increased federal regulation of corporate governance. Moreover, they meshed with the interests of trial lawyers, who had chafed against the restrictions on securities class

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Tougher Version," *S. F. Chron.*, July 25, 2002, at A1 (quoting Rep. George Miller (R-Cal.)).

[42] *See* Romano, *supra* note 18 at 1568-85.

[43] *See id.* at 1534, n. 35.

[44] *See* Zoe-Vonna Palmrose & Ralph S. Saul, *The Push for Auditor Independence, Regulation,* Winter 2001, at 20, available at http://www.cato.org/pubs/regulation/regv24n4/v24n4-3.pdf.

[45] Romano, *supra* note 18 at 1583.

remedies and lawsuits in the Private Securities Litigation Reform Act of 1995 (PSLRA) and imposed by the Supreme Court. In particular, the trial lawyers supported Senator Leahy's effort to lengthen the statute of limitations on securities actions. This gave Democrats a negotiating tool to get the Republicans to agree to cloture.[46] Lawyers, particularly transactional lawyers who advised on corporate governance, had an interest in tightening governance requirements. Thus, an American Bar Association task force, representing the interests of transactional lawyers, made recommendations dealing not only with lawyers but with corporate governance generally, including increasing director independence.[47]

The question is what influence these policy entrepreneurs may have had on the final legislation. Romano points out that the corporate governance proposals these entrepreneurs championed could not be dismissed as symbolic politics – that is, something to wave in front of a gullible public to show that the politicians were doing something.[48] In fact, the politicians did not do much waving – the proposals were hardly discussed in floor debates. These were the sort of "inside-the-beltway" proposals the general public cares little about, particularly compared with more salient issues like increased criminal penalties for misconduct, which everybody can understand.

The role of the policy entrepreneurs may have been to provide grist for the political mill. Although the political environment may have been conducive to regulation, politicians need specific proposals to enact. The policy entrepreneurs put their weight behind specific proposals the politicians could enact. They may not have been symbols in themselves, but at least served to lend substance to the final legislation, in itself a potent symbol that Congress had done something about corporate malfeasance.

The result of the hodge-podge of proposals that came out of the woodwork was legislation that extends far beyond the problems that triggered the regulatory panic, including strict new regulation of the auditor-client relationship and the imposition of a large additional bureaucracy on the accounting profession.

### 6. Populism and political entrepreneurs

Like other products, legislation needs to be sold to its consumers, in this case, the voters. Legislators sometimes have a special ability to opportunistically match specific legislative proposals with the public mood. Jayne Barnard details how Senator Charles E. Schumer was able to do this with respect to what may be one of the most intrusive and costly SOX provisions – the outlawing of certain loans to insiders.[49]

As discussed above, Bush's political problems over his Harken loans were an important factor in putting pressure on Republicans to support SOX. More specifically,

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[46] *See id.* at 1555-58; 148 Cong. Rec. S6534 (daily ed. July 10, 2002) (motion dividing the Leahy Amendment); id. at S6535 (colloquy between Sens. Sarbanes and Gramm) (linking the division and cloture motions); id. at S6538 (statement of Sen. Gramm) (describing agreement).

[47] See *Report of the American Bar Association Task Force on Corporate Responsibility* (March 31, 2003), available at http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf.

[48] *See* Romano, *supra* note 18 at 1585-91.

[49] *See* Barnard, *supra* note 18 at 338-39.

President Bush, in his July 9 speech shortly after the first Harken story, which Schumer had attended, had decried executive loans, though had not proposed any legislation to deal with them. Nevertheless, the *Wall Street Journal* noted that day that the loans were "too popular to disappear anytime soon."[50]

"Soon" had a special meeting in this fast-moving political context. When Bush's own inside loan was reported shortly thereafter, Schumer realized that the time was ripe for a move. So on July 12, 2002, after obtaining White House support, Schumer introduced an amendment in the Senate outlawing insider loans. This was one of only three amendments that were made after cloture, and got special consideration because of Bush's Harken problem.[51] In his statements supporting the amendment, Schumer explicitly played the populism card, asking, "Why can't these super rich corporate executives go to the corner bank, the Sun Trust's or Bank of America's, like everyone else to take loans?"[52] The amendment passed without discussion by voice vote.[53]

### 7. The boom-bust regulatory cycle

SOX was arguably just one example of the "Sudden Acute Regulatory Syndrome"[54] that usually follows a market panic – like the Bubble Act passed in England in the midst of the South Sea Bubble, and the federal securities laws in the U.S. that followed the 1929 crash.[55] When the economy is booming or stable, significant new financial or corporate governance regulation will not help any particular interest group enough so that they will be willing or able to apply pressure for it – or at least enough pressure to overcome opposition by anti-regulatory groups. The pro-regulatory groups cannot enlist the support of consumers or investors who are riding a rising market, or who are simply indifferent to a dull market.

The political dynamic changes, however, when fraud becomes a hot media story. People are susceptible to claims that regulation is needed to "restore confidence" in the market. Moreover, there is a deep-seated distrust of financial markets and envy of rich capitalists that awakens when these markets are going down and not providing goodies. These public attitudes can be seized by policy entrepreneurs, political opportunists and pro-regulatory interest groups.

This "regulatory panic" account of financial regulation suggests that laws like

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[50] Joann S. Lublin, "Questioning the Books: The President Speaks: Loans to Corporate Officers Unlikely to Cease Soon," *Wall St. J*ournal, July 10, 2002, at A8.

[51] *Id.* at 339, n. 102.

[52] 148 Cong. Rec. S6690 (daily ed. July 12, 2002) (statement of Sen. Schumer), quoted in Barnard, *supra* note 18 at 339.

[53] 148 Cong. Rec. S 6690 (daily ed. July 12, 2002).

[54] *See* Larry E. Ribstein, *Sarbox: The Road to Nirvana,* 2004 Mich. St. L. Rev. 279.

[55] See Ribstein, *Bubble Laws*. See also Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence,* 75 WASH. U. L.Q. 849, 850 (1997) (showing that securities market regulation in the U.K. and the U.S. in the eighteenth and nineteenth centuries was adopted only after stock market declines); Romano, *supra* note 18 at 1591-94 (discussing regulation as a function of stock market declines).

SOX are enacted precisely when lawmakers are least able to evaluate them properly. Lawmakers regulating in a crash are likely to underestimate the gains that a vibrant business and capital market environment can provide and ignore the regulatory costs of their actions. Such times are ripe for regulation that penalizes useful practices and generally discourages risk-taking by punishing negative results and reducing the rewards for success.

#### 8. The bottom line: all action, no talk

The above analysis shows that, for several reasons, lawmakers and voters did not seem to be willing to calmly debate the costs and benefits of SOX. Deliberations in Congress were sparse.[56] There was only one day of debate in the House, with hardly anyone speaking on some of the major proposals in the House bill, such as officer loans and audit committee independence. In the Senate Committee, the witnesses were heavily skewed in their views of regulation and their testimony did not attempt to balance costs and benefits or to present evidence that was inconsistent with their conclusions. The Senate debated the resulting bill hurriedly and under cloture, and the bill was passed swiftly with little revision.

Some of the factors that led to this result, such as the political environment, were specific to SOX and are unlikely to recur. But many of the factors that produce a regulatory panic have recurred over time and are likely to arise again. We are doomed to relive the SOX experience unless we can better understand the costs of this type of regulation and the excesses inherent in SOX. Congressmen and interest groups might have resisted the populism and the panic if they better realized the havoc this type of law might cause. Since the most invasive corporate governance provisions did not in any event particularly resonate with the public – that is, they likely were simply pulled off the shelf to fill out the legislation – a better understanding of the costs of governance "reform" may reduce the likelihood of a future SOX. We provide those insights below.

### C. THE SARBANES-OXLEY ACT

At this point it is useful to provide a quick roadmap of what Congress did in the dog days of summer 2002. The provisions will be grouped according to their general objectives.

#### 1. Increased internal monitoring

SOX has several provisions that are intended to ensure better monitoring for potential fraud by the corporation's own agents:

--The board audit committee must consist solely of independent members, and must be responsible for hiring and overseeing auditors.

--Executives must certify reports, with criminal penalties for reckless certification.

--Penalizes executives who fraudulently influence or mislead auditors.

--Mandates disclosures concerning the firm's internal control structure.

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[56] *Id.* at 1551-68.

--Mandates a code of ethics for financial officers.

--Provides for protection of whistleblowers.

**2. Gatekeeper regulation**

The act includes provisions intended to ensure better and more disinterested performance by professionals who are supposed to scrutinize corporate transactions.

--Requires attorney reporting of evidence of fraud.

--Reduces ties financial between auditors and audited companies.

--Provides for an independent Public Company Accounting Oversight Board.

**3. More disclosure**

The Act provides for new categories of disclosure relating to

--the firm's internal control structure and code of ethics

--off-balance-sheet transactions

--pro forma earnings

The Act also provides for SEC rules requiring more rapid disclosure of material changes in financial condition.

**4. Regulation of insider misconduct**

Beyond disclosure and monitoring, the act includes some direct regulation of suspect categories of insider conduct.

--Prohibits loans to insiders.

--Requires return of incentive-based compensation following accounting restatements.

**5. Regulating securities analysts**

The Act includes provisions intended to ensure that securities analysts operate independent from their firms' investment banking activities.

## III. WHAT SHAREHOLDERS WANT – THE OPTIMAL AMOUNT OF FRAUD

The "separation of ownership and control" – the notion that managers of publicly traded corporations may not have incentives to act in their shareholders' best interests – has been the overriding concern of corporation law and corporate governance since before Adolf Berle and Gardiner Means coined the phrase in 1932. Officers and directors may take advantage of shareholders by not working hard, consuming excessive perquisites, paying themselves exorbitant salaries, hoarding cash, building empires,

diversifying the corporation for their personal risk preferences, not taking enough risks, and so forth. Managers use their dominance of the director selection process to promote the election of directors who will defer to them. Shareholders let managers get away with this because it is not worth their time to be active participants in corporate monitoring – they are rationally ignorant and follow the Wall Street Rule of selling their shares rather than complaining about poor performance.

The economic approach to the corporation builds on this tradition and refers to the "separation of ownership and control" as an agency problem – the managerial agents do not always have the incentives to act in the shareholders' best interest. Agency theory characterizes the corporation as a "nexus of contracts" among shareholders, managers, directors, creditors, and employees who voluntarily join together in mutually beneficial transactions.[57] In this economic model, agency costs are the sum of (1) the costs of managers pursuing their own interests at the expense of shareholder value and (2) the costs of resources devoted to dealing with this problem. It is irrational and wastes shareholder value to attempt to perfectly align managerial interests with shareholder interests because the costs of perfect control exceed the benefits. In other words, the optimal amount of self-interested conduct by managers, both for shareholders and for society as a whole, is more than zero.

Agency theory provides a useful framework for thinking about the role of SOX in protecting shareholder value from managerial malfeasance. In the extreme, we can stop all such malfeasance only by outlawing the corporation and forcing business people to stop hiring agents.

How do we determine the optimal amount of fraud? In other words, how much fraud would shareholders be expected to tolerate? One approach is to put it in the context of efficient markets and risk-bearing by shareholders. Efficient securities markets discount the known risk of fraud in the price of securities based on factors such as the nature of the industry and the track records of key executives. This forces firms to deal with these risks if they want to raise new capital. To be sure, some of the risk of fraud cannot be quantified. But shareholders are assumed to own a portfolio of stocks through which they diversify many different risks, including the risks of managerial ineptitude, managerial entrenchment, accounting and other fraud, self-dealing and lawsuits. Thus, through diversification, shareholders can minimize their costs of bearing the risk of fraud. A corollary is that attempting to eliminate all managerial malfeasance would actually hurt diversified shareholders by requiring managers to devote resources to reducing risks that shareholders can deal with cheaply on their own.

Consistent with this market structure, our corporate governance system allows managers to take reasonable business risks on behalf of shareholders. These business risks would include such strategic decisions as entering markets, mergers and acquisitions, research and development, and organizational control issues such as how much to invest in internal controls such as monitoring employee performance. All of

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[57] Market forces provide strong incentives for contracting parties to perform as promised. In this view, corporate law plays the important role of providing standard terms and gap-fillers that define the legal relationships among the parties. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 1-39 (1991); Henry N. Butler, "The Contractual Theory of the Corporation," 11 *Geo. Mason L. Rev.* 99 (1989). The contractarian approach to corporate law suggests that corporations should be free to alter the default rules. Henry N. Butler & Larry E. Ribstein, "Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians," 65 *Wash. L. Rev.* 1, 71 (1990); Frank H. Easterbrook & Daniel R. Fischel, "Contract and Fiduciary Duty," 36 *J.L. & Econ.* 425 (1993).

these business decisions are protected from state law fiduciary liability by the business judgment rule, which allows managers to take reasonably informed risks without fear of second-guessing by litigious shareholders with 20/20 hindsight.[58]

SOX Section 404, which is discussed in detail below,[59] is a good example of this misguided attempt to eliminate all agency costs. This section requires executives to certify the adequacy of their internal controls. The discussion below will demonstrate that the internal controls requirement does not reflect a tradeoff of costs and benefits that is in the best interests of shareholders. Shareholders are not interested in perfect internal controls for the sake of control. They are only interested in improving internal controls if the improvement will increase share value. Yet the early results from the Section 404 internal controls attestations indicate that, although less than 8 percent of the largest 2,500 corporations found deficiencies all firms were required to invest millions of dollars to identify these problems. This suggests that diversified investors would be better off without Section 404. In the absence of SOX, corporate boards and executives would have been guided by rational cost-benefit analysis in determining the extent of controls and the appropriate amount of documentation.

## IV. IMAGINING A WORLD WITHOUT SOX

SOX defenders do not mince words in claiming that SOX is a tremendous success. For example, Harvey Goldschmidt, a former SEC commissioner and strong proponent of the SOX reforms, states, "I think that Sarbanes-Oxley has been a great success in terms of the effect it has had on improved corporate governance. There is no question it has been a great piece of legislation, and anybody who says otherwise is talking like a darn fool." And Representative Michael Oxley – not a "darn fool" – suggests that the issue of benefits transcends data:

> [N]o one can know with any accuracy. . . where we would be today had Sarbanes-Oxley not been created.. . . How can you measure the value of knowing that company books are sounder than they were before? Of no more overnight bankruptcies with the employees and retirees left holding the bag? No more disruption to entire sectors of the economy? I think that's a valuable return for the investment, when the outlays now are a small fraction of the losses that were sustained."

This sort of thinking obviously puts a strong burden of proof on opponents of regulation. Indeed, to the extent that Oxley suggests that the value of the legislation cannot be measured, the burden is impossible to bear.

The burden should, instead, be on proponents of massive new regulation. The overwhelming success and strength of our capital markets, and the dominance of private contracting, suggests that the market works without new regulation, and that regulations should thus be required to pass a cost-benefit test. And, contrary to Oxley's assertion, there are ways to measure both costs and benefits, as demonstrated by the finance studies summarized below in Part V. Although these metrics are imperfect, they can, cumulatively, provide some guidance to regulators if carefully done and understood.

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[58] For an analysis of the rationales for and functions of the business judgment rule, *see* Larry E. Ribstein, "Accountability and Responsibility in Corporate Governance," __ *N.D. L. Rev.* __ (2006).

[59] *See infra* subpart V.A.1.

The analysis should begin with a realistic appraisal of the benefits that have flowed from SOX. It is important to understand that much of what SOX sought to accomplish might have been done at much lower costs by markets alone or under state law without the need for a broad and burdensome new federal regime.

To frame this analysis, assume for the moment that there is less fraud in the post-SOX world. This Part asks if there would have been more fraud over the past three and a half years in the *absence* of SOX. Some of the improvement may have nothing to do with SOX. But even if some market improvement can be traced to SOX, it is far from clear that it would not have been provided by the markets or the states, perhaps more efficiently, if SOX had not been adopted. If Congress had not acted, others may have, and there were already ample mechanisms in place to protect against further frauds. Issuers, securities firms and other market actors have even stronger incentives than Congress to restore "confidence in the market" if, as Congress believed,[60] lack of confidence was driving away their customers and sources of capital.

This Part shows that there are many things that corporations, private organizations and states might have done if Congress had not passed SOX. It also shows that these alternatives may have been at least as effective as SOX in reducing managerial malfeasance and fraud, and concludes that SOX has interfered with the operation of these important corporate governance devices.

## A. CAPITAL MARKET FORCES

Even without SOX or any other law, the capital market would continue monitoring corporations, backed by the extensive mandatory disclosure laws already on the books. Even in the absence of private or public regulation, markets had the capacity to address the problems that surfaced in Enron and related scandals. This section discusses some of the available alternatives.

### 1. Market monitoring

SOX was Congress' response to the particular frauds revealed in Enron, WorldCom and other cases. For example, auditors and lawyers failed to spot or report fraud, so Congress passed provisions mandating reporting and greater independence of these gatekeepers. Bernie Ebbers and WorldCom demonstrated the problems that loans to insiders could cause when not carefully monitored, so Congress decided to ban them.

Securities analysts, investment managers, and others have a strong financial motive to ferret out information. How can the market spot fraud, which by definition is hidden? The same information about past frauds and disclosure lapses that Congress relied on in passing SOX now can inform market actors as to what to look for in the firms they watch. Analysts now know, for example, to look more closely at the fine print in financial statement footnotes and to rely more on "hard" numbers such as free cash flow rather than "soft" numbers affected by firms' decisions on capitalizing and amortizing expenses, unusually high rates of growth and arrogant managers.[61]

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[60] For evidence that there was no lack of investor confidence, see Wallison, *supra* note 21.

[61] See William H. Beaver, "What Have We Learned from the Recent Corporate Scandals that We Did Not Already Know?," 8 *Stan. J.L. Bus. & Fin*. 155 (2002).

Companies also provide information in the form of the mechanisms they adopt, or fail to adopt, for monitoring for fraud. Financial economists are doing significant theoretical modeling and empirical research to determine which corporate practices and characteristics are correlated with financial risk. For example, researchers showed that corporations are more likely to "manage" earnings the more non-audit services they bought from their audit firms.[62] The market evidently caught on to this, because the same study showed that investors tended to devalue firms that disclosed unexpected purchases of non-audit services.[63] There is also evidence that firms subject to SEC enforcement actions from 1978-2002 incurred total market penalties, as measured by expected loss in the present value of future cash flows due to higher contracting and financing costs, that were twelve times the total of SEC and private litigation penalties imposed on these firms.[64] These penalties are visited not only on firms, but also on their managers. Another study shows increased management turnover following earnings restatements and that the employment prospects of the displaced managers of restatement firms are poorer than those of the displaced managers of firms that have not issued restatements.[65]

In the post-Enron environment, firms would similarly put investors on alert if they gave large loans to executives, had executives on the board audit committee or used other governance mechanisms that the market has condemned. The firms could decide whether the benefits they obtain from these devices outweigh the increase in capital costs. They also have incentives to adopt market-favored devices, and to signal in other ways that they are well-managed, as discussed in the next section.

To be sure, market monitoring may not work without mandatory disclosure. But there already is a well-developed mandatory disclosure system. The question for federal regulators and Congress should be whether this system ought to be tweaked to give the market the information it needs. This approach would have preserved the traditional distinction, entrenched for 70 years, between the federal emphasis on disclosure and the state emphasis on internal governance.

In fact, even before Enron's collapse and the advent of SOX, analysts had a lot of the information they needed to be able to spot fraud. For example, in February 2001, eight months before the disclosures that brought Enron down, a hedge fund manager figured out that Enron had been using derivatives to speculate rather than to hedge.[66] The footnotes to Enron's financial statements disclosed the basic facts concerning Enron's

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[62] See Richard M. Frankel et al., *The Relation Between Auditors' Fees for Non-Audit Services and Earnings Quality,* (MIT Sloan, Working Paper No. 4330-02, January 2002), http://papers.ssrn.com/paper.taf?abstract_id=296557.

[63] *Id.*

[64] Jonathan Karpoff, D. Scott Lee & Gerald S. Martin, *The Cost to Firms of Cooking the Books*, (July 25, 2005), http://papers.ssrn.com/paper.taf?abstract_id=652121.

[65] Hemang Desai, Chris E. Hogan & Michael Wilkins, *The Reputational Penalty for Aggressive Accounting: Earnings Restatements and Management Turnover* Accounting Review, Forthcoming.

[66] See Jonathan R. Laing, *The Bear that Roared: How Short-Seller Jim Chanos Helped Expose Enron*, Wall St. Journal Online, http://online.wsj.com/barrons/article/0,4298,SB101191069416063240.djm,00.html.

potential exposure to debts incurred by special purpose entities.[67]

If all these facts were available, why did it take so long for the market to catch on? The answer is that the market was in a boom cycle. "New-economy" firms were exploring methods of doing business for which evaluation metrics had not been developed. Analysts and executives were arguing that the established guidelines for price-earnings multiples did not apply to novel business methods. Optimistic day-traders flush with cash were inclined to agree.

So was SOX necessary to prevent future market vulnerability to fraud? The existence of a repetitive cycle of periods of boom, bust, and regulation strongly suggests not. As noted above, the market disregarded information that was actually in the disclosure documents of firms like Enron. To be sure, this was not clear disclosure – it had to be ferreted out by analysts. But once that had been done, the warning signs were in the open, inviting more careful investigation and evaluation. Perhaps curious analysts would have hit stone walls within the companies, but the absence of information (and a company's unwillingness to provide information) suggests the presence of risk which, in turn, is reflected in the market price.

Moreover, even if more disclosure, or perhaps barring suspect practices, would have prevented Enron and other frauds, it is not clear that such regulations will prevent the *next* fraud – which will not be about special purpose entities or derivatives, but probably about some other practices that neither the markets nor Congress can now anticipate. With or without SOX, the possibility of another major Enron-like corporate fraud would inevitably persist.

**2. Reputations and signaling**

The primary political argument for the passage of SOX was the political need to restore "investor confidence." Although there is good reason to doubt the economic validity of this argument, there is an underlying theoretical argument that supports regulation if the post-fraud securities market is a market for "lemons" that investors will avoid because all investments, like the inventory on a shady used car lot, look like potential losers. This refers to the theory of George Akerlof, the 2001 Nobel Laureate in Economics.[68] It follows from this insight that regulation like SOX is not so much for the benefit of investors, who will avoid future risk, but for that of reputable sellers who will lose business unless they can persuade buyers that the sharks are gone and it is safe to swim.

The question is whether regulation is necessary to reassure investors. Akerlof shared his Nobel Prize with Michael Spence and Joseph Stiglitz for their work on market responses to the lemons problem.[69] In the present context, these would include firms' maintaining good reputations for honesty and signaling to investors and others that they

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[67] *See* William W. Bratton, "Enron and the Dark Side of Shareholder Value," 77 *Tul. L. Rev.* 1275 (2002).

[68] See George A. Akerlof, "The Market for "Lemons": Quality Uncertainty and the Market Mechanism," 84 *Q.J. Econ.* 488 (1970).

[69] See, e.g., A. Michael Spence, *Market Signaling: Informational Transfer in Hiring and Related Processes* (1974).

are not like Enron or WorldCom.

Firms' reputations provide an important way to protect investors. Firms invest significant sums in advertising and in behavior that induces investors to trust them and thereby to reduce their cost of capital.[70] Firms that cheat incur a significant penalty by devaluing the reputation they spent so much to build. This effect was observed recently in mutual funds that suffered significant outflow of funds after news reports of misbehavior.[71]

Signals include maintaining a high level of voluntary formal disclosure, voluntarily joining organizations or obtaining certifications from reputational intermediaries, having candid meetings with securities analysts and the media, or voluntarily adopting mechanisms suggested by governance reformers such as expensing stock options, separating audit and non-audit services, or hiring auditing firms that follow this practice.

Firms also can signal through buying insurance, since the size of the premium indicates the extent of the insured risk. This is a fairly reliable signal, since insurance firms have strong incentives to set the price accurately, and firms' incentives to insure minimize the risk of false signals. There is evidence that firms' directors' and officers' liability insurance premiums accurately indicate the quality of a firm's governance arrangements.[72] Firms also might signal honesty by buying "financial statement insurance," in which the insurance carrier hires the auditor and provides the signal.[73]

An advantage of signaling over mandatory regulation is that each firm can decide whether the benefits of signaling integrity outweigh the costs. For example, some firms may derive substantial benefits from having their auditors do non-audit services, and may have in place alternative monitoring systems that reduce the need for this extra assurance of disinterested auditing. One-size-fits-all regulation precludes this sort of tailoring.

Moreover, mandatory regulation may carry the extra cost of discouraging or disabling potentially valuable signaling. Once the law requires all firms to adhere to the same standard, they have less incentive to signal their integrity. This reduces market incentives to develop and adopt alternative signaling mechanisms. For example, in the absence of SOX, a market in financial statement insurance might have developed that would permit more precise and cost-effective measurement of fraud risk.

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[70] Benjamin Klein & Keith B. Leffler, "The Role of Market Forces in Assuring Contractual Performance," 89 *J. Pol. Econ.* 615 (1981); Oliver Williamson, "Credible Commitments: Using Hostages to Support Exchange," 73 *Am Econ. Rev.* 519 (1983).

[71] *See* Stephen J. Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals,* NYU, Law and Economics Research Paper No. 06-07 (January 2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=877896.

[72] See John E. Core, "The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance," 16 *J. L. Econ. & Org.* 449 (2000) (showing a significant association between D&O premiums and proxies for the quality of firms' governance structures, which is confirmed by positive correlation between firms' insurance premiums and excessive CEO compensation).

[73] See Joshua Ronen, "Post-Enron Reform: Financial Statement Insurance, and Gaap Re-Visited," 8 *Stan. J.L. Bus. & Fin.* 39 (2002).

Given the potential for signaling to restore confidence in the market on a firm by firm basis, the main theoretical defense of SOX is as a subsidy for firms that have relatively high costs of using these mechanisms. One might argue that, without SOX, newer and smaller issuers, which are riskier because the market has less information about them, might have struggled in a risk-sensitive post-Enron market as compared to their bigger and more reputable rivals. But this would be an ironic defense of SOX given the outcry concerning the problems that SOX – particularly its internal controls provisions – creates for smaller firms.[74] If SOX-type regulation is, indeed, better for smaller firms, then it should have been designed with the needs and characteristics of these firms in mind. Clearly, SOX did not meet this alleged need.

### B. SHAREHOLDER MONITORING

Even if SOX had never become law, firms would be subject to scrutiny not only by the capital markets, but also by their own shareholders. Highly visible institutional shareholders like TIAA-CREF have the clout to press for these changes by directly communicating with managers and by enlisting support from other shareholders through shareholder proposals that the firm must subsidize under current SEC rules.[75] Managers would risk market penalties by not responding favorably to proposals that receive significant support. The proposals also could provide information to the SEC as to the extent to which shareholders – whose money is on the line – favor particular reform initiatives.

To be sure, institutional investors such as state pension funds may have their own political agendas, and individual investors lack incentives to spearhead governance reform. But there are also very motivated investors who can institute reform by buying large or controlling interests. The active takeover market of the 1980's was killed by the combination of federal prosecutions of the key players, the Williams Act, and state anti-takeover laws. Indeed, the weakened market for corporate control that resulted from this regulation may partly account for the recent corporate frauds. However, a new market for control has been revived through hedge and private equity funds. These buyers have much more high-powered monitoring incentives than the independent directors, auditors, and lawyers on whom SOX relies so heavily.

The more general lesson from the recent history of takeovers concerns the efficacy of regulation. Takeover regulation was supposed to be the solution to the last problem of excessive job insecurity for managers and workers. It did little to address this problem while helping to weaken governance and thereby create conditions for the next crisis of corporate fraud. The lesson is that additional market regulation may have unforeseeable perverse effects and should be approached with caution rather than embraced in panic.

### C. STATE AND INTERNATIONAL COMPETITION IN THE PRODUCTION OF OPTIMAL SHAREHOLDER PROTECTIONS

Even without SOX, there would still have been the substantial body of state corporate law, which historically, and even after SOX, is the principal mechanism for regulating corporate governance. SOX, however, represented a significant shift away

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[74] *See infra* section V.C.3.

[75] See SEC Rule 14a-8.

from state law in its provisions prescribing the composition of board audit committees, prohibiting certain officer loans and requiring reimbursement of bonuses and stock profits. Even SOX's disclosure provisions, particularly including the internal control disclosures, may indirectly invade state regulation of corporate governance by establishing a de facto governance standard.

The state-based system of regulating corporate governance has been hailed as one of the main strengths of the U.S. capital markets.[76] Although William Cary, a former SEC Chairman, famously decried the competition for corporate charters as a "race to the bottom,"[77] Ralph Winter quickly pointed out that Cary had ignored the fact that efficient capital markets ensure that firms' incorporation decisions are capitalized into the value of their shares.[78] There is significant evidence based on stock returns indicating that firms' incorporation decisions are, in fact, efficient.[79]

There are also strong advantages inherent in adjudication of corporate issues in state courts. As two prominent Delaware judges remarked recently:

> In our experience, the effective adjudication of corporate law disputes requires a great deal of direct involvement by the trial judge. The factual records in such cases are often large and make for demanding reading. Moreover, many of these matters are time-sensitive and involve the application of complex legal doctrines to the evidence in a very short timeframe--a reality that limits the capacity of judges to delegate very much of the work to law clerks. As we understand it, the federal courts already face a stiff challenge in addressing their already formidable caseloads. . . . In view of that reality, it seems unlikely that the federal courts are well-positioned to absorb the burden of adjudicating corporate governance disputes now handled by state courts.[80]

Some might argue that Enron and other frauds indicated a failure of state corporate law. But it is interesting that two of the main culprits, Enron and WorldCom,

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[76] See Roberta Romano, *The Genius of American Corporate Law* (1993).

[77] William Cary, "Federalism and Corporate Law: Reflections Upon Delaware," 83 *Yale L.J.* 663 (1974). For more recent versions of Cary's view, see Lucian Arye Bebchuk & Allen Ferrell, "Federalism and Takeover Law: The Race to Protect Managers from Takeovers," 99 *Colum. L. Rev.* 1168 (1999); Lucian Arye Bebchuk, "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law," 105 *Harv. L. Rev.* 1435 (1992).

[78] Ralph Winter, "State Law, Shareholder Protection, and the Theory of the Corporation," 6 *J. Legal Stud.* 251 (1977).

[79] *See* Sanjai Bhagat & Roberta Romano, "Event Studies and the Law: Part II: Empirical Studies of Corporate Law," 4 *Am. L. & Econ. Rev.* 380, 382-94 (2002) (reviewing studies relating to state competition debate); Peter Dodd & Richard Leftwich, "The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation," 53 *J. Bus.* 259 (1980) (showing "management's decision to reincorporate in another state does not reduce stockholder wealth"); Roberta Romano, "The Need for Competition in International Securities Regulation," 2 *Theo. Inquiries in Law* 387, 495-97 (2001) (reviewing eight studies finding positive abnormal stock returns from changing incorporation state).

[80] *See* William B. Chandler III & Leo E. Strine, Jr., "The New Federalism of the American Corporate Governance System:Preliminary Reflections of Two Residents of One Small State," 152 *U.Pa. L. Rev.* 953 (2003).

were not incorporated in the leading jurisdiction of Delaware, but rather in Oregon and Georgia, respectively. These firms' choice of state law may have been based on an expectation of favorable regulatory treatment or better protection against takeovers than in Delaware.[81] In the wake of Enron, firms might be more careful in eschewing these considerations and focusing on whether the chosen regime protects shareholders against managerial agency costs. This would also encourage Delaware to respond to the heightened concern with agent misconduct.[82]

Moreover, before blaming state law and turning to more federal law, we should consider that a regulatory landscape already increasingly dominated by federal law was ineffective in preventing Enron. It is not obvious that even more federal law is the answer. Mark Roe has argued persuasively that the ever-present threat of federalization necessarily constrains states in regulating corporate governance.[83] As discussed below, SOX may have tightened this noose and further disabled the states from responding to corporate governance problems.

Relying on state law would better enable firms to tailor their governance to their particular circumstances. For example, the evidence indicates that more board independence is not correlated with firm value.[84] A review of state laws on executive loans, which were supplanted by SOX's prohibition of many such loans, indicates significant variation, from prescribing procedures for approval, requiring the board to identify a corporate benefit, or providing for no default regulation at all.[85]

Theoretically, the advantages of state competition might be extended to the international scene, with international jurisdictional competition as to disclosure rules.[86]

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[81] Enron reincorporated from Delaware to Oregon in 1997 in order to buy an Oregon electric utility, Portland General Electric, and be eligible for the intrastate exemption of the Public Utility Holding Company Act. See Staff of the Senate Committee on Governmental Affairs, 107th Cong., Financial Oversight of Enron: The SEC and Private-Sector Watchdogs 26 (Oct. 8, 2002), available at 2002 WL 31267528. Georgia led the country in adoption of a particularly effective "dead-hand" poison pill. See *Invacare Corp. v. Healthdyne Tech., Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997), a device Delaware invalidated in *Quickturn Design Sys. v. Mentor Graphics Corp.*, 721 A.2d 1281 (Del. 1998); *Carmody v. Toll Bros. Inc.*, 723 A.2d 1180 (Del. Ch. 1998).

[82] Delaware courts are well suited to responding quickly to the regulatory challenge presented by corporate fraud. See Jill E. Fisch, "The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters," 68 *U. Cin. L. Rev.* 1061 (2000).

[83] Mark J. Roe, "Delaware's Competition," 117 *Harv. L. Rev.* 588 (2003).

[84] *See* Sanjai Bhagat & Bernard Black, "The Non-Correlation Between Board Independence and Long-Term Firm Performance," 27 *J. Corp. L.* 231 (2002); Sanjai Bhagat & Bernard Black, "The Uncertain Relationship Between Board Composition and Firm Performance," 54 *Bus. Law.* 921 (1999); Bhagat & Romano, *supra* note 79, 402-03 (2002).

[85] *See* Barnard, *supra* note 18.

[86] See Stephen J. Choi & Andrew T. Guzman, "Portable Reciprocity: Rethinking the International Reach of Securities Regulation," 71 *S. Cal. L. Rev.* 903 (1998); Roberta Romano, "Empowering Investors: A Market Approach to Securities Regulation," 107 *Yale L.J.* 2359 (1998). For criticisms of these proposals, see James D. Cox, "Regulatory Duopoly in U.S. Securities Markets," 99 *Colum. L. Rev.* 1200 (1999); Merritt Fox, "Securities Disclosure in a Globalizing Market: Who Should Regulate Whom," 95 *Mich. L.*

Foreign firms already can choose to "bond" their integrity by cross-listing in the U.S. or other jurisdictions and thereby subjecting themselves to these legal regimes in addition to those in their home country. There is substantial evidence for this bonding explanation of cross-listing.[87] Full-fledged international competition currently is hobbled by the fact that the U.S. insists on regulating all trading within their borders regardless of where the firms are based. Thus, if international competition is not as successful as state competition, it is because of the overreaching of federal law. Piling on more federal law through SOX aggravates rather than reduces this problem.

## D. REGULATION BY STOCK EXCHANGES AND OTHER PRIVATE INSTITUTIONS

Finally, it is worth wondering whether private organizations might have picked up any regulatory slack that existed in the absence of SOX. Firms can supplement market discipline by subjecting themselves to regulation by non-governmental bodies. In a manner similar to the signaling discussed above, a firm's decision to be regulated would be evaluated by the capital markets and reflected in its stock price.

Firms already are subject to governance provisions in stock exchange listing agreements. Exchanges theoretically have an incentive to compete for listings by offering rules that reduce listed firms' cost of capital.[88] Thus, shortly after SOX was passed, the New York Stock Exchange Board of Directors adopted listing standards relating to director independence that went beyond SOX's regulation of the membership of audit committees.[89] The NYSE, for example, has an incentive in competing with NASDAQ and other exchanges to encourage firms to pay higher listing fees in exchange for a lower cost of capital by assuring investors in those firms that the NYSE is actively monitoring them. [90]

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*Rev.* 2498 (1997).

[87] *See* Larry E. Ribstein, "Cross-Listing and Regulatory Competition," *Review of Law & Economics:* Vol. 1: No. 1, Article 7, http://www.bepress.com/rle/vol1/iss1/art7 (2005).

[88] See generally Paul G. Mahoney, "The Exchange as Regulator," 83 *Va. L. Rev.* 1453 (1997).

[89] *See* Corporate Governance Rule Proposals Reflecting Recommendations From the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors (Aug. 1, 2002), available at http://www.nyse.com/pdfs/corp_gov_pro_b.pdf. (requiring a majority of the board to have no material relationships with the firm, and lengthening to five years the "cooling off" period for board service by former employees of the issuer or its auditor, requiring that directors meet without management, requiring wholly independent nominating and compensation committees in addition to the independent audit committee, requiring the chair of the audit committee to have accounting or financial management expertise, requiring the audit committee to have sole responsibility for hiring the auditing firm, and prohibiting compensation of audit committee members apart from directors' fees).

[90] There is some reason to believe that stock exchanges no longer can fulfill the function of regulating the governance of listed firms. Jonathan Macey and Maureen O'Hara argue persuasively that changing technology has lowered the cost of trading, facilitating the emergence of competing trading venues, which has affected the viability of exchanges as regulators. Jonathan R. Macey and Maureen O'Hara, "From Markets To Venues: Securities Regulation in an Evolving World," 58 *Stan. L. Rev.* 563 (2005). Among other problems, exchanges cannot effectively discipline listed firms that have a variety of trading venues. Also, with so many available trading venues, an exchange does not internalize the benefits of its regulatory efforts, and therefore has an incentive to invest too little in regulation and enforcement. As a result, "self-regulation" by the exchanges has really become SEC regulation forced, or at least strongly

Other types of self-regulatory organizations might also play a significant role in monitoring firms. There is evidence, for example, that peer review in auditing firms[91] and competition between professional auditing associations can provide effective monitoring of auditing firms.[92]

The upshot of the analysis and evidence presented in this Part is that the American corporate governance system has numerous self-correcting forces that are likely to be more focused and more measured than an economy-wide regulatory intervention such as SOX. Neither Congress nor SOX's defenders give credence to the historical, institutional strengths of our corporate governance system. A greater appreciation of the market forces and institutional incentives leads to the inevitable conclusion that there was little opportunity for Congress to add much value. In short, the benefits of SOX necessarily have been slight. Unfortunately, as detailed below, SOX's costs have been enormous.

## V. THE COSTS OF SOX

The current defense of SOX is that, despite its evident costs, at least it helped rid us of the fraud that had taken the capital markets down after Enron. As discussed below in this Part, the direct costs of SOX are quite high – indeed, high enough to have attracted significant attention in the business press.

Many defenders focus on these direct compliance costs, and reassure us that these costs are temporary, will decline as firms figure out how to comply, and in any event are worth it if the result is reducing fraud. However, these assessments are based on an overly sanguine view of what SOX compliance actually entails and a failure to realize what a heavy weight it ties around the legs of US firms. Among other things, SOX has diverted executives' attention from the hard work of maximizing shareholder value and distorted executives' incentives and investment decisions. As discussed in Part VII, the most extensive and persuasive study of SOX's financial costs estimates the loss in total market value of firms around legislative events leading to the passage of SOX at $1.4 trillion.[93] This astronomical amount suggests that the stock markets implicitly estimated the net costs of SOX to be much greater than simply the present value of the future direct costs of compliance. The lesson from Part III was that the risk of corporate fraud and agent misconduct does not necessarily justify regulation if the costs of the regulation exceed the cost of the fraud and misconduct that would occur in the absence of regulation. Although SOX was ostensibly passed to protect investors, it hurts them if it forces corporations to spend more on protection than they are gaining in fraud reduction.

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urged, on the exchanges in order to prevent a race to the bottom in regulation.

[91] Gilles Hilary and Clive Lennox, "The Credibility of Self-Regulation: Evidence from the Accounting Profession's Peer Review Program," forthcoming *Journal of Accounting and Economics* (showing that opinions issued by peer reviewers provided credible information based on evidence that audit firms gained clients after receiving clean opinions from their reviewers and lost clients after receiving modified or adverse opinions).

[92] *See* Paul V. Dunmore & Haim Falk, "Economic Competition between Professional Bodies: The Case of Auditing," 3 *Am. L. Econ. Rev.* 302 (2001) (showing that competition between professional auditing associations can efficiently substitute for most government regulation);

[93] *See* Zhang, *Economic Consequences of the Sarbanes-Oxley Act of 2002*, available at http://w4.stern.nyu.edu/accounting/docs/speaker_papers/spring2005/Zhang_Ivy_Economic_Consequences_of_S_O.pdf.

It is useful to keep in mind that one person died from swine flu, and 32 from the vaccine. This Part considers some sources of SOX's direct and indirect costs.

## A. DIRECT COMPLIANCE COSTS

This subpart discusses the direct compliance costs imposed by SOX that have attracted the most media attention.

### 1. Section 404 Internal Control Disclosures and Attestation

Consistent with the disclosure philosophy of the original 1933 and 1934 Acts, SOX increases mandated disclosure in several areas. Perhaps the most troublesome new disclosure provision has been Section 404, which imposes a brand new and extensive obligation on managers to assess the quality of their internal controls. Little discussed or debated in Congress, and little noticed during the whirlwind of July 2002, it provides for SEC rules requiring firms' annual reports

> to contain an internal control report, which shall-- (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Section 404 acquires extra importance because of two other sections of the law requiring senior executives to take personal responsibility for these new annual report disclosures. Section 302 provides for SEC rules requiring senior officers to certify in each annual or quarterly report not only that they know of no material misstatements or omissions in the report, but that they

> (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.

The officers must certify that they have disclosed to firm's auditors and board audit committee

> 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 . . . any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.

Finally, the signing officers have must indicate "significant changes in internal controls or in other factors that could significantly affect internal controls" since the last evaluation.

Section 906 requires a certification by the issuer's CEO and CFO that "the

periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer." These requirements include, of course, the internal controls disclosures under Section 404.

The SEC has, in fact, issued voluminous rules implementing and interpreting these provisions.[94] To give a taste of the rules, they clarify that the officers must sign off on, among other things, whether transactions are recorded as necessary and provide assurances regarding unauthorized acquisition, use or sale of assets.[95] Changes that might affect internal controls that the officers must evaluate include significant corporate transactions, expansion into new regions, changes in management or organizational structure.[96] The SEC has also made clear that management must follow methodologies established by recognized bodies after public comment.[97]

SOX also requires external auditors to opine on both managers' assessment and on their own evaluation of control effectiveness.[98] The provision was implemented by Audit Standard 2 promulgated by the Public Company Accounting Oversight Board (PCAOB), the auditor regulator that SOX created (and whose appointment is the basis of the Free Enterprise Fund lawsuit). Section 404 created a new standard of what potential problems needed to be disclosed – specifically, "significance" rather than the traditional test of "materiality." This standard will have to be developed through many years of case law and SEC rulemaking. In the meantime, firms and auditors have to guess how the test will be applied.

The SEC initially estimated that its proposed rules implementing SOX §404 "would impose an additional 5 burden hours per issuer in connection with each quarterly and annual report"[99] This estimate was sharply rebuked in comments on the proposed rule.[100] The SEC's final rule revised the estimate up to "around ... $91,000 per company," not including "additional cost burdens that a company will incur as a result of having to

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[94] *See* SEC Release No. 33-8124 (Aug. 29, 2002); SEC Release No. 33-8238 (June 5, 2003); SEC Release No. 34-49884 (June 17, 2004).

[95] *See* SEC Rules 13a-15(f), 15(d)-15(f).

[96] *See* SEC Release 33-8238.

[97] See Rules 13a-15(c), 15d-15(c); Release 33-8328.

[98] See §103(a)(2)(A)(iii).

[99] Securities & Exchange Commission, *Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002*, Release 33-8138 (22 October 2002), available at http://www.sec.gov/rules/proposed/33-8138.htm.

[100] See, e.g., Comment Letter — File No S7-40-02; Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002 (27 November 2002), available at http://www.sec.gov/rules/proposed/s74002/cklafter1.txt (comment from Cary Klafter of Intel stating that "[b]ased on our actual experience to date, we believe that the Commission has underestimated the time and effort involved in complying with these rules by at least a factor of 100, if not a greater order of magnitude").

obtain an auditor's attestation."[101] Moreover, the SEC was way off the mark even after it revised its cost estimates. For example, Financial Executives International estimated compliance costs at $4.36 million per company as of mid-2005.[102] AMR Research has estimated that companies will spend $6 billion to comply with SOX in 2006.[103] One can only wonder how the SEC (or plaintiffs' attorneys) would react to errors and restatements of similar magnitude by a publicly traded corporation.

There was an outcry from firms as the internal controls rule kicked in for financial statements due after November 15, 2004 – an outcry so intense that it may have accounted in part for the early departure of SEC Chairman William Donaldson. The SEC responded in several ways to the concerns about internal controls reporting – by delaying reporting by small and foreign companies,[104] by convening an Advisory Committee on Smaller Public Companies, which has recommended exemptions of or at least modified requirements for smaller companies,[105] and by a Roundtable in April 2005[106] followed by a May 16 Policy Statement[107] (joined by a policy statement from the PCAOB[108]) on implementing the internal controls audits. The Policy Statement observed:

> Although it is not surprising that first-year implementation of Section 404 was challenging, almost all of the significant complaints we heard related not to the Sarbanes-Oxley Act or to the rules and auditing standards implementing Section 404, but rather to a mechanical, and even overly cautious, way in which those rules and standards apparently have been applied in many cases. Both management and external auditors must bring reasoned judgment and a top-down, risk-based approach to the 404 compliance process. A one-size fits all, bottom-up, check-the-box approach that treats all controls equally is less likely to improve

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[101] Securities and Exchange Commission, *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Release No 33-8238 (11 June 2003), available at http://www.sec.gov/rules/final/33-8238.htm, at n 174.

[102] Financial Executives International, available at http://www.fei.org/404_survey_3_21_05.cfm.

[103] *See supra* text accompanying note 11.

[104] *See* SEC Release 33-8545 (March 2, 2005), available at http://www.sec.gov/rules/final/33-8545.htm (extending compliance date for non-accelerated filers and foreign private issuers to fiscal years ending after July 15, 2006); SEC Release 33-8618 (September 22, 2005), available at http://www.sec.gov/rules/final/33-8618.pdf (extending compliance date for non-accelerated filers to July 15, 2007).

[105] *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission*, draft of February 14, 2006, available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport_d.pdf.

[106] The results of the roundtable and a "guidance" issued by the SEC are reported in *Staff Statement on Management's Report on Internal Control Over Financial Reporting* (May 16, 2005), available at http://www.sec.gov/info/accountants/stafficreporting.htm. The transcript of the Roundtable is available at http://www.sec.gov/spotlight/soxcomp/soxcomp-trans.txt.

[107] www.sec.gov/news/press/2005-74.htm.

[108] http://www.pcaobus.org/Rules/Docket_008/2005-05-16_Release_2005-009.pdf.

internal controls and financial reporting than reasoned, good faith exercise of professional judgment focused on reasonable, as opposed to absolute, assurance.

The upshot of the Roundtable and Guidance, as described in a speech last November by SEC Commissioner Cynthia Glassman,[109] is that Glassman was "still hearing stories of auditors identifying over 40,000 key controls and, while significant reductions in auditors' fees were projected at the time of the roundtable, recent anecdotal reports suggest that such fee reductions have not yet materialized."

It should not be surprising that the SEC's and PCAOB's jawboning were not enough to "bring reasoned judgment and a risk-based approach to the process."[110] As discussed further below, the problem is that auditors, corporate executives who also sign off on financial statements, and corporations must fear not only regulatory sanctions if they understate risks and the need for controls but also civil litigation and criminal prosecutions the next time inherent business uncertainty drives a firm's price down.

One striking thing about the controversy over the costs of compliance with Section 404 is that, even though the costs are much higher than anyone in the government predicted, no one in Congress or the SEC is advocating reconsidering the propriety of Section 404 – although there is some concern about its adverse impact on smaller firms. SOX's defenders dismiss the problem as one of start-up costs that will be amortized over time. But many of the costs are ongoing and are likely to remain high, even if lower than during the initial period.[111]

Another striking thing about the controversy is that it was so predictable. Precisely the same thing happened when Congress adopted the first major set of internal controls in 1977 in the Foreign Corrupt Practices Act. The controversy was quelled only when the SEC adopted an interpretation and policy statement.[112] If Congress had done its homework, it would have foreseen the problems that would result from SOX's much broader internal controls provision.

### 2. Audit Committee Independence

Corporate reformers long have loved the idea that directors who are not employed full-time by the company and who are otherwise independent of the company and its insiders will aggressively monitor executives' performance on behalf of shareholders. Reformers have ignored theoretical questions such as why it is logical to assume that one who is employed full-time elsewhere would have adequate time, incentives, and information to be effective, or why any problems with non-independent directors would

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[109] http://www.sec.gov/news/speech/spch111705cag.htm.

[110] As the SEC Advisory Committee has noted, *supra* note 105 at 26, AS2 was developed for external auditors and "does not provide management with guidance on how to document and test internal control or how to evaluate deficiencies identified," despite the fact that SOX §404 clearly provides for different requirements for managers and for external auditors.

[111] See, for example, survey data compiled by CRA International, *Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update* (December 8, 2005), http://www.crai.com/pubs/pub_4896.pdf.

[112] *See* Advisory Committee, *supra* note 105 at 24-25 (discussing this history).

not be reflected in share price. They have also ignored the ample data showing that corporate profitability is generally unrelated to the number of independent directors on the board.[113]

The specific SOX contribution to board structure was to ensure that a company's auditors are chosen and overseen by a fully independent audit committee. This focus was not surprising given the lapses in oversight by Enron's auditor, Arthur Andersen. But as Congress rushed to act in the headlong process discussed in subpart II.B, nobody asked the right questions about whether any of this could have been prevented by requiring more independence. Remarkably, nobody seems to have cared that the Enron audit committee *was* independent. Nobody inquired as to the difficulty directors faced in overseeing auditors. Nobody wondered whether this fix was necessary or effective in addition to SOX's provisions applying directly to audit firms. Is it worth the cost for firms to pay *both* the increased audit costs under the Act *and* the increased costs of audit companies? Nor did anyone ask whether any but the largest companies could afford the stringent new audit committee requirements, or what these requirements would mean to foreign issuers subject to SOX with board structures very different from those of U.S. companies.

The data before and after SOX lends little support to the notion that the benefits of increased audit committee independence are worth the costs. Roberta Romano reviews 16 studies attempting to relate audit committee independence to various performance measures and finds that ten fail to show that audit committee independence improves performance, one reports inconsistent results for different models, and three of the remaining studies suffer from methodological flaws.[114] The factor that seems to matter more in the studies is whether the audit committee members are *financially sophisticated.*

Rules requiring independent directors may be much more burdensome for small than for large firms. One study found that small firms paid $5.91 to non-employee directors per $1,000 in sales before SOX period compared with $9.76 per $1000 in sales after SOX, while large firms' costs increased only from $.13 per $1,000 in sales to $.15.[115] This disproportionate impact on small firms stifles entrepreneurial incentives and, in effect, denies access to public capital markets.

This section has summarized some of the theoretical and empirical work on the direct costs of SOX. The next several sections discuss some of the indirect costs of SOX.

## B. MANAGING IN THE SHADOW OF SOX: "A CLIMATE OF FEAR"[116]

SOX is a burdensome intrusion into the internal affairs of public companies. Such an intrusion could be justified by regulators if it corrected a market failure and resulted in benefits greater than costs. However, as discussed above, the benefits are

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[113] This is summarized in "Market v. Regulatory Responses to Corporate Fraud," 28 *J. Corp. L.* 1, 26-29 (2002).

[114] *See* Romano, *supra* note 18 at 1532.

[115] See Linck, Netter & Yang, *Effects and Unintended Consequences of the Sarbanes-Oxley Act on Corporate Boards* (March 2005), available at http://papers.ssrn.com/paper.taf?abstract_id=687496.

[116] *Business Week*, April 24, 2005.

likely small and the direct costs are high. The indirect costs are also substantial.

### 1. Section 404 internal controls

SOX's most troublesome provision is Section 404, the so-called "internal controls" provision. As discussed above, this provision involves serious direct compliance costs. SOX defenders argue that these costs are worth the deterrence that internal controls reporting and certification provides to fraud. But it is harder to justify the significant long-term effects that internal controls reporting has on business.[117]

First, modern firms, unlike the small shops of the early 19th century, rely on specialization of functions, automation, delegation of authority, and complex hierarchies. Managers have to be able to trust their subordinates. SOX raises a serious question about whether this sort of trust is inconsistent with the need to have adequate "controls." Thus, SOX will surely provoke redundancies that detract from bureaucratic efficiency.

Second, SOX clearly penalizes change and innovation. Any upgrades, new software, or acquisitions would have to be evaluated as "significant changes in internal controls or in other factors that could significantly affect internal controls." The safer course, when in doubt, is to do nothing.

Third, SOX requires firms to devote significant resources to not only tracking information, but providing a costly and unnecessary paper trail. For example, the SEC's rule defining executives' certification obligations says

> An assessment of the effectiveness of internal control over financial reporting must be supported by evidential matter, including documentation, regarding both the design of internal controls and the testing processes. This evidential matter should provide reasonable support: for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; for the conclusion that the tests were appropriately planned and performed; and that the results of the tests were appropriately considered.[118]

Of course firms need to find and discipline fraud. But, as we have repeatedly emphasized, firms will be less profitable if they have to spend more on preventing fraud than the fraud was costing them.

The risks imposed by the internal controls provision fall directly on auditors or executives who sign off on the internal control reports. Since auditors and executives are less able to bear risk than the shareholders of publicly held firms who hold diversified portfolios, the auditors and executives may respond by either demanding greater compensation or adjusting their behaviour to reduce the risk. Indeed, one study finds a post-SOX decline in the ratio of incentive compensation to salary after the passage of

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[117] For a discussion of the business effects of SOX compliance, see Brian Doherty, "You Can be Too Careful," *Reason*, January, 2006, http://www.reason.com/0601/fe.bd.you.shtml.

[118] SEC Release no. 33-8238, *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, at n. 79.

SOX, and in firms' research and development expenses and capital expenditures.[119] These results indirectly indicate reduced manager incentives to invest in, and be compensated based on, the riskier long term. Ultimately, the shareholders bear most of this risk.

### 2. Impact on managerial risk-taking: independent directors

SOX requires audit committees to be made up entirely of independent directors. This seemed like a reasonable response to the accounting scandals because it appeared that senior executives had been able to dominate the auditors and audit committees of Enron, WorldCom and others. As mentioned above, board independence has long been a favorite panacea of corporate governance reformers despite questions about its cost-effectiveness. Moreover, Peter Wallison has offered an argument that independence can actually be harmful:

> The independent directors of a company are part-timers. No matter how astute in the ways of business and finance, they know much less about the business of the companies they are charged with overseeing than the CEOs and other professional managers who run these enterprises day to day. Unfamiliarity in turn breeds caution and conservatism. When asked to choose between a risky course that could result in substantial increases in company profits or a more cautious approach that has a greater chance to produce the steady gains of the past, independent directors are very likely to choose the safe and sure. They have little incentive to take risk and multiple reasons to avoid it.[120]

### 3. Constraining executive compensation: insider loan prohibitions

Executive compensation is a perennial hot button issue in corporate governance. Yet, SOX did not directly address the area. Perhaps Congress was mindful of the perverse incentives created by its last foray into executive compensation, in 1993, when it limited the tax deductibility of executive pay to $1 million annually unless it was "performance based."[121] This law naturally encouraged more reliance on stock options which, in turn, increased managers' incentives to manage earnings and focus on short-term results.[122] Moreover, a predictable result of this reform is that executives increasingly will be rewarded based on "random" components of company performance rather than the results of their own efforts.[123] Now concern about excessive managerial

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[119] Cohen, Day & Lys, *The Sarbanes Oxley Act of 2002: Implications for Compensation Structure and Risk-Taking Incentives of CEOs*, (July 23, 2004), available at http://papers.ssrn.com/paper.taf?abstract_id=568483.

[120] Peter J. Wallison, *Blame Sarbanes-Oxley,* AEI Online (September 1, 2003), http://www.aei.org/publications/filter.all,pubID.19123/pub_detail.asp.

[121] *See* I.R.C. §162(m).

[122] Statement of the Financial Economists Roundtable on "The Controversy Over Executive Compensation" (November 24, 2003) http://www.luc.edu/orgs/finroundtable/statement03.pdf.

[123] *See* Robert F. Göx, *Tax Incentives for Inefficient Executive Pay and Reward for Luck* (October 2005), available at http://ssrn.com/abstract=823884.

compensation[124] has spurred a massive SEC effort to overhaul executive compensation disclosure.[125] This is likely to be only the beginning of more executive compensation "reform," as the cycle of misguided tinkering continues.

SOX's contribution to the executive compensation reform party was Section 402, prohibiting insider loans. The problem with this regulation is that such loans have the potential benefit of encouraging insider ownership of company stock, which tends to align their interests with those of the shareholders.[126] To be sure, insider loans may have costs.[127] But Jayne Barnard suggests that Congress might have better balanced costs against benefits by examining the terms, purpose and size of the loan, the company's expectations for repayment of the loan, manner of approval and the existence and extent of disclosure to investors. In other words, there is a vast difference between the mammoth questionable loans from WorldCom to CEO Bernie Ebbers and many of the other insider loans that SOX outlawed. Even if some insider loan regulation was efficient, it is better left to the states, which have a variety of strategies for dealing with these loans.[128] Moreover, federal regulation might have taken several forms, including enforcing existing disclosure laws, increasing disclosure, mandating particular approval or collection procedures, and prohibiting certain types of loans.[129]

Instead of this careful balancing of costs and benefits, Congress precipitously responded to the Republicans' need to reduce the damage from disclosures concerning the President's loans many years before, and under pressure from Senator Schumer's populist opportunism.[130]

Congress' action left numerous questions unanswered concerning the relationship between the loan prohibition and numerous corporate practices currently authorized by state law, including advancement of attorneys' fees and expenses in litigation, agreements facilitating executives' exercise of stock options, and corporate payment of life insurance

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[124] See Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004).

[125] See U.S. Securities Exchange Commission, Proposed Rule Change: Executive Compensation and Related Party Disclosure (January 27, 2005), http://sec.gov/rules/proposed/33-8655.pdf.

[126] See Ribstein, *supra* note 54; Charles M. Elson, "The Duty of Care, Compensation, and Stock Ownership," 63 *U. Cin L. Rev.* 649, 695 (1995).

[127] *See* Khuldeep Shastri & Kathleen M. Kahle, *Executive Loans*, in AFA 2004 San Diego Meetings: EFA 2003 Annual Conference Paper No. 184, at 10, Feb. 2003, at http://ssrn.com/abstract=423447 (showing that insider loans from 1996-2000 made to facilitate stock purchases were often diverted to other uses); Elizabeth A. Gordon et al., *Related Party Transactions: Associations with Corporate Governance and Firm Value,* in EFA 2004 Maastricht Meetings Paper No. 4377, at 6, Aug. 2004, at http://ssrn.com/abstract=558983 (finding negative relationship between industry-adjusted returns and insider loans).

[128] *See* Barnard, *supra* note 18 at 344-45.

[129] *See id.* at 349.

[130] *See supra* text accompanying note 49.

premiums for executives.[131] In desperation, after receiving little official clarification,[132] lawyers from twenty-five large law firms drafted their own guidance,[133] only to leave themselves open to a charge that they had violated the antitrust laws.[134] Even Sarbanes and Oxley expressed disagreement about whether clarification was necessary.[135] The SEC's Advisory Committee on Smaller Public Companies has recommended that the SEC clarify various aspects of this provision, noting that it has not yet done so.[136] Such confusion and waste of legal talent are just additional evidence of the indirect costs of SOX.

#### 4. Lawyer monitoring

SOX Section 307 calls for the SEC to promulgate a rule "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 chief executive officer, and, if they do not respond, to the audit committee, other independent directors, or the board. This provision was a response to well-publicized reports that Enron's outside lawyers had failed adequately to act on information they had concerning misdeeds within the company.

After SOX, the SEC had to figure out how lawyers could fulfil their reporting obligation. An important part of the SEC's rule was to permit corporations to set up something called a Qualified Legal Compliance Committee ("QLCC") as a reporting mechanism. Two commentators criticized this innovation as likely to increase the cost to issuers of obtaining and retaining high quality directors, increase the demands on scarce director time, and … interfere with board collegiality and board-management relations"[137]

An empirical study of how the QLCC rule has actually functioned showed that, while the SEC had predicted that 3,620 issuers would form QLCCs, the number by mid-

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[131] *See* Barnard, *supra* note 18 at 350-51.

[132] The SEC eventually provided limited guidance as to the legitimacy of foreign bank loans to bank executives, *SEC Adopts Fund Disclosure Rules and Foreign Bank Loan Exemption; Proposes Shell Company Rules,* at http://www.sec.gov/news/press/2004-50.htm. The Department of Labor eventually clarified the application to ERISA plans. Field Assistance Bulletin 2003-1, April 15, 2003.

[133] See Sarbanes-Oxley Act: Interpretive Issues Under § 402-Prohibition of Certain Insider Loans, at www.mayerbrown.com/sarbanesoxley/interpretiveissuesundersec402.pdf.

[134] Mark R. Patterson, *Law-Fixing: Should Lawyers Agree How to Interpret Statutes?,* in Fordham School of Law, PUB-LAW Research Papers No. 50, at 18-9, May 5, 2004, at http://ssrn.com/abstract=555706. For a counterargument and other observations, see Larry E. Ribstein, *Should lawyers agree how to interpret statutes?*, Ideoblog, January 11, 2005, available at http://busmovie.typepad.com/ideoblog/2005/01/should_lawyers_.html.

[135] Deborah Solomon, *Sarbanes and Oxley Agree to Disagree*, Wall St. J., July 24, 2003, at C1.

[136] *See* Advisory Committee, *supra* note 105 at 90.

[137] Fisch & Gentile, "The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors," 53 *Duke L. J.* 517, 583 (2003).

September 2005 was only 556, about 3% of eligible firms.[138] The main problem the author found was that lawyers and directors believed that this structure inappropriately shifted responsibility for legal compliance decisions away from the managers, where it has traditionally been, and onto the board, which is not equipped for determining how to handle legal risk. This, of course, means that the board may have to bear legal liability for not acting on risks that are identified by reports to their QLCCs. On the other hand, investment funds and trusts have been more willing to form QLCCs, since those firms do not have separate managerial employees and welcome this opportunity for dealing with potential conflicts of interest by their investment advisors. This study sheds light on the main problem with SOX §307, and indirectly on a central problem with SOX. Even if some adjustment in relationships between corporations and their lawyers is justified, by regulating the details of the relationship between lawyers and corporations, SOX risks interfering with structures that are firmly entrenched under state law and current practice, with unpredictable and potentially costly results.

Another potential problem with Section 307 is that removing relationships with lawyers from operating management and putting them into the hands of independent directors erects a barrier between firms' managers and the professional advisors these managers must deal with every day.[139]

Thus, mandating significant new lawyer monitoring is not only a waste of legal talent, but also disrupts candid communications and traditional hierarchical relationships. Moreover, if encouraging more lawyer monitoring is necessary, there are ways to do so cost-effectively through the structure of professional firms and ethical rules.

#### 5. Monitoring by corporate executives

SOX increases monitoring duties of executives by requiring them to certify reports and internal controls. This forces corporate executives to immerse themselves in the minutiae of their firms which, as discussed below in Section V.C.2., may not be an efficient use of valuable managerial resources. Also, imposing litigation risk on individual managers is likely to cause them to insist on precautions and paperwork that diversified shareholders would find excessively costly. Thus, the executive certification requirements exacerbate the costs of the internal controls requirements discussed above. Moreover, as discussed below in Part VI, the litigation risk inherent in the certification requirements may contribute to excessive timidity in corporate management. With potentially billions of dollars in liability at stake, the most profitable corporations subject to SOX will be the ones whose executives are well-trained to anticipate litigation difficulties, rather than business issues.

#### 6. Building the paper trail

SOX imposes complex new record-keeping obligations on corporations. On the one hand, they have to document everything they do, creating a paper trail of explanations. On the other hand, if there is a fraud and an investigation, some email or other document that was innocuous at the time it was created might be crucial evidence

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[138] Robert Eli Rosen, "Resistances to Reforming Corporate Governance: The Diffusion of QLCC's," forthcoming, *Fordham L. Rev.*, http://papers.ssrn.com/paper.taf?abstract_id=830131.

[139] *See* Larry E. Ribstein, "Limited Liability of Professional Firms after Enron," 29 *Journal of Corporation Law* 427 (2004).

for the plaintiff if, in hindsight, it indicated a problem that should have been pursued. SOX will necessitate the development of a new field of expertise in corporate paper-shuffling. As discussed below in Section V.C.1 and 2., the need for such expertise will divert managerial resources from more productive skills and tasks.

#### 7. Whistle-blowing

SOX §806 subjects corporate executives to heightened scrutiny by protecting whistle-blowing employees from reprisals. This responds to reports of attempts to squelch employee reports of the fraud at WorldCom. In general, it is likely that many employees eventually will learn about aspects of any massive fraud.

Congress did not, however, sufficiently consider the potential costs of this provision. Most importantly, Section 806 essentially creates a new subtopic in employment law that hinders employers from efficiently monitoring their employees. Workers who "cause information to be provided" concerning a securities violation to the SEC, Congress, or "a person with supervisory authority over the employee," now have job protection under SOX. Given the open-ended language of the provision, an employee can threaten the firm with embarrassment even if his information is less than damning. Firms are likely to be litigating over, for example, when an employee "reasonably believes" that information shows a securities law violation and whether the job action was due to the whistle blowing.

Congress also obviously did not think long and hard over who should administer this new employment law. As it happens, it delegated enforcement to safety and health regulators who have enough problems handling their main jobs without getting into the brave new world of financial fraud.[140]

### C. OPPORTUNITY COSTS OF SOX

Subpart B catalogued the various problems managers face in the wake of SOX but did not consider how much all this is going to cost. SOX's drafters and defenders seem to think that managers have plenty of time and energy and that, as long as they do not have much else to do, they may as well spend time on the tasks SOX assigns to them. In fact, management energy and resources are scarce. What is spent on SOX compliance is not spent on other activities that may be more valuable to the firm and to society. This recalls Milton Friedman's admonition memorialized as "TANSTAAFL" – "there ain't no such thing as a free lunch."[141]

#### 1. Diversion of managerial talent

SOX has demanded the attention all board members and senior officers of every publicly traded company in America. It is very difficult to measure the opportunity cost of the time devoted to complying with SOX. For example, if a CEO whose annual salary

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[140] See Deborah Solomon, "For Financial Whistle-Blowers, New Shield is an Imperfect One," *Wall Street Journal*, October 4, 2004, A1.

[141] *See* Milton Friedman, *There's No Such Thing as a Free Lunch* (1975). The phrase was originated by Robert Heinlein, *The Moon is a Harsh Mistress* at 12 (1967)("Oh, 'tanstaafl'. Means 'There ain't no such thing as a free lunch.' And [there????] isn't," I added, pointing to a FREE LUNCH sign across room, "or these drinks would cost half as much.").

is $1 million estimates that one-quarter of his time is devoted to complying with SOX, then an accountant might calculate that the SOX cost the company $250,000 in the CEO's time. However, the costs are surely much higher. The CEO is paid to add value – much more value than his salary.[142] The SOX mandates mean that the most talented American business people must devote less time to increasing shareholder value than they otherwise would have been able to do, draining precious managerial resources at a time when U.S. businesses are subject to increasing competition from countries that are not saddled with SOX.

SOX not only diverts executive time from important managerial matters, but may be instrumental in diverting the executives themselves. Many corporate executives are leaving public corporations, with their greatly increased risk of SOX liability, for the greener pastures of private equity.[143] The allocation of executive talent should depend on market opportunities, not federal regulation.

### 2. From entrepreneurs to hall monitors

SOX is a problem not just for the firms that must incur high costs to comply, but because of the social costs that result from the business that does not get done and the firms that are not formed. SOX in effect represents a political judgment that less risk of fraud or bad business outcomes is necessarily good for society. Some of SOX's social costs are attributable to the disproportionately high costs SOX imposes on smaller companies, as discussed in the next section. As the SEC's Advisory Committee concluded, "[d]isproportionate compliance burden will likely have a negative effect on the competitiveness and capital formation ability by smaller companies, thus hurting the U.S. economy."[144] However, the problem can arise because of burdens imposed on larger firms as well.

First, the disproportionate compliance costs per dollar of capitalization for smaller firms impose social costs by discouraging start-up ventures. The venture capital market is built on the assumption that successful venture-capital-financed start-ups ultimately will exit from the venture phase into the public securities markets. To the extent that SOX is a tax on smaller public firms, it is therefore also a tax on entrepreneurial ventures.

Second, SOX imposes social costs by causing firms that have already been formed either to go private or stay privately held. In this situation the owners, at least as a group, take the course of action that maximizes their wealth given legal costs. However, there may be a social cost to the extent that there are gains to society in addition to those to the owners from the firm being publicly owned. This may be the case in part because public ownership enables diversification of risk, and thereby encourages entrepreneurial activity. Firms need to balance the higher agency costs of separating ownership and control against risk diversification advantages. A problem with SOX in this respect is that it forces at least some firms to accept a tax on public ownership that they would not

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[142] *See* Michael C. Jensen & Kevin J. Murphy, "Performance Pay and Top Management Incentives," in Michael C. Jensen, *Foundations of Organizational Strategy* (Harvard University Press, 1998) http://ssrn.com/abstract=94009.

[143] *See BusinessWeek Online*, "Going Private," February 27, 2006, available at http://www.businessweek.com/magazine/content/06_09/b3973001.htm.

[144] Advisory Committee, *supra* note 105, Conclusion 9.

contract for as a way of reducing agency costs. Society also may gain from public or community ownership of some types of firms. For example, many firms going private in 2004 were community financial institutions, a type of firm for which public ownership may confer a social benefit.[145]

Third, SOX may reduce the flow of resources to riskier firms. Firms whose earnings are relatively variable, that engage in novel or more complex types of business for which the accounting standards are more uncertain, or that use novel business practices such as hedging and derivatives, are all subject to increased liability risk under SOX, particularly because of the greater need for disclosures about internal controls. This is supported by evidence that certain types of firms tend to find material control problems – younger smaller firms, and larger firms that are relatively complex and undergoing rapid change.[146] These additional risks may make it harder for the firms to find high-quality executives, auditors and outside directors. Top executives may be attracted by more stable firms that have lower liability risk, firms in less risky industries, or non-public companies that are not subject to SOX. They also might find jobs with better risk-reward profiles in consulting or auditing given the need for these services under SOX. In other words, SOX may have the effect of shifting business from innovating and inventing to simply looking for fraud.

Fourth, SOX may cause social costs by deterring acquisitions of smaller firms by larger firms. The SOX internal controls disclosure and certification requirements impose substantial burdens on firms acquiring new lines of business. These acquisitions, like going public, may be an important mechanism for financing entrepreneurial activity. They also may have the effect of moving assets to firms that are better able to minimize regulatory risks, or may help reduce this risk by giving buyers an incentive to investigate risk and sellers an incentive to reduce it.[147] To be sure, SOX may also increase acquisitions because it increases the returns to size. But this happy circumstance of achieving economies of scale in SOX compliance would likely only occur with the merger of firms that had similar internal control systems prior to the acquisition, since otherwise the acquiring firm would have to invest considerable resources in harmonizing the control systems. Moreover, the economics of scale in compliance does not subtract from the costs of deterring acquisitions. Rather, it adds to social costs by encouraging acquisitions that would not be efficient without SOX.

### 3. Reducing smaller firms' access to public capital markets

The internal controls rule also places a particularly heavy burden on smaller firms, with significantly lesser benefit to investors. This is supported by evidence that smaller and less actively traded firms reacted more unfavorably to events that increased

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[145] *See* William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of 'Going Private,'* Emory Law and Economics Research Paper No 05-4 (February 2005), available at http://papers.ssrn.com/paper.taf?abstract_id=672761.

[146] See Jeffrey T. Doyle, Weili Ge & Sarah E. McVay, *Determinants of Weaknesses in Internal Control Over Financial Reporting*, July, 2005, http://papers.ssrn.com/paper.taf?abstract_id=770465.

[147] *See* Jason Scott Johnston, *Signaling Social Responsibility: On the Law and Economics of Market Incentives for Corporate Environmental Performance,* http://papers.ssrn.com/paper.taf?abstract_id=725103 (May 11, 2005); Michael P. Vandenbergh, "The Private Life of Public Law: Accounting for the Influence of Private Agreements on Public Regulation," 105 *Colum. L. Rev.* __ (2005).

the likelihood of SOX's passage.[148] In particular, smaller firms have relatively higher overhead costs than larger firms, and therefore must struggle to compete with them. Any increase in overhead imposes an extra burden. Smaller firms compete, in part, through flexibility – the ability to rapidly change business plans to meet customer needs, and to combine functions in single individuals.

SOX imposes a dual hit on these firms by both imposing rigid and inflexible rules and increasing overhead costs.[149] Moreover, these are not merely start-up costs of compliance, but ongoing.[150] Thus, it is not surprising to see that internal controls reporting costs small firms more per dollar of capitalization or revenues than larger firms.[151] This effect is compounded for small firms in the start-up phase, for which the risk assessment Section 404 requires is likely to be more difficult. This may, in turn, reduce socially beneficial entrepreneurial activity.

Conversely, SOX's provisions, and particularly its internal controls reporting, are inherently less beneficial for small than for large companies. The risks posed by small business failure to the economy are lower, since they represent only a small fraction of total market capitalization.[152] Internal control structures are less useful in small firms, which rely on top managers for control, and where these managers in any event can override internal controls.[153] Given the lower benefits of controls in smaller companies, it is not surprising that smaller firms were more likely than larger firms to find weaknesses in internal controls when they set up these systems.[154]

The heavy burden that SOX imposes on small firms has had the significant side effect of causing these firms to reduce their public ownership to avoid SOX. They can do this by becoming privately held or by "going dark" – that is, reducing the number of nominal public shareholders to below 300, which is the threshold for application of the

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[148] *See* Engel, Hayes & Wang, *The Sarbanes-Oxley Act and Firms' Going-Private Decisions* (2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=546626.

[149] *See* Advisory Committee, *supra* note 105 at 31-33, 34.

[150] *Id* at 34-35.

[151] *See* A.R.C. Morgan, *Using Reported Weakness Disclosures to Benchmark Internal Controls*, available at http://www.arcmorgan.com/Form/Weakness_form.htm (showing that companies with sales less than $250 million incurred $1.56 million in costs on internal controls while firms with sales of 1-2 billion incurred $2.4 million in costs, including internal costs, opportunity costs and intangibles); Advisory Committee, *supra* note 105 at 29-30 (graphs showing post-SOX external audit fees as percentage of revenue much higher for smaller companies, and higher ratios of audit fees to capitalization and compliance costs to revenues).

[152] *Id.*, Appendix I, Table 12 (showing that such firms represent about 80% of total by number, but only about 7% by capitalization).

[153] *Id.* at 30-31.

[154] *See* Ge & McVay, *On the Disclosure of Material Weaknesses in Internal Control after the Sarbanes-Oxley Act* (2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=724481.

Securities and Exchange Act of 1934, of which SOX is a part.[155]

SOX has clearly caused some firms to go private. This is indicated indirectly by evidence of post-SOX declines in small firms' share prices,[156] and of more positive share price reactions to going private after enactment of SOX than before.[157] More directly, a recent paper compares the post-SOX rate of going private among American firms with the rate among foreign firms that were not subject to SOX and produces evidence consistent with the hypothesis that SOX induced small firms to become private during the first year following enactment.[158] By comparing firms that were and were not subject to SOX, the article controls for non-SOX factors that could have caused firms to go private.

Why should we care if firms are going private?[159] The liquidity, risk-bearing and informational advantages of public ownership potentially make firms more valuable than they would be if they were closely held. To be sure, this does not mean that all firms should be public, but it does suggest that it may be socially costly to, in effect, put a tax on public ownership. The whole point of SOX is supposedly to encourage public ownership by building "investor confidence." Unfortunately, the firms most in need of this "confidence," and therefore the ones SOX is purportedly helping the most, are the smaller, less established firms that are in fact most disadvantaged by it.

Studies also have shown that 200 firms went dark in 2003, the year after SOX was enacted,[160] that more firms went private after SOX,[161] and that 44 of 114 firms that went private in 2004 cited SOX compliance costs as a reason.[162] There is evidence that firms with higher audit fees were more likely to go dark, which further links going private with the costs of complying with SOX.[163] Going dark means that firms stay public, since the

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[155] Securities and Exchange Act of 1934, s 12(g)(5).

[156] *See* Engel, et al, *supra* note 148.

[157] *Id* (also finding more favorable share price reaction to going private in firms with high inside ownership, which may have had relatively low benefits from being public, and therefore larger net gains from going private); Christian Leuz, Alexander J. Triantis, & Tracy Yue Wang, *Why do Firms go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations* (2004), University of Pennsylvania, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=592421 (2004).

[158] Ehud Kamar, Pinar Karaca-Mandic & Eric Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, (November 2005), http://www.law.ucla.edu/docs/talley_012306.pdf.

[159] For a debate on this issue, see Victor Fleischer, "Is SOX leading more firms to go private?" (January 24, 2006), *Conglomerate*, http://www.theconglomerate.org/2006/01/is_sox_leading_.html; Larry E. Ribstein, *Ideoblog*, "Who cares about the disappearing small public firms?" (January 24, 2006), available at http://busmovie.typepad.com/ideoblog/2006/01/who_cares_about.html.

[160] *See* Leuz et al, *supra* note 157.

[161] See Engel, et al, *supra* note 148.

[162] *See* Carney, *supra* note 145.

[163] See Marosi & Massoud, *Why Do Firms Go Dark?* (November 2004), available at

300-shareholder minimum for registration includes shares held in "street name" on behalf of multiple beneficial holders. These firms lose disclosure transparency, which may help insiders but hurt outside shareholders who remain in the firm. Two studies show that firms lose share value when they announce that they are going dark, and that, especially after SOX, going dark transactions are positively correlated with insider ownership.[164] Firms might lose value from going dark because this transaction signals that they have fewer opportunities for growth, and therefore less need to make disclosures that would aid capital raising. Indeed, the studies show that these firms do tend to have weaker growth potential. But there is also evidence that firms that go dark have characteristics such as lower accounting quality and more free cash that indicate greater likelihood of insider misconduct.[165] In other words, these firms may have perverse reasons for wanting to avoid disclosure. Even before SOX, insiders could try to avoid disclosure obligations by going private. But SOX's higher disclosure costs now give them a legitimate explanation. Even if this is the real explanation, SOX would be indirectly causing a loss of securities law protection for precisely those shareholders who need it most.

These effects of SOX's requirements, particularly including the internal controls rule, on small firms mean that SOX is serving as an entry barrier to public ownership of business firms.

## D. CUTTING OFF INFORMATION

SOX may not only increase firms' disclosure costs, but also may actually reduce the quantity and quality of disclosure in some respects.

### 1. Taking the informed out of the loop

SOX, by reducing potential conflicts of interest, also severs links that could provide high-quality information. Most importantly, prohibitions on consulting work by auditors and requiring periodic change of auditors reduces potential "knowledge spillovers" between auditing and consulting and truncates the learning process in auditor-client relationships.[166] Similarly, at the director level, directors who have other links with the firm might do a better job recognizing concerns that might arise in audits and the tricks insiders might be playing, and therefore may be more effective members of audit committees, than directors who have "Caesar's wife" independence.

Also, the SOX provision requiring lawyers 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" obviously inhibits conversations between lawyers and the firm's agents, as discussed above. Indeed, this issue was thoroughly debated in drafting Rule 1.13(b)-(c) of the ABA's Model Rules of Professional Conduct, which rejected a SOX-type approach. Rule 1.13(b) requires the lawyer to "proceed as is reasonably necessary in

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http://papers.ssrn.com/sol3/papers.cfm?abstract_id=570421.

[164] *See* Leuz, et al, *supra* note 157; Marosi & Massoud, *supra* note 163.

[165] Leuz, et al, *supra* note 157.

[166] *See* Rick Antle et al., *The Joint Determination of Audit Fees, Non-Audit Fees, and Abnormal Accruals (Yale School of Management,* Working Paper No. AC-15, June 14, 2002) (showing that audit firms' provision of non-audit services did not affect the incidence of abnormal accruals), http://papers.ssrn.com/paper.taf?abstract_id=318943.

the best interest of the organization" giving consideration a variety of factors. This language requires lawyers to exercise professional judgment about reporting facts, and considering a variety of different actions. With SOX, however, Congress did not hesitate to radically change the relationship between lawyers and their corporate clients.

The question in these situations is whether the benefits of higher-quality information outweigh the costs of potential bad incentives. The answer may vary from one situation to another, which suggests that the one-size-fits all SOX answer is inappropriate. For example, the amount of information directors or auditors get from their other links with the firm may depend on the complexity or unique properties of the firm's business. Also, the costs of potential incentive problems may depend on the quality of monitoring the firm is getting from other sources. A fully independent audit committee may be enough to ensure that the auditor is doing its job without also prohibiting the auditor from performing non-audit services.

### 2. Reducing trust

SOX also may reduce information flow between employees by reducing trust and creating adversarial relationships within the firm.[167] For example, a worker whose conduct was at least arguably innocent or defensible in the light of applicable rules, but nevertheless hurt the firm, might reasonably fear punishment by overly zealous monitors or whistleblowers and therefore may be reluctant to communicate with them.

Also, insiders who are closely monitored may become less trustworthy. Some scholars think that legal sanctions "crowd out" the motivations to be trustworthy that people have when they are not subject to these sanctions.[168] Also, the widespread dislike of what many corporate employees view as wasted effort and paperwork under SOX might make SOX compliance a kind of game or adversarial process and thereby discourage cooperation.

The trick, then, is finding the precise balance between sanctions that help insure that insiders will not rely excessively on underlings, and sanctions that encourage underlings to be more untrustworthy. Again, this is best done on a firm-by-firm basis rather than by one-size-fits-all regulation. And it certainly cannot be done by the sort of rush to judgment that happened in the summer of 2002.

### 3. Inducing cover-ups

After insiders have committed acts for which they can be held liable, their interests may change from serving the firm’s interest in protecting its reputation to serving their own interests in staying out of jail. Although a cover-up also may increase potential penalties, the insider may decide that he has a better chance of avoiding detection. Also, insiders who are facing jail may become less risk-averse and gamble everything on even a small chance of not getting caught.[169]

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[167] As to the interrelation between law and trust, see Larry E. Ribstein, “Law v. Trust,” 81 *B.U. L. Rev.* 553 (2001).

[168] *See, e.g.,* Bruno S. Frey, *Not Just for the Money* 7-8 (1997).

[169] See Richard W. Painter, “Lawyers' Rules, Auditors' Rules and the Psychology of Concealment,” 84 *Minn. L. Rev.* 1399 (2000); Jeffrey J. Rachlinski, “Gains, Losses, and the Psychology of

SOX raises these problems by imposing liability, including criminal liability, even on those who have not themselves engaged in self-aggrandizing conduct, but have certified reports where they had knowledge of internal controls lapses or failed to disclose information to auditors and the audit committee.

Although there is often a correlation between this conduct and more culpable wrongs, in some situations SOX may make criminals out of those who would otherwise be innocent. For example, Section 302 requires officers to certify that they have disclosed to auditors "any fraud, *whether or not material,* that involves management or other employees who have a significant role in the issuer's internal controls." Suppose, for example, the officer took office supplies, or knows of an officer or accountant who did, in violation of company rules (perhaps imposed because of SOX). By not disclosing and certifying, the officer has committed a criminal offense, punishable under §906 by up to ten years in jail. Given these provisions, in future cases executives might find themselves exposed to criminal and civil liability at the time of approving defective procedures, before they knew or could have known that the procedures were being used to perpetrate fraud. When they do find out about the fraud, their existing exposure may induce them to participate in a cover-up.

## E. PERVERSE INCENTIVES AND UNDOING EFFICIENT RISK-BEARING

An important effect of SOX is to put an increased burden of the risk of corporate on monitors and gatekeepers such as auditors, lawyers, outside directors and senior executives. This is true not only of the liability provisions discussed above, but also of provisions like section 304, which requires reimbursement of compensation and stock profits following accounting misstatements regardless of whether the executive knew of the fraud and even if he exercised all reasonable care in monitoring and instituting controls.

This is questionable policy. As discussed at the beginning of Part III, a significant function of the modern corporation is to reduce the costs of risk bearing by enabling investors to own diversified portfolios of shares. For diversified shareholders, if one company goes down because of fraud, the portfolio is still largely intact. But SOX undoes this advantage by shifting enormous risk back to individuals. Under SOX, an executive who does not take every conceivable precaution against fraud exposes himself to the risk of a personal catastrophe. Even if the executive is protected from personal liability through indemnification or insurance, he may behave more cautiously than the shareholders would want to avoid the risk litigation poses to his reputation, which the executive cannot reduce by diversifying.[170]

Nor can the significant risk-shifting in SOX be justified on the ground that the

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Litigation," 70 *S. Cal. L. Rev.* 113 (1996).

[170] As for insurance, the firm and the shareholders are probably in a better position to monitor executives than the insurer. This may explain why directors' and officers' liability insurance became costlier and scarcer after Enron and WorldCom increased the liability threat, and thus the burden on insurers relative to shareholders. *See* Tamara Loomis, "D&O Insurance Not a Sure Thing," *N.Y.L.J.*, August 30, 2002, at www.law.com; Christopher Oster, "Directors' Insurance Fees Get Fatter," *Wall St.J.*, July 12, 2002, at C1 (discussing the large rise in premiums and deductibles); Christopher Oster, "Insurers Expected to Try to Deny WorldCom Officers' Coverage," *Wall St. J.*, July 1, 2002, at C14 (noting that "the recent rash of earnings restatements and accounting problems has driven up rates for D&O policies"). Indemnification just throws the risk back on the corporation and the shareholders where it belonged in the first place.

defendants are better able to monitor or take precautions against fraud. In many situations there may be little that an auditor or a lawyer effectively can do to prevent or spot fraud. Instead, they might order excessive precaution – more than the shareholders would want if they could make the decision – in order to protect themselves from the risk of ruinous liability. In other words, the same separation of ownership and control that leads to agent fraud also leads to excessive precautions against it. Instead of reducing agency costs, SOX may actually increase them.

Consider the ways that risk-averse executives may respond to the extra risk SOX imposes. They may avoid types of business or transactions that are particularly likely to trigger suspicion and liability in the event of fraud, even if these transactions maximize the value of the firm. This would include, for example, derivatives and special purpose entities that attracted so much attention in Enron but that may be valuable if properly managed. Or risk-averse executives may adjust disclosure so as to minimize liability but not necessarily increase accuracy. For example, they may use overly conservative accounting methods,[171] or hedge or qualify disclosures. This may reduce errors like those common in the pre-SOX era at the cost of introducing a different type of error. It will not necessarily increase market efficiency because market prices reflect basic asset values and expectations of future cash flows rather than accounting methods.

These incentives to excessively avoid risk might be offset by compensating executives in ways that make them act more like shareholders, such as with options or restricted shares.[172] Yet SOX moves in the opposite direction by banning some types of loans to executives, including loans for buying the company's stock. In this way, SOX simultaneously creates a problem and limits private contractual solutions to the problem.

## F. CRIMINALIZATION OF CORPORATE AGENCY COSTS

SOX is one of many examples of the recent trend toward using criminal sanctions to deter and punish social and commercial conduct that traditionally has been subject only to civil sanctions.[173] Although criminalization of all anti-social activities may be politically popular or expedient, there are numerous reasons for questioning the propriety of using such sanctions against many individual and corporate actions. For example, many regulatory crimes are strict liability crimes that do not require the traditional proof of criminal intent, *mens rea*.

SOX's most important criminal provisions are Section 807, which increases the criminal penalty for knowing securities fraud, including imprisonment for up to twenty-five years, and Section 903, which increases imprisonment for mail and wire fraud from five to twenty years. Apart from increasing the penalties, SOX exacerbates the "over-criminalization" problems discussed above by enabling criminal liability even for those who have not themselves engaged in self-aggrandizing conduct, but have certified reports

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[171] *See* Gerald J. Lobo & Jian Zhou, "Did Conservatism in Financial Reporting Increase after the Sarbanes-Oxley Act? Initial Evidence," *Accounting Horizons*, 2006 (showing an increase in conservatism in financial reporting following SOX, including reporting lower discretionary accruals, incorporating losses more quickly than gains in reporting income).

[172] Bhagat & Romano, *supra* note 79 at 409 (reviewing studies)

[173] *See* Paul Rosenzweig, *The Over-Criminalization of Social and Economic Conduct,* Heritage Legal Memorandum #7, http://www.heritage.org/Research/LegalIssues/lm7.cfm.

where they had knowledge of internal controls lapses or failed to disclose information to auditors and the audit committee. In this regard, it is worth noting that the new crimes added by SOX are on top of numerous other criminal sanctions – including the common law fraud and federal securities laws – that are being used to prosecute Lay, Skilling and others.

### 1. The folly of criminalizing corporate agency costs

The challenge of controlling corporate agency costs is at the heart of corporate law and the contractual theory of the corporation. Senior executives and board members are expected to act on behalf of their shareholders. In addition to fiduciary duties under state corporation law, there are strong market incentives for officers and directors to act in their shareholders' best interests. Of course, because monitoring of executive performance is costly, there is always some opportunity for executives to behave in ways that do not maximize shareholder value. Such agency costs are a fact of corporate organization. Indeed, they are anticipated and reflected in market prices. The market rewards firms that do a better job of controlling agency costs.

If corporations do not control agency costs and maximize share value, several things that are not good for officers can happen. First, the corporation can become the target of a tender offer or proxy battle for control. Second, the corporation will not fare well in its product markets and will lose market share and may ultimately go bankrupt. And, if agency costs are extraordinary, civil lawsuits may be brought against the board and officers.

Of particular concern with SOX is that in future cases executives might find themselves exposed to criminal and civil liability at the time of approving defective procedures, before they knew or could have known that the procedures were being used to perpetrate fraud. A major concern of agency theory has been that corporate managers were not being diligent enough in pursuing their obligation to maximize the value of the firm. For example, managers could simply be lazy. Under SOX, lazy can become a crime – failure to take the time to adequately evaluate controls before attesting to their adequacy can result in criminal liability. This threat of criminal liability should take care of the lazy part of agency costs. However, criminal liability might create a larger problem – instead of being lazy, managers might focus too many of the corporation's resources on ensuring the adequacy of corporate controls in order to avoid personal criminal liability. That is, in order to avoid criminal liability, the managers are likely to use corporate resources to their own benefit even though they know it is not in the best interest of shareholders. In this way, criminal liability might actually increase agency costs.

The analysis of criminal sanctions explains why corporate executives will tend to interpret section 404 compliance requirements strictly. As long as criminal liability is perceived as a consequence of failure to comply, over-compliance is going to be the norm.[174] The SEC and PCAOB's suggestions in Spring 2005 that auditors back off on

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[174] SEC Commission Paul S. Atkins summarizes the problem:

> Before people will rationalize their approach to the internal control process, both the SEC and the PCAOB will have to give people comfort that we will actually allow people to use their professional judgment and that they will not be second-guessed. Both the SEC and the PCAOB recently issued guidance on these issues. Both sets of guidance acknowledged that more needs to be done in this area and that the current approach was too granular, was not risk-based and did not

their strict interpretations[175] fell on deaf ears because criminal liability in a statute is much more powerful than a pep talk.

#### 2. Criminal liability for false certifications

SOX explicitly contemplates criminal liability for false certifications. As with civil liability, the SOX internal controls and certification provisions give prosecutors a potent new tool: they can now get a conviction without having to prove knowledge of fraud, but rather only knowledge of a deficiency in controls. This obviously increases the likelihood of a determination of guilt in some cases, and exacerbates the inherent problems of criminal liability in this context.

Criminal liability for internal controls lapses exacerbates another problem with criminal liability in the corporate governance context: The criminal law loses both its moral force and moral legitimacy if it is used to discipline behavior that is not clearly distinguishable from innocent behavior or that is not regarded by most people as culpable. Thus, even if manipulating corporate transactions to give a misleading picture of the firm is inefficient or morally wrong, it should not necessarily be criminal because it is often difficult to distinguish such behavior from innocent aggressive accounting. It is an even more serious problem if the defendant simply falsely certified the adequacy of internal controls, even if the defendant arguably knew that the precautions were inadequate.

#### 3. SOX in the context of current prosecutor practices

SOX's criminal provisions should be analyzed in the context of how federal prosecutors will use their expanded powers to enforce these provisions.

First, SOX helps prosecutors to use their broad discretion to coerce guilty pleas by threatening long prison sentences – now increased by SOX §906 – and offering the option of shorter sentences or civil fines. Plea-bargaining defendants then are available to testify against others in their firms. In SOX "internal controls" trials, the plea-bargaining defendants might testify not only about what their co-defendants knew about the fraud, but also about circumstances bearing on what they should have known about the inadequacy of controls.[176]

Second, prosecutors are increasingly using their power and discretion to circumvent the protection of the attorney-client privilege by demanding waivers as a

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employ a top-down strategy.

Remarks Before the SIA Leadership Luncheon, San Francisco (June 8, 2005), http://www.sec.gov/news/speech/spch060805psa.htm.

[175] *See supra* text accompanying note 107.

[176] At least in jury trials, this dynamic is further affected by prosecutors' ability to take advantage of what has been called criminal defendants' "ambiguity aversion" – while prosecutors are repeat players whose decision depends on the known overall conviction rate, defendants only care about their individual case, where the prospects are ambiguous. *See* Stein & Segal, *Ambiguity Aversion and the Criminal Process,* http://papers.ssrn.com/paper.taf?abstract_id=846044.

condition of favorable treatment.[177] Although SOX did not create this problem, it exacerbates it by expanding the scope of corporate criminal liability. In the wake of SOX, federal prosecutors have more opportunity and leeway to use failure to cooperate with an investigation as a lever to obtain information. Suppose, for example, that a U.S. attorney begins an investigation into the possibility of executive wrongdoing, perhaps alerted by a SOX-protected whistleblower. It has become standard practice for the prosecutors to demand that the corporation "agree" to waive the attorney-client privilege. Prosecutors can threaten corporations that refuse to agree with an expanding array of penalties under SOX. Moreover, federal prosecutors have used the Sentencing Guidelines to extract the waiver on the ground that failure to waive the privilege would be evidence of the corporation's failure to cooperate which would result in higher sanctions under the Guidelines. The U.S. Department of Justice has an official policy on waiver and adamantly denies that it has been abused.[178] Corporate general counsel and their outside counsel, however, continue to raise the issue and insist that is serious threat. At the ABA's annual meeting in Chicago in August 2005, the ABA House of Delegates passed a resolution stating it "opposes the routine practice by government officials of seeking to obtain a waiver of attorney-client privilege or work product doctrine through the granting or denial of any benefit or advantage."[179]

Finally, information that has been pried from the company when either the company or its executives are under the threat of criminal prosecution, even if it does not lead to criminal convictions, may find its way into the hands of civil attorneys who will then use it against the company.

## G. AUDITOR REGULATION

As detailed above, SOX imposes significant new regulation on auditing firms, including the creation of a new regulatory body with which auditors much register, the PCAOB, regulation of auditing standards, and restricting ties with clients. This regulation may impose significant burdens on auditing firms. For example, auditors may need to protect themselves from liability or sanction by insisting on routinely checking every piece of information they receive from clients, even if the costs of this type of audit outweigh the benefits to investors in uncovering fraud. Remember that investors in publicly held corporations hold diversified portfolios, which makes it cheaper for them to bear risk than to put it on the auditing firms. Moreover, auditor checking may duplicate fraud protection from other sources, such as inside managers, lawyers and outside directors.

Rules mandating auditors' financial independence by barring them from performing ancillary services for clients were particularly contentious. Because of the auditor independence rules, firms cannot use their own auditor to advise them on appropriate compliance methods. Rather, they have to use a consultant, which could be another auditing firm, who must compile information about the business from scratch, in

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[177] *See* Remarks of former Solicitor General Theodore B. Olson, "Forced Waiver Attacks Right to Counsel," Atlantic Legal Foundation, Attorney-Client Privilege: Erosion, Ethics, Problems and Solutions (March 9-10, 2005), http://www.sec.gov/news/speech/spch060805psa.htm.

[178] *See* Mary Beth Buchanan, "Effective Cooperation by Business Organizations and the Effect of Privilege Waivers," 39 *Wake Forest L. Rev.* 587 (2004).

[179] *See* http://www.abanet.org/buslaw/attorneyclient/home.shtml.

order to help set up the system that their auditor will now review. This additional expense for the company does not produce profits for most firms, since it is necessitated solely by the suspicion, unsupported by data,[180] that non-audit work for clients reduces audit quality. But it is good for accounting firms, since the inefficiency adds to their profits even as it reduces those of the clients. So auditing firms get rich from a law that was intended in part to address their own failures. This regulation was the product of "policy entrepreneurs," particularly including former SEC Chairman Arthur Levitt, who strongly advocated the regulation in Congressional testimony while disregarding studies that might have reduced the persuasiveness of the testimony.[181]

There is an additional problem inherent in auditor regulation that, if auditors must bear some of the risk of fraud or reporting errors, it may be harder or more costly for riskier firms, such as start-ups or innovative firms, to obtain the auditing they need in order to access the public markets. Thus, there have been reports that, following SOX, auditors are dropping clients that are "considered too small to be worth the extra work now required, as well as those judged too risky to work with under the new accounting rules"[182] Ironically, a law intended to improve auditing reduced the availability of auditing services.

## H. REGULATION OF ANALYST CONFLICTS

Securities analysts are a crucial source of market efficiency, which is, in turn, an important way to spot fraud and evaluate firms' monitoring and reporting mechanisms. Analysts' links with the investment banking departments of their firms arguably compromise their independence. Section 501 of SOX provides for the adoption of SEC rules intended to address these conflicts. However, ties between analysts and investment bankers signal information that is otherwise too costly to communicate because of legal restrictions on disclosure.[183] This regulation decreases information as it increases independence. Thus, the costs of this regulation are likely to exceed the benefits because, among other things, it reduces the effectiveness of market monitoring detailed above.

## I. CRIPPLING THE "GENIUS" OF AMERICAN CORPORATE LAW

As discussed in Part IV.C., efficient corporate governance rules could evolve in response to Enron and other meltdowns in the absence of SOX through state competition

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[180] *See supra* note 166.

[181] The evidence on the value of this restriction is far from convincing. Romano showed that 15 of 25 studies on the effect of non-audit services on audit quality reports demonstrated no connection between the provision of non-audit services and audit quality, one found no connection for big-five accounting firms, and three found that non-audit services improved audit quality. Testing of other relevant factors undercuts the other surveys' findings that non-audit services affect quality. See Romano, *supra* note 18 at 1535–1537. There is also evidence of negative market reaction to the restriction on provision of non-audit services. See Rezaee & Jain, *The Sarbanes-Oxley Act of 2002 and Security Market Behavior: Early Evidence* (March 22, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=498083.

[182] *See* Browning, "Sorry, the Auditor Said, But We Want a Divorce," *New York Times*, February 6, 2005, sec 3, p 5, col 1.

[183] *See* Spindler, *Conflict or Credibility: Analyst Conflicts of Interest and the Market for Underwriting Business*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=564381.

to supply corporate law. Given the potential positive role of state competition in corporate governance reform, it is unfortunate that SOX moves in the opposite direction, toward an erosion of that role. There was once a fairly clear divide between federal law on disclosure and state law on substantive governance rules. The Supreme Court clearly endorsed this distinction in the *Santa Fe* case.[184] However, since *Santa Fe* Congress and the SEC have been moving toward greater federalization of corporate governance.

SOX represents a qualitative leap and a significant new threat to state corporate law. Specifically, SOX makes numerous inroads into corporate governance issues formerly considered to be quintessentially for state control, unrelated to the kind of disclosure rules that were formerly the exclusive province of federal law. Among other things, SOX requires complete independence of audit committee directors, along the way providing a new federal definition of director independence; directly controls executive compensation by requiring some bonuses to be returned to the company and by prohibiting certain executive loans; determines the power of a board committee vis a vis the board as a whole, the shareholders and the managers by requiring that the board's audit committee control the hiring and firing of accountants and the non-audit work accountants do for the corporation; and provides for specific SEC rules on off-balance-sheet transactions and special purpose vehicles.

The problem of federal interference in state competition is not simply a matter of the federal government ousting the states from particular issues where federal supervision is deemed necessary, such as takeovers in the Williams Act. Rather, the problem is that each federal intervention in corporate governance law increases the general federal presence, has spillover effects beyond the specific federal rules adopted and increases the threat of future intervention. These effects incrementally reduce both the scope and incentives for state action. As pieces of exclusive state jurisdiction fall away, the states are increasingly constrained in applying a consistent policy framework to interrelated issues such as fiduciary duties and board powers. Moreover, state legislatures and courts have less incentive to undertake major policy initiatives in areas that Congress and the SEC are occupying or seem likely to occupy soon. In other words, entire areas of state lawmaking become “vestigialized,” as David Skeel showed has happened for governance of insolvent firms in the wake of federal bankruptcy law.[185] Thus, even if the federal government were able to legislate more efficiently on a particular issue – and there is little reason to think is can after SOX – the federal legislation may be inefficient given its overall effect on state policymaking in corporate governance.

The executive loans prohibition is especially problematic because it departs so strikingly not only from the disclosure orientation of federal law, but also from the state law approach of leaving these issues to shareholder and manager voting. It also replaces an active state evolution in this area that has produced several distinct approaches from which firms can choose.[186] As Delaware Chancellor Chandler and Vice-Chancellor Strine have written:

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[184] *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977).

[185] *See* David A. Skeel, Jr., “Rethinking the Line Between Corporate Law and Corporate Bankruptcy,” 72 *Tex. L. Rev.* 471 (1994) (arguing that the federal law of corporate bankruptcy discourages both state and federal resolution of issues that lie in the boundary between bankruptcy and state law).

[186] *See supra* text accompanying note 128.

> By this method, Congress took upon itself responsibility for delimiting the range of permissible transactions that corporations chartered by state law could consummate. In itself, the mandate is relatively trivial, but its precedential significance may not be. What's next? A ban on going private transactions? Or on options-based compensation of executives? Or on interested transactions?[187]

Moreover, apart from the areas of specific invasion of substantive rules, the internal controls reports under SOX §404 invade a developing area of state law on directors' duties to ensure that "information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance."[188] Although most Delaware corporations have taken advantage of a Delaware statutory provision to waive the duty of care, which would implicate this duty, Delaware courts have been developing a "good faith" duty that theoretically could embrace a duty to develop information and reporting systems. Alternatively, the Delaware legislature could decide to explicitly adopt a non-waivable duty in the wake of Enron. But SOX effectively precludes these state law alternatives.

The costs of the creeping federalization of corporate governance include ousting the expert Delaware courts from the ability to develop detailed policy on a case by case basis, and the opportunity states offer for proposing a variety of approaches to difficult governance issues. Delaware Chancellor Chandler and Vice Chancellor Strine note that SOX and other reforms adopted in 2002 following Enron substitute a rigid, one-size-fits-all federal approach for Delaware's "principles-based" approach:

> The Delaware approach has tended to create incentives for particular good governance practices, yet also recognizes that what generally works for most boards may not be the best method for some others. The fiduciary duty form of accountability is well-suited to this sort of flexibility because it is context-specific in application. But because the 2002 Reforms naturally take a more rule-based form, they come with the risk of codifying (by statute or contract) an array of procedures that, when implemented in their totality, might be less than optimal.[189]

The different approaches of federal and state law sometimes may force a collision. For example, in *Newcastle Partners, L.P. v. Vesta Insurance Group, Inc.*,[190] the Delaware Court of Chancery refused to allow the company to further delay its annual meeting to give its accounting firm time to supply audited statements required by the SEC. The court said, "[t]here are, of course, some circumstances in which a state's governance of internal corporate affairs is preempted by federal law, but those instances are rare, and occur only when the law of the state of incorporation is 'inconsistent with a

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[187] *See* Chandler & Strine, *supra* note 80.

[188] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

[189] *See* Chandler & Strine, *supra* note 80 at 979-80.

[190] Del. Ch, November 15, 2005. See the discussion in Larry E. Ribstein, "A Chicken Game in Delaware, *Ideoblog*, November 19, 2005, http://busmovie.typepad.com/ideoblog/2005/11/a_chicken_game_.html.

national policy on foreign or interstate commerce.'" As federal law makes further inroads into state governance law, these confrontations are likely to become more frequent.

The conflicts threaten to impose a federal perspective on corporate governance that sharply contrasts with the perspective that has emerged from decades of lawmaking in Delaware and other states. Thus, in contrasting Congress' and the SEC's emphasis on the "ordinary investor" with Delaware's more realistic understanding of the important role of institutional shareholders, Delaware Chief Justice Myron Steele has said:

> Increasingly institutional shareholders dominate the market. Do they need an advocate in DC wedded to prescriptive regulation or can their complaints, if any, be as readily and more equitably addressed by private ordering in State civil law litigation on a case by case contextual environment? Moving corporate governance to DC means increased costs with little effort to determine benefit, an arena for dispute resolution decisionmaking that is not unbiased and portends no guarantee that the guidelines, regs or pronouncements from the banks of the Potomac will enhance long term shareholder value. Those who advocate a drift from the common law resolution of disputes by a highly trained and experienced cadre of jurists to the bureaucracy in DC should be careful what they wish for.[191]

More often, rather than direct confrontation, federal law will cause subtle changes in state law, or make this law more indeterminate. For example, the SOX approach, particularly including its rules on director independence, apparently has had the effect of destabilizing Delaware law. Delaware Vice Chancellor Strine predicted immediately after SOX was passed that federal law would pressure state courts to consider personal, social, and professional relationships in assessing director independence.[192] One writer documented state decisions citing SOX, noting that during 2003 the Delaware Supreme Court sharply increased both the number of reversals of chancery court rulings and results favoring plaintiff shareholders.[193] Another discussed how the chancery court, apparently responding to SOX, expanded the state definition of director interest to move closer to the federal standard, though the supreme court apparently limited this to the sensitive context of special litigation committees.[194]

Of particular interest in this respect is SOX's apparent effect on the shifting results in the Disney litigation involving Michael Ovitz's employment contract and termination. Prior to SOX, the Delaware courts had dismissed a shareholder complaint against the Disney board.[195] On remand, following SOX, Chancellor Chandler refused to

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[191] Myron Steele, "Sarbox and De," *NYU Journal of Law and Liberty Blog*, October 27, 2005, available at http://www.nyujll.org/blog/index.php?paged=3.

[192] Leo E. Strine, Jr., "Derivative Impact? Some Early Reflections on Corporate Law Implications of the Enron Debacle," 57 *Bus. Law.* 1371, 1372 (2002).

[193] Renee M. Jones, "Rethinking Corporate Federalism in the Era of Corporate Reform," 29 *J. Corp. L.* 625 (2004).

[194] *See* Lisa M. Fairfax, "Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards," 31 *Ohio N. U. L. Rev.* 381 (2005).

[195] See *Brehm v. Eisner*, 747 A. 2d 244 (Del. 2000).

dismiss the amended complaint.[196] But then, two years later, after a lengthy trial, Chancellor Chandler denied all relief.[197] To be sure, the shifts are not clearly attributable to SOX.[198] However, it is reasonable to infer that these shifting outcomes in the same highly publicized case are at least partly attributable to the Delaware courts' concerns about further corporate law in the wake of SOX.

To the extent that federal law is causing a shift in the Delaware law on director independence, and even apart from the problems inherent in decreeing a single norm from Washington, this shift is likely in the wrong direction. Chancellor Chandler and Vice Chancellor Strine note that SOX forbids a director affiliated with a substantial shareholder from service on the audit committee. They point out that this restriction may apply to the representatives of venture capital or leveraged buyout firms:

> This incentive system is contrary to much good thinking in academia and in Delaware decisional law, both of which have taken the view that independent directors who have a substantial stake as common stockholders in the company's success are better motivated to diligently and faithfully oversee management.[199]

The judges are also concerned that as the federal prohibition on ties with officers creeps into state law it

> could have an unfair effect if extended into the litigation context without appropriate sensitivity. There may well be situations in which the CEO of a company is entirely capable of acting "independently" on an issue because his management status (and presumed desire to keep it) has no bearing at all on his incentives. … [W]ell-qualified people may be dissuaded from serving on boards, to the resulting detriment of stockholders.[200]

In short, SOX could have significant negative effects in eroding the competition among the states to supply corporation law – what Roberta Romano has called the "genius" of our corporate law system.[201] The effect cannot be blinked away by arguing that SOX's interference with state law is only on specific issues. This federal intrusion, when coupled with the federalization that had preceded SOX and the threat SOX poses for the future, could seriously weaken the viability of state corporation law. SOX harms a major institutional framework that has generated effective corporate governance for over 100 years. Combined with the discussion of the manifest defects of SOX, there is strong reason to believe that the costs of SOX's adverse effect on the development of

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[196] *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003).

[197] *In re The Walt Disney Company Derivative Litigation*, Delaware Chancery Court 2005 WL 1875804 (August 9, 2005).

[198] *See* Roe, *supra* note 83 at 643 (commenting after the Chancellor's 2003 opinion that "[t]he difficulty here is to sort out whether its abrupt shift was due primarily to the federal gravitational pull, to the dynamics of the litigation, or to the state's direct perception of the underlying corporate problems).

[199] *See* Chandler & Strine, *supra* note 80 at 992.

[200] *Id.* at 998.

[201] Roberta Romano, *The Genius of American Corporate Law* (1993).

state law outweigh any benefits of an increased federal presence in this area.

## J. CHASING AWAY FOREIGN FIRMS

The effect of SOX on issuers that are not based in the United States is a classic example of the non-obvious, and even unintended, consequences of the Act. The application of the Act to non-US firms was not debated and scarcely mentioned during Congress' brief deliberations. Yet SOX's new substantive governance standards and liabilities impose especially high costs on foreign firms trading in the US.

The most attention has been given the SOX requirements for independent audit committees. The SEC rules interpreting this provision exclude from the audit committee an "affiliated person," defined as one who "controls, or is controlled by, or is under common control with, such issuer."[202] This is a problem for the vast majority of non-US firms that are controlled by one or a few large shareholders.[203] The Act is particularly problematic for firms subject to the law of Germany and other countries that require two-level boards consisting of a managerial unit and a supervisory unit. German companies with two-level boards appoint the auditor at the shareholders' annual general meeting upon nomination and determination of the auditor's independence by the supervisory board.[204] Thus, complying with SOX may conflict with the shareholders' appointment power under German law. SOX excludes anyone who receives a "consulting, advisory or other compensatory fee from the issuer" or is "an affiliated person" of the issuer,[205] which may include most labor members of the German supervisory board. And SOX may exclude others who have relationships with the company, including representatives of banks and other large shareholders who have significant monitoring functions in German firms.

Other SOX provisions may conflict with foreign firms' home country law. Just as the SOX executive loan prohibition goes further than many state laws, it also conflicts with foreign laws, such as German law, which permits loans approved by the supervisory board. Also, SOX requirements for executive certification of reports and supervision of internal controls, as well as other rules imposing liability on executives and requiring return of executive compensation paid during restatements, may conflict with laws in other countries such as Japan providing for hierarchies that differ from the simple triangle in US firms. Not only might it be difficult to identify which people the Act covers, but SOX provisions may be inappropriate in these countries because executives are less powerful and less in need of policing.[206] Also, SOX provisions requiring monitoring by and independence of lawyers and other professionals may not make sense in countries where the professionals lack independence from clients. Indeed, SOX's entire scheme for regulating the internal governance of firms may make little sense in firms that rely on

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[202] 17 CFR §240.10A-3(e)(1)(i).

[203] *See* Faccio & Lang, "The Ultimate Ownership of Western European Corporations," 65 *J. Fin. Econ.* 365 (2002).

[204] Aktiengesetz §119 I Nr. 5; HGB §318 I.

[205] 17 CFR §78j-1(m)(3).

[206] *See* Lawrence A. Cunningham, "From Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX," 1 *International Journal of Disclosure and Governance* 2, 4.

monitoring by large shareholders rather than fiduciary duties and other regulation.

The differences between SOX and foreign law may arise unexpectedly. For example, the SOX whistle-blowing provisions, which provide for anonymous tips, may conflict with European privacy laws.[207] US companies operating in Europe may be forced to either comply with SOX or comply with local law. Even worse, EU data-protection laws are applied differently in each of the 25 countries, making it even harder for US companies to comply with SOX. SOX therefore imposes significant costs on non-US firms to which it applies.[208] This includes not only firms that have elected to trade in the US, but subsidiaries of United States firms.

The anecdotal evidence shows that SOX is taking a toll on the trading of foreign securities here. For example, John Thain, CEO of the New York Stock Exchange, reported that for the two years after SOX new cross-listings fell to half the annual totals prior to the Act. New York's share of new stock offerings of foreign companies dropped from 90% in 2000 to 10% in 2005, in large part because of the high costs SOX imposes on foreign firms.[209] Meanwhile, London is pressing its regulatory advantage by offering a special low-cost market (AIM) for smaller companies just as the US, through SOX, is raising costs for these firms.[210]

The reduced presence of foreign firms in the US causes significant problems in the US market. These include both reduced income to the US securities industry and reduced access of US investors to foreign firms, because of the higher costs of trading foreign firms on foreign markets rather than on US markets. This phenomenon is hurting the "ordinary investors" Congress and the SEC always purport to worry about, since professionals can always buy shares in London.

SOX's defenders initially relied on the idea that there was no hard data on the effect of SOX on foreign firms and cross-listings,[211] and the inconclusive fact that firms were continuing to cross-list in the US. However, harder evidence of SOX's effect on foreign firms has now become available. Kate Litvak has shown that stock prices of foreign companies cross-listed in the US declined during key announcements indicating the Act's application to foreign issuers, and increased in reaction to announcements

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[207] *See* David Reilly & Sarah Nassauer, "Street Sleuth, Tip-Line Bind: Follow the Law In U.S. or EU?," *Wall St. J.*, September 6, 2005, p. C1, available at http://online.wsj.com/article/0,,SB112596782625632302,00.html?mod=todays_us_money_and_investing.

[208] See Marks, "The Sarbanes-Oxley Act: Costs and Trade offs Relating to International Application and Convergence," 17 *Research in Accounting Regulation* (2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=499403; Ribstein, *supra* note 87.

[209] *See* Craig Karmin & Aaron Lucchetti, "New York Loses Edge in Snagging Foreign Listings," *Wall St. J.*, January 26, 2006 at C1, available at http://online.wsj.com/article/SB113824819390656771.html?mod=todays_us_money_and_investing.

[210] *See* Craig Karmin, "London Calling," *Wall St. J.*, December 23, 2005 at C1, available at http://online.wsj.com/article/SB113530126767530086-search.html?KEYWORDS=london+calling&COLLECTION=wsjie/6month/.

[211] See Michael A. Perino, "American Corporate Reform Abroad: Sarbanes-Oxley and the Foreign Private Issuer," 4 *European Business Organization Law Review* 213 (2003).

qualifying application of the Act. These reactions were strongest for European companies and companies from high-GDP countries – that is, firms from a relatively high quality institutional environment.[212] The study controls for economic and political factors by, among other things, comparing companies within a given country that are, and are not, cross-listed.

Not surprisingly in light of these facts, non-US firms complained loudly soon after SOX was passed. From the beginning there has been some concern in the US that SOX would threaten cross-listings.[213] Among other protests, 24 major German corporations, including DaimlerChrysler, Bayer, and Deutsche Telekom, requested an exemption from the Act.[214] Foreign firms have continued to react, particularly to the SOX internal controls certification. Some firms, spurred by the approaching application of this rule, want an exemption for foreign firms that have less than five percent of their share volume trading in the US, rather than the 300-shareholder rule that now applies.[215]

The effect of SOX on non-US firms has triggered a political dynamic that may have far-reaching consequences. This began when the US responded to criticisms from German and other companies by issuing a rule that partially exempts foreign firms from some SOX requirements.[216] The rule, among other things, permits non-executive employees in foreign-based issuers to serve as audit committee members, large shareholders to send observer representatives, and foreign firms to substitute for the audit committee a board of auditors or similar body whose independence and responsibility for appointing and overseeing the firm's auditor is provided for in home country legal or listing provisions.[217] Also, the SEC has clarified that the SOX prohibition on trading during pension blackouts applies only to foreign firms' principal executive, financial and accounting officers;[218] lawyers' duties under SOX do not apply to foreign attorneys not admitted in the United States, and who do not advise clients regarding US law;[219] and the

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[212] Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross-Listed in the US*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=876624, U of Texas Law, Law and Econ Research Paper No. 55 (December 22, 2005).

[213] For the initial outcry, see the comments by representatives of foreign firms in response to the SEC's rulemaking on the audit committee requirements. These comments are collected at http://www.sec.gov/rules/proposed/s70203.shtml, and summarized at http://www.sec.gov/rules/extra/s70203summary.htm#P1121_88452.

[214] *See* Petition for Rulemaking submitted by the Organization for International Investment, File No. 4-462 (Aug. 19, 2002)

[215] *See* Anna Snider, "Going Sox-less," *California Lawyer*, October 2004 at 37; Floyd H. Norris, "European companies push for relief from U.S. security laws," *International Herald Tribune* (February 12, 2004), available at http://www.iht.com/articles/129181.html.

[216] 17 CFR §240.10A-3.

[217] 17 CFR §240.10A-3(c)(3).

[218] See Securities and Exchange Commission, "Insider Trades During Pension Fund Blackout Periods," 17 CFR §§240, 245 and 249 [Release No. 34-46778; IC-25795; File No. S7-44-02] (Nov. 6, 2002).

[219] See *Implementation of Standards of Professional Conduct for Attorneys*, Release 33-8185, 17

SEC has delayed until 2006 the application of internal controls reporting to foreign firms.[220]

These rules raise the question of how far the SEC can go in exempting foreign firms before triggering significant complaints from their US competitors in the US capital markets. The exemptions undoubtedly are attributable to some extent to the fact that foreign firms are much better able to exit the US market than US-based firms, which may be subject to US laws even if they trade overseas, and which have other business reasons for needing to trade in the US. To the extent the exemptions are, or should be, based on the costs of compliance, they arguably should apply to any firm that is incorporated under and must comply with the corporate law of another country, regardless of where the corporation's operations are based. But any such exemption would invite US firms to avoid US law by incorporating elsewhere. To the extent that such competition forces US regulators and legislators to reassess the damage they have done to American securities markets, such exit by US firms could ultimately help correct the SOX mistake.

## VI. THE LITIGATION TIME BOMB

SOX's defenders say that the main problem with SOX is the costs of filling out forms, that for big firms this is mainly a startup cost that will be fixed as firms adjust, that the SEC can fix the bigger problem for small firms by exemptions or modifications of the rules, and that the remaining costs are outweighed by the benefits. As discussed in the preceding Part, this is unduly sanguine. Even from a paperwork perspective, SOX threatens to cause a major restructuring in how firms do business. The problems become even more serious if one considers SOX from the perspective of the litigation it will trigger a few years out.

This Part explains that a SOX litigation "time bomb" will explode with the next major stock market adjustment because SOX not only provides new causes of action, it also appears to make proving liability relatively easy by tracing the decline in market price to some inadequacy in internal controls. Similarly, SOX litigation "time bomblets" will be triggered whenever a specific industry or sector suffers a downturn. Shareholder litigation on this scale should not be confused with investor protection.

### A. A REVIEW OF LIABILITY THREATS UNDER SOX

The biggest liability threats under SOX arise under Sections 302 and 906. As detailed above, Section 302 requires officers to certify not only the accuracy of the financial statement, as they were required to do even before SOX, but also that they have

--designed "internal controls" that ensure that material information is "made known" to the officers,

--evaluated and presented their conclusions as to the effectiveness of these controls as of at least 90 days prior to the report,

--disclosed to the firm's auditors and board audit committee "significant deficiencies" in the design of the controls that could affect processing and reporting of

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CFR 205.2(j) (defining "non-appearing foreign attorney") (August 5, 2003), http://www.sec.gov/rules/final/33-8185.htm.

[220] SEC Release No. 33-8545 (March 2, 2005), http://www.sec.gov/rules/final/33-8545.htm.

financial data,

--identified for the auditors “material weaknesses in internal controls” and “any fraud, whether or not material” involving employees “who have a significant role in the issuer's internal controls,” and

--indicated “significant changes in internal controls or in other factors that could significantly affect internal controls” since the last evaluation.

The SEC has further articulated executives’ internal controls reporting obligations.[221] According to the SEC

> [t]he assessment of a company's internal control over financial reporting must be based on procedures sufficient both to evaluate its design and to test its operating effectiveness. Controls subject to such assessment include, but are not limited to controls. . . . . related to the prevention, identification, and detection of fraud. The nature of a company's testing activities will largely depend on the circumstances of the company and the significance of the control. However, inquiry alone generally will not provide an adequate basis for management's assessment.

As discussed above, the assessment “must be supported by . . . . documentation, regarding both the design of internal controls and the testing processes.”

Violation of these provisions are treated the same as violations of other securities law provisions.[222] That would include private class action suits under the general anti-fraud provisions of the securities laws, including Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5, for false certifications. The SEC has already indicated the potential for personal liability for false certifications in an administrative proceeding against Richard Scrushy and HealthSouth for false certifications under the requirements of pre-SOX law.[223] This case illustrates that the concept of executive certification of reports is not new to SOX. What SOX added is the potential for liability not only for knowing of untruths as to the actual numbers, which is what the SEC claimed against Scrushy, but also for knowing about bad processes that ended up producing bad numbers. SOX Section 906 includes the bracing addition of criminal penalties of up to a million dollars fine and 10 years in prison for one who certifies under this section “knowing” that the periodic report does not comply with the section’s requirement, or five million dollars and 20 years for “willfully” certifying with this knowledge.[224]

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[221] See SEC Release 8238, *supra* note 118.

[222] See Sarbanes-Oxley Act §3(b)(1), 15 U.S.C. §7202.

[223] SEC Litigation Release no. 18044 (March 20, 2003). The certification was pursuant to SEC Order 4-460, Order Requiring the Filing of Sworn Statements Pursuant to §21(a)(1) of the Securities Ecchange Act of 1934 (June 27, 2002). A court has already upheld the constitutionality of Section 906 in connection with this case. *U.S. v. Scrushy*, 2004 WL 2713262 (N.D.Ala. 2004).

[224] It is interesting to speculate how these provisions and rules might have been applied to the frauds at Enron and other companies that provided the impetus for SOX. Many of these cases involved bad accounting by underlings in the company for largely correct underlying data. For example, Xerox accelerated revenues from long-term equipment leases, Qwest and Global Crossing manipulated revenues and expenses on sales of fiber optic capacity, and most notoriously, WorldCom blatantly misstated billions

## B. USING 20/20 HINDSIGHT TO ASSESS RISK

SOX cases will turn on whether the problem (almost certainly a precipitous drop in share price) occurred because of a "significant" deficiency or "material weakness" in controls that the executives should have reported to the auditors, or because of a gap in an internal control system that the executives had assessed in the certified report as adequate. SOX takes care of the case in which senior executives arguably deliberately build a wall between themselves and the fraudsters. But there are serious problems with applying these standards where the executives have not been deliberately fraudulent. To begin with, as Harvey Pitt has pointed out,[225] even a tiny possibility that a flaw in the system could permit a very serious event such as destruction of the company could be "material" taking into account the magnitude of the potential problem. There is also a question which "controls….related to the prevention, identification, and detection of fraud" will be deemed to have been necessary to prevent the new kinds of fraud arising in future cases, particularly if the fraud originates deep in the organization.[226]

Even if courts and the SEC are ultimately reasonable in applying these provisions, this reasonableness might come only after considerable litigation expense. As Pitt observes:

In a litigation following the discovery of an error and using 100% hindsight, the

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in current expenses the company incurred to use transmission networks as capital expenditures. Some cases, like Sunbeam, involved false data – in that case, phony sales and rebates. This is reminiscent of one of the biggest frauds of all, Equity Funding, in which managers and employees simply manufactured life insurance policies.

Consider also cases where the impropriety of the accounting depends on complex background facts. For example, some of Enron's off balance sheet special purpose entities should have been on the balance sheet under applicable accounting rules because they had outside (non-Enron) equity less than three percent of total capital. Andrew Fastow, Enron's chief financial officer, told the Enron board that the entities *did* have the requisite outside equity, but this was not true. As it happened, he never gave the board the specifics. SOX will now clearly require senior executives to get the specifics – but what if the Fastow of the future Enron lies or fabricates documents? More problematically, what if there is no background documentation? In the notorious Nigerian Barge case, Merrill Lynch brokers face jail for assisting in a transaction that was purportedly a purchase of barges from an Enron but that was allegedly not a legitimate sale because of an informal promise by Enron to buy the barges back. The court had to rely on hearsay as to the side deal.

A similar case arose recently in which the inside counsel of a Siemens subsidiary was indicted for preparing a transaction a minority-owned joint venture that was allegedly not really a joint venture. The indictment quotes an email that established the absence of the requisite profit-sharing arrangement. It says that the Siemens subsidiary "relied on Roth [the inside counsel] to ensure legal compliance with the applicable ordinances." U.S. v. Faust Villazan, Superseding Indictment, 05 CR 792 (N.D. Ill. 2006), para 11.

[225] Harvey L. Pitt, Forbes.com, *Commentary, Trials and Tribulations of Enron and S-Ox*, avao;an;e at http://www.forbes.com/home/columnists/2006/01/20/enron-sarbox-pitt-commentary-cx_hlp_0123harveypitt.html (January 23, 2006).

[226] For example, under what circumstances might the executives or Siemens be liable under SOX in the situation discussed immediately above for failing to have internal controls that would have ensured advance disclosure of the problem of the enterprise that was not a joint venture?

> plaintiff's attorney isn't going to draw any distinction between probability and fact. As a result, a one-in-one-thousand event and incidents of higher probability are treated the same. Management must deal with both with the same degree of response. This creates considerable uncertainty for accountants during an audit and leads them to stress caution at the expense of cost.

One might argue that SOX prevents excessive liability by requiring only that the certifiers know of internal controls weaknesses or deficiencies. This "scienter" requirement might work, at least to some extent, if the question were whether the managers knew of the fraud. But as emphasized above, SOX moves the culpability back a step, to whether the executives knew of deficiencies in the procedures for spotting fraud. The managers may well have known at the relevant time about a particular characteristic of the internal control system that they assessed as adequate, and even that this characteristic might fail to spot fraud under some circumstances, but not that this gap was a sufficient problem that it needed to be rectified, or that it was a "significant" deficiency that needed to be identified for the auditors.

SOX is likely also to lead to litigation under state fiduciary law, either on the basis that federal law affects the application of state duties, as by defining director independence, or through a claim that violation of the Act injured the firm.[227] Moreover, as violations of law, these claims arguably would be non-waivable under Delaware law.[228]

## C. LITIGATORS' INCENTIVES

Civil trial lawyers and government attorneys have strong incentives to bring cases under these new provisions since, as just discussed, they eliminate the troublesome need to prove knowledge of actual fraud. The trial lawyers do not necessarily have the interests of shareholders or investors in mind, since risk-averse defendants (officers and directors) face incentives to settle even dubious cases, particularly if their indemnification or insurance depends on an unfavorable outcome.

One can hope that courts will filter out the worst cases, particularly by dismissing them on the pleadings or other preliminary stage. But courts face the perennial problem of the hindsight bias. To be sure, courts appear to be dealing with this problem through the "fraud by hindsight" doctrine. But as Gulati, Rachlinski and Langevoort have shown, the cases applying this doctrine actually are using this rationale to justify management of what they subjectively conclude are weak cases without realistically dealing with the underlying bias problem.[229] Thus, there is no reason to believe that this doctrine developed for the specific context of determining the *existence* of fraud will be adequate to deal with the new issue under SOX of whether senior executives wrongfully certified the processes for *preventing* fraud. Thus, even courts that are supposedly wary of *fraud*

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[227] *See* Chandler & Strine, *supra* note 80 at 987.

[228] See *id.* at 987, n. 90 (noting the qualification in Del. Code. Ann. Tit. 8, §102(b)(7)(ii) for knowing violation of law). To the extent that federal law compels directors to do what Delaware law permits or requires, state courts might be forced to align state with federal standards. This was the issue that was narrowly avoided in the *Vesta* case, discussed *supra* text accompanying note 190.

[229] *See* Mitu Gulati, Jeffrey J. Rachlinski & Donald C. Langevoort, "Fraud by Hindsight," 98 *Nw. U.L. Rev.* 773 (2004).

by hindsight may well impose liability for *precaution* by hindsight – that is, the failure to protect ex ante against frauds that have become obvious only later.

It may be that courts will impose civil and criminal liability for SOX violations only against corporate thieves and defrauders as in past cases. If so, the problems discussed above may not be serious. But that is to say that SOX is not pernicious only if it is ineffective.

## D. THE POTENTIAL FOR BLACKMAIL

SOX creates an ideal scenario for "litigation blackmail" in the sense of inducing settlements for more than the value of the claim because individual officers and directors face the threat of heavy discovery costs and potentially ruinous liability. This is particularly serious in light of the fact that, even before detonation of the SOX time bomb, securities class action settlements have increased on an inflation-adjusted basis from $150 million in 1997 to $9.6 billion in 2005, with the average settlement size increasing sevenfold during this period, despite the enactment in 1995 of the Private Securities Litigation Reform Act intended to rein in securities class actions.[230]

The increased likelihood of blackmail is evident from several characteristics of post-SOX litigation. First, the event triggering litigation is likely to be a large and public loss of shareholder wealth providing an opportunity for exaggerated damage claims. Plaintiffs may be able to bring "fraud-on-the-market" claims in which all investors who traded during the period in which facts were not disclosed can recover the difference between the price at which they traded and the value as measured by the price adjustment when the facts were disclosed.[231] The damages are highly likely to exceed any realistic estimate of the loss by shareholders as a whole because, among other things, it is rarely clear how much of the price adjustment on disclosure can be attributed to the misrepresentation, and damages are not offset by the gains of the investors with whom the plaintiffs traded.[232] Moreover, damages based on the price decline following disclosure might be significantly increased by a sort of feedback loop – the risk of litigation over the disclosure itself increases the price decline.[233]

Second, liability may turn not only on outright theft or lying about basic facts, but on whether executives certifying the firm's disclosures should have known about certain risks and the need for controls to deal with them.

Third, to the extent that plaintiffs sue both managers and the corporation itself, the

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[230] *See* Kenneth M. Lehn, "Private Insecurities," *Wall. St. J.*, February 15, 2006, p. A16, available at http://online.wsj.com/article/SB113996764865374191.html?mod=todays_us_opinion.

[231] *See Dura Pharmaceuticals, Inc. v. Broudo*, 125 S.Ct. 1627 (2005) (holding that allegation of price inflation at the time of purchase were insufficient and implying that plaintiff must also allege a market adjustment following a corrective disclosure).

[232] *See* Larry E. Ribstein, "Fraud on a Noisy Market," http://papers.ssrn.com/sol3/papers.cfm?abstract_id=803064, forthcoming *Lewis & Clark L. Rev*.

[233] *See* Richard A. Booth, *Who Should Recover What in a Securities Fraud Class Action?* U of Maryland Legal Studies Research Paper No. 2005-32 (February, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=683197.

actions may harm even some of the investors on whose behalf the action is brought to the extent they are shareholders in the defendant corporation. The significant risk of liability and the potential for extravagant damages may induce managers to enter into settlements on behalf of the corporation that are not in the shareholders' interests. Since plaintiffs have little information about the facts when the complaint is filed, defendants can be expected to win most cases. Diversified shareholders therefore would prefer to settle very few cases: they are willing to take the risk of the occasional loss, particularly since the corporations in their portfolios will be plaintiffs about as often as they will be defendants. Individual defendants, on the other hand, stand a chance of losing everything in every case, and therefore have a strong incentive to settle, particularly if settlements (but not adjudications of liability) are covered by indemnification or insurance.

Fourth, litigation may cause significant distraction as executives and staff must prepare for trial and comply with burdensome discovery requests. These costs are part of the calculus executives must take into account when deciding whether settling even a weak lawsuit is in the company's interest. Moreover, executives have an extra incentive to settle lawsuits to avoid the personal stress and embarrassment of litigation.

### E. WHAT CAN SHAREHOLDERS DO ABOUT THE TIME BOMB?

Although the litigation time bomb is ticking loudly enough for anybody to hear, there is not much shareholders can do to avoid it. Although shareholders can minimize the risk of managerial malfeasance, they cannot diversify away firms' compliance costs. Although firms have varying risks of fraud, the risk of SOX litigation forces all firms – good and bad – to incur excessive compliance costs. For this reason, rational shareholders would probably rather take their chances with good old fashioned fraud and theft than the litigation lottery created by SOX.

## VII. THE BOTTOM LINE – HAS SOX BEEN WORTH IT?

SOX's defenders claim that, despite all of the havoc that SOX has wrought, it has been worth the cost for curtailing the terrible frauds that lead to the Act. We have shown that much of this could have been accomplished without federal intervention and that SOX's costs have been more subtle and extensive than its defenders have suggested. This Part discusses what we know so far about whether SOX's supposed benefits outweigh its costs.

Since SOX there have been several studies showing the overall effects of SOX. The most direct evidence is the effect of SOX's enactment on firms' market value. These studies, several of which were analysed by Romano,[234] generally indicate that the market has reacted negatively to the adoption and implementation of SOX, though the results are inconclusive because it is difficult to infer causation when the law affects every stock in the market.

The most extensive and persuasive study of SOX's costs estimates the loss in total market value of firms around legislative events leading to the passage of SOX at $1.4 trillion.[235] The study specifically found that the market reacted negatively to the restriction of the provision of non-audit services, provisions relating to corporate

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[234] *See* Romano, *supra* note 18 at 1541-43.

[235] *See* Zhang, *supra* note 93.

governance, and the internal controls provision. Firms with "weak" governance declined as the likelihood of passing tough SOX rules increased, indicating that investors thought that the costs of such rules to poorly governed firms would exceed the benefits. In other words, if SOX were effective in protecting shareholders, then the market prices of firms with weak governance would have increased with the passage of SOX. Instead, the prices declined, suggesting that SOX does not protect even the investors in poorly governed corporations.

Another earlier study also showed that enactment of SOX was associated with negative stock returns, although the SEC's post-enactment implementation was associated with positive returns, suggesting that the market was pleasantly surprised that SOX was not enforced or interpreted as rigorously as expected.[236] Also, the study finds no significant differences between SOX's effects on firms that had been managing earnings or had fully independent audit committees, and those on firms that were not managing earnings or did not have independent audit committees. This indicates that the market did not expect SOX reforms in these areas to be meaningful.

Two other stock price studies suggested SOX may have had positive effects for some firms. One found that the SOX governance rules had a positive effect on the value of large firms, but no significant effect on small firms.[237] Another found that events "favorable" to SOX's enactment were associated with positive stock returns.[238] But this study also found that firms that were better governed before the Act did better after SOX. This is generally consistent with the distinction between well and poorly governed firms in the first study discussed above. However, it is not clear what it means, since the better-governed firms arguably had *both* lower compliance costs and lower benefits from the SOX reforms. So the numbers could just mean that the firms that were already paying a lot for governance did better after SOX than their previously more efficiently managed rivals, who were now forced to incur higher costs. In any event, the bottom line result as to the effect of SOX contradicts the result of the much more extensive study cited above. Moreover, none of the studies is conclusive. Among other things, it is difficult to draw causation inferences from an event like SOX that affects the entire market. Also, the market might have been expecting even worse legislation than SOX given the environment in which SOX was enacted.

There is also evidence of positive market price reaction to the SOX executive certification requirement.[239] Another study shows that firms' share prices did not react to certification, suggesting that the market could separate good from bad firms without

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[236] Li, Pincus & Rego, *Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002: Overall and as a Function of Earnings Management and Audit Committee Effectiveness* (November 2003), available at http://papers.ssrn.com/paper.taf?abstract_id=498083.

[237] Chhaochharia & Grinstein, *Corporate Governance and Firm Value — The Impact of the 2002 Governance Rules* (June 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=556990.

[238] See Rezaee & Jain, *supra* note 181.

[239] See Griffin & Lont, *Taking the Oath: Investor Response to SEC Certification* (November 19, 2003), available at http://papers.ssrn.com/paper.taf?abstract_id=477586 (showing more positive reaction for firms with prior securities litigation); Hirtle, *Stock Market Reaction to Financial Statement Certification by Bank Holding Company CEOs* (July 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=425002 (for bank holding companies that certified prior to the rule's compliance deadline, showing that the effect on share prices was correlated with the opacity of the firm's earnings).

certification.[240] Romano analyses two of the studies in detail and concludes that it is difficult to draw "any definitive conclusion" from them.[241]

There are several reasons to have serious doubts about whether SOX can be worth these high costs. First, there is evidence that the market simply does not care that much about the information SOX is extracting at such high costs. A study has found that firms disclosing internal controls weaknesses have a slightly higher cost of equity, but that this difference is mainly associated with general economic characteristics of the disclosing firms, except for a few firms that delayed their SOX 404 disclosures.[242] Further studies of this sort may provide additional information about the impact of SOX disclosures.

Second, there is the serious question whether the SOX disclosures will have their intended effect of preventing fraud. For example, the recent Refco bankruptcy unfolded after disclosure that its CEO owed the firm $430 million. Neither SOX nor the intensive disclosure required in an initial public offering could protect investors. The prospectus did not disclose that the company's "receivables" were owed by its CEO or other "related party" since the identity of the debtor was disguised by cycling the loan through a customer.[243] The lesson is that all the disclosure in the world, including the detailed disclosures SOX requires of internal controls, cannot prevent fraud, even in a relatively small organization. And if business people were not deterred from willful fraud prior to SOX by the risk of long jail sentences or fines under prior law, increasing the terms, raising the penalties and extending the scope of liability to include failure to prevent fraud will not accomplish this either. These changes are more likely to deter honest people from engaging in risky but productive businesses than they are to prevent dishonest people from circumventing the law.

Third, even if SOX elicits information that is valuable to rational and informed investors, it is unrealistic to expect that this will prevent another Enron-type bubble. During the boom that led to SOX even sophisticated investors ignored ample warnings, such as the fact that WorldCom was repeatedly meeting its projections to the penny. They also ignored the warning of a hedge fund manager that Enron had become a derivatives speculator with unhedged investments.[244] They bid Enron up to fantastic price-earnings multiples despite the obvious risk that its business, even if legitimate, was very vulnerable to competition. Investors were susceptible to confirmation and conservatism biases that led them to discount evidence that was inconsistent with the sky-

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[240] Bhattacharya, Groznik & Haslem, "Is CEO Certification Credible?," 26 *Regulation* 8 (2003), available at http://papers.ssrn.com/paper.taf?abstract_id=511122.

[241] *See* Romano, *supra* note 18 at 1542.

[242] *See* Maria Ogneva, Kannan Raghunandan, and K.R. Subramanyam, *Internal Control Weakness and Cost of Equity: Evidence from SOX Section 404 Certifications* (October 2005), AAA 2006 Financial Accounting and Reporting Section (FARS) Meeting Paper available at http://ssrn.com/abstract=766104.

[243] *See Editorial, Overseeing Refco,* Wall St. J., , p. A18 (October 17, 2005), available at http://online.wsj.com/article/SB112950980774970305.html?mod=todays_us_opinion; Deborah Solomon & Michael Shroeder, "How Refco Fell Through Regulatory Cracks," *Wall St. J.*, p. A18, (October 18, 2005), available at http://online.wsj.com/article/SB112959398166971354.html?mod=todays_us_page_one.

[244] See Laing, *supra* note 64.

high expectations engendered by the long-running bubble market.[245] More information alone cannot prevent these judgment errors. Even if it were possible to pound investors until they understood the risk, this might just drive investors in the opposite, equally unrealistic, direction, particularly in bear markets.

In short, all of the mountains of information and inconvenience that SOX causes cannot prevent another Enron. The only thing that might have some effect is for investors to be more knowledgeable, careful and skeptical, and to learn from their mistakes. As discussed in Part IX, investor education holds out some hope. But SOX moves in the opposite direction, towards dis-education, by offering the false hope that Congress and the SEC have found the magic bullet that prevents fraud.

## VIII. IMMEDIATE POLICY IMPLICATIONS

The preceding analysis supports the overwhelming conclusion that SOX was a colossal mistake. By any reasonable standards of public policy analysis, SOX should be repealed. In a recent survey, 58% of corporate directors in the US favored repeal or overhaul of SOX.[246] However, despite the mounting evidence and criticism, repeal is highly unlikely. Even if society is losing, the Act retains the support of influential interest groups and the press, as discussed in subpart II.B. The big losers, such as entrepreneurs, are less organized and therefore less influential.

There is, however, a possible avenue to change. A favorable court decision in a recently filed lawsuit could provide the leverage to enact some major changes in SOX. On February 8, 2006, the Free Enterprise Fund filed a lawsuit[247] alleging that the PCAOB violates the Appointments Clause of the Constitution because its members need to be appointed by the President or heads of executive branch departments rather than the SEC.[248] This suit has the potential to overturn all of SOX, which lacks a severability clause. However, if the plaintiff prevails, the courts are likely to give Congress a window of opportunity to fix the Act. Although political reality makes it unlikely that Congress will repeal SOX, lawmakers may be able to seize the opportunity to fix the Act's worst flaws.

It is, therefore, worth discussing the changes that Congress should consider if it has the opportunity or inclination. These changes might turn SOX from a debacle into a model for future federal regulation, along the lines of the suggestions in Part IX, below. Although some changes could be adopted by the SEC,[249] and indeed Congress could be expected to delegate significant authority to the SEC, the SEC needs Congress to authorize and guide significant revisions. Indeed, it is not even clear that the SEC has the

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[245] *See generally,* Ribstein, *supra* note 232.

[246] *See* Chris Evans, "Directors call for Sarbanes-Oxley Repeal," *Accountancy Age* (Feb 23, 2006), available at http://www.accountancyage.com/accountancyage/news/2150885/sarbanes-story.

[247] *See supra* text 13 and accompanying text.

[248] For analysis of this issue, see Nagy, *supra* note 14.

[249] The SEC is already considering some of these changes, particularly including the forthcoming recommendations of the its Advisory Committee on Smaller Public Companies, *supra* note 105.

authority under current law to adopt the changes it is considering.[250]

## A.DEFUSE THE LITIGATION TIME BOMB

As detailed in Part VI, SOX created a litigation time bomb that will explode with the next major market downturn. All of the perverse incentives of SOX are exacerbated by this threat. Congress can prevent this by amending the Act to provide that violations of SOX cannot be enforced by private lawsuits.

Congress acted before to curb excessive litigation against corporations. For example, in 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA), which attempted to curb abuses in securities class-action litigation by eliminating so-called "professional plaintiffs" and instituting more-stringent pleading standards. In 2005, Congress passed the Class Action Fairness Act,[251] which attempted to control forum shopping in favorable "magnet" state courts by permitting removal of many class actions to federal courts.

Congress can cite in support of an amendment addressing the litigation risk from SOX language in the Supreme Court's recent *Dura* opinion.[252] The Court noted:

> [A]llowing a plaintiff to forgo giving any indication of the economic loss and proximate cause that the plaintiff has in mind would bring about harm of the very sort the statutes seek to avoid.….It would permit a plaintiff "with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence." *Blue Chip Stamps*, 421 U.S., at 741, 95 S.Ct. 1917. Such a rule would tend to transform a private securities action into a partial downside insurance policy. . . .[253]

Thus, removing the litigation time bomb – a modest, but very important, reform of SOX – may have significant political and legal traction.

## B. ALLOW OPT-OUTS OR OPT-INS

Congress demonstrated in SOX that it simply could not foresee the full effects of sweeping corporate reforms. This is an important reason why corporate governance has generally been controlled by state, rather than federal, law. If a state makes a mistake,

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[250] The Advisory Committee report, *id.* at 44, n. 96, argues that the SEC has authority to adopt exemptions for small firms under the Securities and Exchange Act, §36(a)(1) and SOX §3(a). However, the former section does not even apply to SOX §404, which is not part of the Exchange Act, while the latter provision provides only for rules "in furtherance of this Act," which arguably would not include a broad exemption. *See* William Sjostrom, *Can the SEC Exempt Small Companies from Sarbanes-Oxley 404? (Part 2)*, Truth on the Market, February 27, 2006, available at http://www.truthonthemarket.com/2006/02/27/can-the-sec-exempt-small-companies-from-sarbanes-oxley-404-part-2/.

[251] Available at http://files.findlaw.com/news.findlaw.com/hdocs/docs/clssactns/cafa05.pdf.

[252] *See supra* note 231.

[253] 125 S.Ct. at 1634.

firms can, in effect, opt out by reincorporating in another state. If Congress makes a mistake, firms can avoid it only by the far more costly route of moving their activities and capital-raising offshore. This suggests that Congress might minimize the risk of imposing unanticipated costs – that is, the costs of Congress miscalculating the impact of its regulation – by permitting firms to opt into or opt out of at least some of SOX's provisions. Leading candidates for opt-out would be the Section 404 internal controls provision discussed in subpart V.B.1 and the Section 402 prohibition on executive loans discussed in subpart V.B.3.

The argument against opt-out is that this is contrary to the rationale for regulating disclosure through mandatory federal laws. Investors arguably need a certain minimum amount of information to make investment choices, including choices based on applicable governance rules. So, the argument goes, shareholder choice does not work for the very rules that make this choice effective. A problem with this argument, however, is that investors would not be making this choice about disclosure in the dark: they would know, at least, that they would be making a riskier investment because of what the firm may choose not to tell them. Indeed, risk-averse investors might tend to place an unrealistically high weight on this consideration, thereby giving firms an incentive to opt for disclosure. There are more sophisticated arguments for mandatory disclosure,[254] but these arguments do not tell us precisely what disclosures should be required.

Two considerations support making some provisions of SOX, including those noted above, optional. First, as emphasized throughout this paper, the optimal amount of fraud is not zero. At some point regulation of fraud and disclosure is so costly that it is inefficient. The question is, who should decide when that is the case? Even if some mandatory disclosure is efficient, there may be significant debate at the margins. In these situations, it makes sense to let the shareholders decide. The debate raging over the internal controls disclosures indicates that this should be one of the marginal provisions for which opt-out is appropriate. Moreover, this public debate highlights for the shareholders both the costs and benefits of opting out of this particular disclosure provision.

Second, it is important to keep in mind that what is most significant about SOX is the way it veers off from the federal government's traditional concern with disclosure and into the sort of substantive governance provisions that traditionally have been the province of state corporate law. This is certainly true of the executive loan provision. It is also arguably true of some ostensibly disclosure-oriented provisions like the internal controls provision that effectively regulate governance. While the provision *says* only that the firm must disclose internal controls problems, in substance the provision not only strongly encourages firms to have controls, but effectively requires them to set up an internal framework that enables them to make the disclosure. This is regulation of governance and not merely of disclosure. In at least these cases, and probably others, shareholders should have the same opportunity they have under state law to decide the terms of their investments.

The specific mechanism for opt-out or opt-in could be the very proxy framework that Congress has approved as the basis for enabling shareholder choice. Thus, directors could propose the option in the proxy materials, and would be required by the proxy rules to give full disclosure of the reasons for and consequences of the proposal. Alternatively, shareholders could make an opt-in or opt-out proposal either by sending out their own

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[254] *See, generally,* Easterbrook & Fischel, *supra* note 57, Ch. 11.

proxy materials, or by taking advantage of the shareholder proposal rule.[255]

There are additional questions whether any options should be provisions that apply by default unless the firm opts out or that apply only if the firm opts in, the specific procedural requirements for opt out or in, which provisions would be subject to opt in or opt outs, and which companies would have the options. Congress might delegate some of these questions to the SEC, to be determined through rulemaking after notice and comment.[256]

## C. FOREIGN FIRMS

Prior to the Enron and WorldCom imbroglios, American capital markets were widely considered the strongest in the world. As discussed in subpart V.J., SOX has made American markets less attractive to foreign companies, in part by imposing substantive governance provisions that conflict with these firms' home country laws. This has provided a significant competitive opening for other securities markets, particularly including London.

Congress can address this problem by exempting foreign firms either from SOX generally or from specific provisions, such as the audit committee and internal controls provisions that are so troublesome for many foreign firms. Alternatively, assuming Congress does not make these provisions or make the Act optional for all firms, Congress can make them optional for foreign firms. This might be the best approach, since some cross-listing foreign firms might actually prefer to "bond" their disclosures by subjecting themselves to the highest level of US regulation.[257]

A potential problem with SOX exemptions and opt-outs for foreign firms is that this might give a significant advantage to foreign firms over their US competitors, particularly given the high costs of SOX discussed throughout this paper. One response is that the different treatment is justified on the ground that foreign firms are subject to regulation in their home countries. But US firms might protest that this regulation is weaker – it at least does not include SOX.

This problem might be dealt with by extending the exemption or the opt-out to any firm that is subject to the governance law of another country, irrespective of where it is physically based. Under current rules, whether a firm is subject to US regulation depends on *both* where the firm is incorporated and organized[258] and where its business, shareholders and management are located.[259] This would appropriately reflect the key reason for exempting foreign firms. In other words, this change to SOX, while specifically responding to the need to treat US and foreign firms comparably, might be a

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[255] *See* SEC Rule 14a-8.

[256] The SEC's Advisory Committee on Smaller Public Companies, *supra* note 105, has already started to consider a broad opt-in proposal for smaller firms, discussed in *infra* note 261.

[257] *See supra* text accompanying note 87.

[258] *See* SEC Rule 3b-4(b).

[259] *See* SEC Rule 3b-4(c).

modest beginning toward recognizing a true regime of jurisdictional choice.[260]

## D. EXEMPT SMALL CORPORATIONS

As discussed in subpart V.C.3, SOX presents significant problems for small firms, since the compliance cost per dollar of capitalization is much higher for these firms. Moreover, SOX's disproportionate impact on these firms is entirely unwarranted, since the corporate meltdowns that led to SOX were a phenomenon of large corporations. To the extent that SOX addressed the problems in these firms, its provisions are not necessarily appropriate for small firms. In particular, small firms may have far less need for extensive internal controls provisions throughout the organization. Of course there will be a question as to what the dividing line should be for any "small firm" exemption. As with the provision suggested in subpart A, this might be left to SEC rule.

As with foreign firms, Congress might give small firms the ability to opt into or out of SOX provisions. Small firms might be given this option only for certain provisions that are much more costly or less appropriate for smaller firms, such as the internal controls provision. Congress might also provide for a sliding scale in which the Act or some of its provisions do not apply at all to the smallest firms, and allow opt-ins and opt-outs for medium-sized firms. This discussion indicates only some of the many alternatives to one-size-fits-all mandatory regulation Congress can pursue.

There is, of course, a question concerning the appropriate cut-off for smaller firms. The SEC's Advisory Committee on Smaller Public Companies[261] has already done significant work on this issue. The Committee has in process a general opt-in proposal that would specifically include the internal controls provision that would permit opt-in for the smallest firms, defined as the smallest 1% by total capitalization and less than $125 million in annual revenue, and the next smallest 5% by total capitalization with less than $10 million in revenue. The Committee's careful proposals reflect consideration not only of the differential reporting burdens and benefits of smaller firms, but also the need for standards that are transparent and relatively easy to apply. However, it is important to keep in mind that this Committee was constrained to operate within the existing statutory framework. Congress' mandate in revising the Act, and the scope of any SEC rulemaking power under a revised Act, might be significantly broader than what is permitted under current law.

## E. REMOVE CRIMINAL PENALTIES

As discussed in subpart V.F., SOX exacerbates the increasing over-criminalization of corporate law by not only increasing criminal penalties for violation of the securities laws, but providing new crimes, particularly including those based on certification of inadequate internal controls. The dramatic post-Enron trials and plea bargains demonstrate not only that prosecutors have many powerful pre-SOX criminal sanctions at their disposal, but also the potential for prosecutorial abuse of these sanctions. These sanctions make the corporate suite a very dangerous place even for law-abiding executives. They may react by avoiding public firms that are subject to SOX, or engaging in conduct that is far more conservative than diversified shareholders would prefer – including excessive attention to internal controls disclosures.

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[260] *See* Ribstein, *supra* note 87.

[261] *See supra* note 105.

Criminal liability under SOX was one of the clearest examples of Congress attempting to appease popular sentiment and engaging in symbolic politics[262] rather than careful lawmaking. But the firms and executives who must live under this regime, and the corporate criminal defendants are not mere "symbols." If Congress has an opportunity to revisit SOX in a calmer atmosphere, one of its first responses should be to eliminate criminal liability under its provisions. To be sure, this would be only a partial response to the general problem of over-criminalization. But it could be an important first step.

## IX. THE FUTURE: REGULATORY HUBRIS OR GREATER HUMILITY?

So far we have shown the high costs and dubious benefits of SOX, as well as the powerful political forces that push for SOX and other corporate reforms. These problems are not a one-time regulatory quirk, but rather are inherent in corporate governance regulation. The forces that produced SOX have converged before and can be expected to converge again. The lesson from this discussion is that policy analysts and corporate law scholars need to be prepared for them.

Failure to be prepared can result in much more intrusive regulation with the next generation of "reform." As bad as SOX has been in many respects, it clearly could have gone further. SOX relies mostly on disclosure, albeit disclosure provisions that can have significant substantive governance implications. Its most invasive provisions, such as the executive loan prohibition, relate only to specific pockets of activities rather than spreading across the range of corporate decision-making.

What might be next? In a recent paper James Fanto serves up a sobering vision of the future of the largest business firms being saddled with "monitors" employed by the SEC who keep a close eye on the firm's management.[263] Fanto bases his suggestion on the regulations that already govern banks. This sort of invasive regulation is obviously inappropriate for entrepreneurial business corporations that are not subject to federal deposit insurance. The risk of failure and even fraud is built into any successful capitalist system, and can be shouldered by investors holding diversified portfolios of shares priced by efficient markets to reflect risk. But while the proposal flops as normative prescription, it might be worth a look as prediction. As long as our political leaders accept the idea that the law should strive to eliminate all risk of fraud to the extent possible – even at excessive cost – we should brace for the next set of reforms when the current ones fail at their impossible task.

It is entirely possible that the next boom and bust will bring the next regulatory panic, and with it another demand that Congress "restore confidence" in the market. The reformers will again step up, forgetting that SOX was supposed to be the law that ends all laws, ignoring the futility of trying to regulate away fraud, and urging yet another try. This time they will have Fanto's, or some similar proposal, queued up and ready to go.

Will the business community put up a united front against further encroachment,

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[262] *See supra* text accompanying note 48.

[263] James Fanto, *Paternalistic Regulation of Public Company Management: Lessons from Bank Regulation*, http://papers.ssrn.com/paper.taf?abstract_id=873667 (January 4, 2006). For a critique, *see* Larry E. Ribstein, "Business Corporations as Banks: The next Step in Corporate Governance Reform?," *Ideoblog*, January 21, 2006, http://busmovie.typepad.com/ideoblog/2006/01/business_corpor.html.

as it did not do against SOX? Not necessarily, because as Fanto points out, it may be better for executives to accept a monitor who tells them what to do every step of the way than to accept the risk of liability when they do not follow the increasingly extensive rules. Fanto says:

> The business community may even find that it is in its interest not to oppose the corporate monitor, if it only recognizes that the regulation of public firm management is already a long way down the paternalistic road, but, at least with regards to enforcement, in a way that is not favorable to this management. Executives and board members are now sanctioned harshly for their faults by the SEC and federal prosecutors without having the kind of relationship with a regulator that might make unnecessary the sting of enforcement.

So the business community may be willing, next time, to accept a long-term "relationship" with regulators rather than just the casual dating that occurs now.

There is a possible alternative to this dismal scenario. We can try to understand the true costs and benefits of regulation, and regulate in light of that understanding. This would involve regulators appreciating the significant limitations on government's ability both to eliminate fraud and to anticipate the full consequences of regulation. The following presents some suggestions of what regulating in light of this understanding might look like.

## A. PERIODIC REVIEW AND SUNSET PROVISIONS

We have articulated the consequences and costs that Congress undoubtedly did not expect. These costs may become evident only after the effects of the act are carefully tested. Important new legislation like SOX provides a sort of laboratory for financial economists. Although some of SOX' consequences and costs should have come as no surprise to dispassionate academic observers, Part II demonstrates that Congress does not act in anything like the relaxed conditions of the ivory tower. Moreover, any legislation poses the risk of costs that no one can anticipate, including the risk that business developments will render legal controls unnecessary.

For these reasons, significant new financial and governance regulation like SOX that displaces and supplements prior regulatory approaches should be subject to periodic review and sunset provisions. Although Congress, of course, always can undertake such reviews, prior experience indicates that it will not. Legislation is a one-way regulatory ratchet. It arises when the conditions for reform are ripe for a regulatory panic. The conditions for a "deregulatory panic" are less likely to develop. Firms learn to live with the extra costs and may not be willing or able to bear the costs of lobbying for repeal, at least in the absence of a regulatory cataclysm. Thus it is not surprising that SOX sponsor Michael Oxley, despite recognizing that SOX was "excessive" in some respects and admitting that it had been rushed through Congress, suggested that Congress would not be revisiting the issue, even as to the seriously affected small companies.[264] He said, "If I had another crack at it I would have provided a bit more flexibility for small- and medium-sized companies." In other words, Congress normally does not have "another crack" at regulation. A sunset or review mechanism would change that.

Perhaps Congress can learn some lessons from itself. The USA Patriot Act was

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[264] *Financial Times*; http://www.ohioscpa.com/publications/ohiocpa/default.asp?article=3505-1.

passed less than one year before SOX and, like SOX, was passed by an overwhelming majority. Unlike SOX, the USA Patriot Act includes sunset provisions for some of its most controversial provisions.[265]

The Patriot Act's sunset provision forced Congress and the President to re-evaluate and debate those provisions – in an atmosphere far removed from the immediate post-9/11 panic. American investors would benefit from a sober re-evaluation of SOX. Perhaps the courts will provide that opportunity. For future regulatory panics, Congress would do well to remember the lessons from the Patriot Act.

## B. CERTIFICATION AND OPT-OUT APPROACHES

The law might regulate "humbly" by imposing optional rather than mandatory rules. For example, the law could supplement market or private fraud prevention mechanisms by prescribing a certification regime, and let firms decide whether they want to certify.[266] The government function here would be to provide an organization that could provide a signal of honesty that investors could rely on. But firms can decide for themselves whether the signal costs too much to send. Similarly, the government could prescribe a regulatory scheme but permit firms to opt out as long as they get the requisite approval from their owners and make the appropriate disclosures to investors.[267] For example, the law might, as in the UK, let firms "comply or explain" — that is, opt out of compliance as long as they explain that they are doing so and why.[268]

## C. NUANCED REGULATION

Regulation should take account of differences among firms and regulatory contexts. The best way to do that is to make the regulation optional, as discussed in subpart B. If mandatory rules are deemed necessary to fix significant market defects, Congress should focus such rules on the specific problems that cannot be dealt with by optional rules. It should also design the rules taking into account differences among firms as to the need for regulation and the costs of compliance. For example, Congress clearly should have scaled costs by firm size, as well as take into account the different internal governance structure of foreign firms subject to SOX.[269]

## D. INVESTOR EDUCATION

The corporate frauds SOX addressed happened in part because of investors'

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[265] See Congressional Research Service, Library of Congress, *USA Patriot Act Sunset: Provisions that Expire on December 31, 2005*, http://fpc.state.gov/documents/organization/34499.pdf.

[266] See Stephen Choi, "Market Lessons for Gatekeepers," 92 *Nw. U.L. Rev.* 916 (1998).

[267] Romano, *supra* note 18 at 1595-97 also discusses the possibility optional regulation.

[268] It may be necessary to adjust disclosure requirements to be sure that they produce meaningful information. See Sridhar Arcot & Valentina Giulia Bruno, *In Letter but not in Spirit: An Analysis of Corporate Governance in the UK*, http://papers.ssrn.com/paper.taf?abstract_id=819784 (May 26, 2005) (showing that firms increasingly are complying with the "comply or explain" regulations in the UK, but often using standard explanations for non-compliance).

[269] *See supra* subpart IV.F.

willingness to ignore indications of questionable accounting and willingness to accept extravagant claims about unproven business plans. These problems might be mitigated more cost-effectively by providing some minimal training in the basics of finance.[270] This education might help offset some judgment biases of investors, teach the rudiments of efficient markets and how hard it is for ordinary investors to "outsmart" the market, and warn investors of the folly of not investing in diversified portfolios or index funds. Even if investors continue to fall for scams, at least they could be persuaded not to bet their life savings and retirement. For example, instead of trying to rid the market of all potential conflicts, including those that have net benefits for investors and firms, investors might be alerted to the problems of conflicts and then allowed to make their own judgments.[271]

Congress and the SEC could start this education process by ensuring that their own regulatory efforts do not mislead investors into believing that markets are safer than they are.[272] For example, moves toward subsidizing securities research for ordinary investors imply that investors should be researching and investing in individual stocks. Shareholders are better off diversified and rationally ignorant.

## E. DEREGULATION

Some problems in the securities markets could be mitigated by *reducing* the amount of regulation that already exists. An example is the SEC's regulation of disclosure to securities analysts. Analysts have strong incentives to ferret out information about firms, including information about potential fraud. Congress recognized the importance of analysts' monitoring role by adding provisions to SOX concerning analyst conflicts.

Yet prior to Enron the SEC promulgated Regulation FD which had the effect of hobbling analysts' ability to get information. Regulation FD requires firms that disclose information privately to analysts also to disclose the information publicly.[273] This regulation reduces analysts' incentives and ability to research by denying them the ability to have one-on-one conversations with corporate executives. It also reduces firms' incentives to disclose, since there is some information they have no obligation to disclose publicly, and would rather not disclose at all if this would require them to disclose it

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[270] *See* Lawrence A. Cunningham, *Outsmarting the Smart Money*, 181-200 (2002); Lawrence A. Cunningham, "Behavioral Finance and Investor Governance," 59 *Wash. & Lee L. Rev.* 767 (2003).

[271] The SEC has already moved in this direction. See S.E.C., Analyzing Analyst Recommendations (suggesting that investors note potential conflicts inherent in analyst recommendations), at http:// www.sec.gov/investor/pubs/analysts.htm.

[272] See Donald C. Langevoort, *Managing the 'Expectations Gap' in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV.1139 (2003) (the SEC must try "to persuade investors that the issuers are honest enough to justify broad and confident public participation without committing its own version of a fraud on the market"); See Donald C. Langevoort, "Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation," 97 *Nw. U. L. Rev.* 135 151 (2002) (discussing "myth" of desirability of encouraging trading by the retail investor); Henry T.C. Hu, "Faith and Magic: Investor Beliefs and Government Neutrality," 78 *Tex. L. Rev.* 777, 883 (2000) (noting that government intervention "has led many investors to believe that [the Federal Reserve] can and would prevent a stock market crash").

[273] Selective Disclosure and Insider Trading, Exchange Act Release No 33-7881, 15 August 2000, 2000 WL 1201556.

publicly. For example, firms can disclose pieces of information to trusted analysts that might be subject to misinterpretation if disclosed piecemeal to the market.[274] There is evidence that, in fact, some firms have chosen to stop disclosing information rather than disclosing publicly.[275] Indeed, Regulation FD may have given insiders an excuse to hide from inquiring analysts, where before they would trigger negative inferences by doing so. Regulation FD was enacted before Enron. Thirty years ago, insurance industry analyst Ray Dirks broke the notorious Equity Funding scandal. Regulation FD may have inhibited analysts from performing a similar function today. Not surprisingly, there is evidence that analysts' forecasts have declined following Regulation FD.[276]

Regulation FD is part of the SEC's and former Chairman Arthur Levitt's quixotic quest to ensure "fairness" in information. This effort is doomed to failure because inequality of information is a basic fact of the securities markets. If one group is denied the information, another will get it.[277] The main effect of forcing sharing of information is not to eliminate inequality but weaken the incentives to gather and create information that efficient securities markets rely on. Although Regulation FD may reduce firms' ability to "buy" analysts' support with exclusive information, it is far from clear that this is a serious problem given the market's ability to punish biased analysts.

## X. CONCLUDING REMARKS

SOX was suspect from the beginning – enacted in haste in the middle of a regulatory panic with almost no deliberation on even its most important provisions and little or no credible evidence supporting the need for new regulation of any kind.

Laws were already in place to deal with the fraudulent conduct that emerged with the bursting of the millennial bubble,. It makes no sense to impose significant new regulation, even if this regulation might reduce fraud, if regulatory costs exceed any possible benefit from fraud reduction. In fact, SOX has been horrendously costly, with the best evidence of its effect on market prices standing at almost a trillion and a half dollars.

Some of the costs of SOX are in the form of direct compliance, including the notorious internal controls provision and the burden of finding directors to comply with the new audit committee independence rules. SOX's defenders attempt to fall back on the argument that these direct costs (although much higher than even they expected them to be) will decline in time as firms put compliance systems in place. But even if this is the case, it is only a feeble response to SOX's problems, since we estimate that these direct

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[274] *See* Commissioner Laura S. Unger, SEC Special Study: Regulation Fair Disclosure Revisited (Dec. 2001), http:// www.sec.gov/news/studies/regfdstudy.htm.

[275] *See* Ahmed & Schneible, *Did Regulation Fair Disclosure Level the Playing Field? Evidence from an Analysis of Changes in Trading Volume and Stock Price Reactions to Earnings Announcements*, (22 January 2004), available at http://papers.ssrn.com/paper.taf?abstract_id=498002.

[276] Anup Agrawal & Sahiba Chadha, *Who is Afraid of Reg FD? The Behavior and Performance of Sell-Side Analysts Following the SEC's Fair Disclosure Rules* (AFA 2003 Washington, DC Meetings, Oct. 2002) http://papers.ssrn.com/paper.taf?abstract_ id=301484.

[277] *See* David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449 (1986).

compliance costs are only about a fifth of the total costs SOX imposes.

SOX's indirect costs – both those that have already manifested, and those looming on the horizon – are legion. They include

--The costs of managing in the "climate of fear" created by SOX's myriad new liabilities and rules, particularly including the Section 404, including constraints on managerial risk-taking.

--Limits on executive compensation through the insider loan prohibition.

--The opportunity costs of diverting executives' time from business management to paper management.

--The high costs imposed on small firms, effectively forcing many to forego public ownership, and reducing valuable entrepreneurial activity.

--Reducing the flow of information and trust in firms by, among other things, turning employees and lawyers into hall monitors.

--Putting the cost of business failure on corporate executives, thereby undoing the efficient diversification of risk enabled by public securities markets.

--Furthering the trend toward criminalizing ordinary agency costs, with significant impact both on corporate management and the criminal justice system.

--Placing significant new burdens and risks on auditors, thereby forcing additional inefficient risk-bearing and making it even harder for smaller and riskier firms to enter the public markets.

--Regulation of securities analysts that reduces their incentives to gather the information that is important to market efficiency.

--Interfering with state regulation of corporate governance, which has been a significant reason for the success of our capital markets.

--Discouraging foreign firms from trading in the U.S., thereby eroding the U.S. dominance in world securities markets.

--Setting a litigation time bomb that will explode in the next economic downturn, exposing firms to ruinous litigation from hindsight evaluation of their disclosures in response to SOX's new requirements.

SOX defenders might persist even in the face of this litany of costs in saying that, despite the huge costs, our capital markets derive incalculable benefits from reducing the fraud that had eroded investor confidence prior to SOX. However, even if we assume for the sake of argument that the risk of fraud is lower now than before SOX, it is not clear that this is as a result of SOX's provisions or that the market or the states would have not have responded on their own if SOX had not been adopted.

Congress should, and may have an opportunity and incentive to, reexamine SOX. Even if the result is not complete repeal, Congress should consider revisions that would reduce the horrendous costs SOX imposes. Possible revisions include exemptions of foreign and small firms, eliminating criminal and civil penalties for violation of SOX,

and permitting opt-in or opt-out of at least some the Act's provisions by at least some types of firms.

An understanding of these high costs and minimal benefits and of the forces that produced this misguided legislation may help to prevent a regulatory debacle in the future. We make specific recommendations for any future regulation of the capital markets that are suggested by the SOX experience, including optional provisions, periodic review and sunset provisions, and regulation whose scope is more carefully designed and focused. SOX should teach us to respond to fraud in a more measured way, with regulation that works with rather than against markets.