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Sarbanes-Oxley As an Inside-the-Beltway Phenomenon

By Peter J. Wallison

The idea that investors lost confidence in corporate America, the securities markets, and financial disclosure after Enron, WorldCom, and the other corporate scandals has now been firmly imbedded in our national psyche. Speeches by SEC officials assert that new regulations are still necessary to restore this depleted confidence, and business leaders, media commentators, and politicians speak of an investor loss of confidence arising out of the corporate scandals as though it were a fact. In reality, there is very little evidence that this crisis actually occurred—at least among investors. If there was a crisis of confidence, it seems to have been among the political class and the media. And if investors lost confidence, it was not in the markets or in financial disclosure but in the good sense of the nation's political leadership.

It is an article of faith among financial commentators and policymakers that the Sarbanes-Oxley Act was necessary to restore investor confidence in the securities markets after Enron, WorldCom, and the other corporate scandals of 2001 and 2002. As a result of this view, just about every new regulation proposed by the Securities and Exchange Commission (SEC) is said to be part of the process of helping investors get over their loss of confidence in the stock market and financial disclosure, and countless speeches by lawmakers and business leaders repeat this formulation in order to provide support for their positions on one or another public policy issue. The SEC's proposal to enhance the ability of shareholders to nominate non-management directors and the plan of the Financial Accounting Standards Board to require corporations to expense employee stock options are only two examples of this phenomenon.

Failure of Whose Confidence?

Yet a close study of events in the stock market before and after Enron and WorldCom provides very little support for the proposition that investors suffered any loss of confidence in the stock markets as a result of these events. Indeed, this should not be surprising. Dishonesty and manipulation of financial reports has always been an unavoidable part of free markets, which ultimately reflect all aspects of human behavior, good and bad. The possibility that there are some companies—even many companies—that have misstated their financial results is probably already priced into the market, so we should not expect that investors would lose confidence in the securities market as a whole because something happens that has always happened in human affairs.

In addition, sophisticated investors already understand the deficiencies of generally accepted accounting principles (GAAP) as a financial disclosure mechanism and have always used cash flows rather than balance sheet numbers and earnings per share to assess the value of companies. They would not suddenly be shaken by the news that GAAP financial statements might be overstated, or that auditors might not have found the many ways that corporate management can hide adverse results and display favorable ones. The same is not necessarily true of the members of the media and the Washington political class, who—while understanding the foibles and human weaknesses of those within their own worlds—seem to believe that everyone else is naïve and unsophisticated. Politicians and reporters

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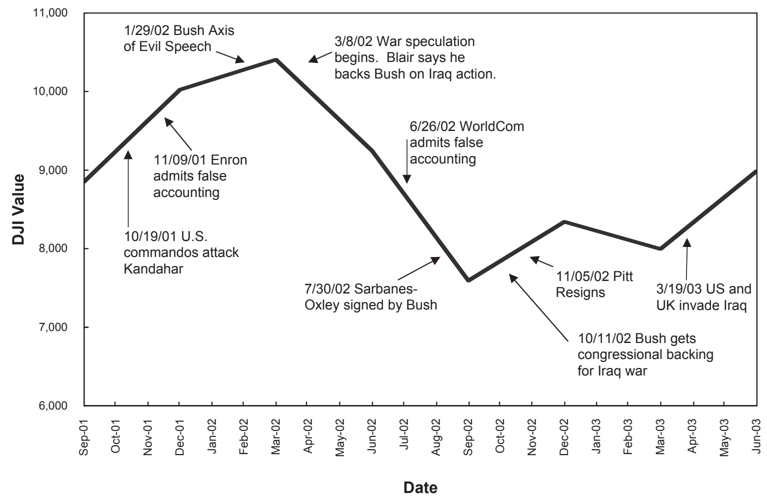
seldom have much personal experience with markets, financial statements, or the assessment of financial values and thus believe that financial statements are more important to investors than in fact they are.

As we might expect, then, the reactions to Enron and WorldCom in the political and media worlds were very different from the reaction in the investor world. Unfortunately, however, the political class has the ability to create laws, and—under pressure from the media—create they did, apparently under the dual misapprehension that investors had never considered that dishonesty and financial manipulation occur in the stock markets, and that by regulating the way financial statements are audited they would make a material difference in investors' respect for GAAP financial statements. Accordingly, Sarbanes-Oxley should be seen as a response to how the media and the political class thought investors *should* react, rather than how investors actually reacted.

Figure 1: **Dow Jones Industrial Average, September 2001–June 2003**



The act was rushed through Congress in July 2002, amid claims that Enron, WorldCom, and other corporate scandals had caused a dramatic loss of investor confidence in the honesty of corporate America and the accuracy of financial reports. To be sure, it is very difficult to be definitive about the state of mind of a group as large as investors, and so many other things are happening at any given time that no one factor can be deemed wholly determinative, but if we look only at what actually took place in the stock market during the relevant period it would be reasonable to explain Sarbanes-Oxley as the consequence of a loss of confidence in corporate America by the media and the political class rather than as a loss of confidence by investors.

Most people who remember that period in late 2001 and early 2002 will recall that after Enron's collapse nothing much happened. The *New York Times* ran a series of articles about Enron's political connections, with suggestions of widespread corruption in the political and financial worlds, but as shown in figure 1 the market was largely unaffected. The Dow Jones Industrial Average continued to rise, probably on the success of the U.S. effort in Afghanistan. There was no apparent loss of investor confidence, although of course it could be argued that the Dow would have risen further if the Enron scandal had not occurred. Nevertheless, it is clear that the scandal did not create a negative reaction in the market strong enough to overcome the general optimism that followed the invasion of Afghanistan.

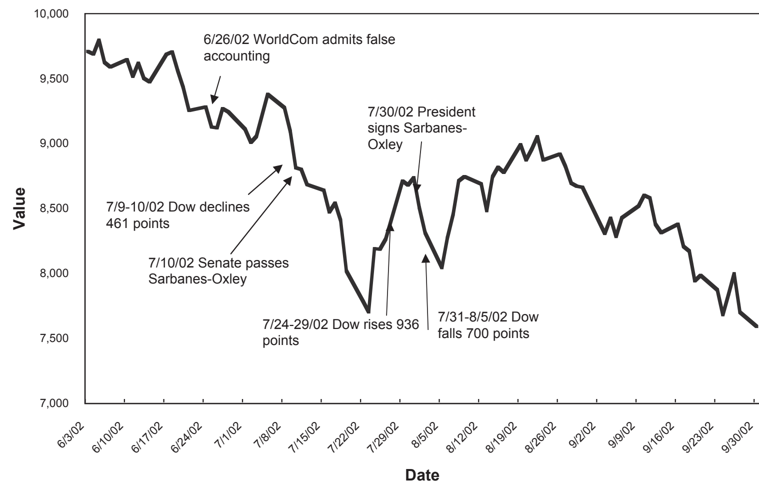
In the wake of Enron, the House of Representatives passed a relatively modest bill, and the SEC was preparing to set up a mechanism for reviewing and regulating the standards for how audits were performed. The Senate Banking Committee, then chaired by Senator Sarbanes (D-Md.), was considering a much more ambitious bill, but most observers thought it was not going anywhere and many doubted that Congress would pass any legislation at all.

Then on June 26, 2002, WorldCom announced that it had found billions of dollars in falsely categorized items in its financial statements, suddenly and adversely changing its financial results over many prior years. This was certainly a shock of some kind to the markets, but the Dow fell only 6 points that day, and then rose 150 points the following day. Investors, in other words, seemed to take the WorldCom revelation in stride. Over the next six trading days (the July 4 holiday intervened), the net change in the Dow was an *increase* of 153 points.

But the press and the political class seemed to fall into a panic, arguing that the act was necessary to combat a crisis of investor confidence in the stock markets. Former SEC chairman Arthur Levitt seemed to be on all the cable news and talk shows, arguing that accountants had been suborned by the consulting work they did for their auditing clients, casting doubt on the accuracy of their audit reports and certifications. The news coverage consistently suggested that Enron and WorldCom were symptomatic of a systemic problem.[1] But if we look closely at the movements of the Dow at that time it is very hard to find a correlation between key events in the Enron-WorldCom-Sarbanes-Oxley saga and the behavior of the markets.

Stock Market Fluctuations

Figure 2: **Dow Jones Industrial Average, June–September 2002**



Indeed, the market was quite stable until July 9 and 10, when President George W. Bush and Congress began to press for tough legislation. (See figure 2.) On July 9, the president called for immediate action to deal with corporate fraud; the Senate rushed the Sarbanes bill to the floor, and it was passed almost unanimously on July 10. On these two days, the Dow plunged, falling 179 points on the day President Bush spoke, and another 283 points on July 10. The president's speech and the Senate action were clear signals that a tough and heavily regulatory bill was coming, so it is reasonable to interpret the huge declines in the Dow on July 9 and 10 as a highly negative investor reaction to the new legislation. The news media interpreted the declines on these two days as further evidence of a crisis of investor confidence, but given the correlation between legislative action and the declines in the Dow it is more likely that investors had lost confidence in the country's political leadership than in the stock markets. In the following two weeks, from July 10 to July 24, as the Sarbanes bill worked its way through the congressional process, the Dow fell another 1,000 points.

The act was passed by Congress on July 24 and was sent to the president for his signature, which was a foregone conclusion. The Dow gained 936 points between July 24 and July 29, but it is unlikely that this gain was the result of congressional action on the bill, which had become a virtual certainty as early as July 10. There was almost no political opposition to strong legislation; the Democrats hoped and Republicans feared that voters would blame the Republicans—as the party thought to be closest to business—for the corporate scandals. This turned out not to be a legitimate fear, as later polls showed that Americans generally regarded the Democrats and Republicans as equally close to business.[2] Later polls also showed that that the American people did not want additional laws on this subject either, believing that the matter could be handled with the prosecution of the wrongdoers rather than new regulation.[3] In any event, shortly after the president signed the bill, on July 30, the Dow fell another 700 points. So it does not appear that the Act's becoming law restored much confidence. And thereafter, with the usual ups and downs along the way, the Dow fell another 1,000 points between July 30 and the end of September.

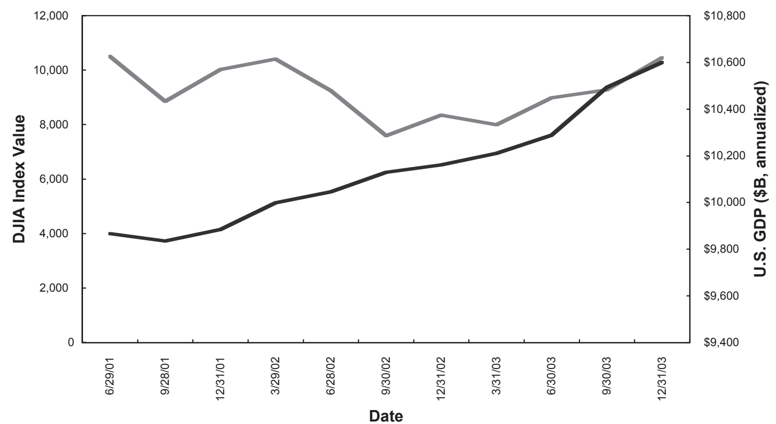
All this suggests that something else, not a loss of investor confidence, was influencing the market. If we look at figure 1, which covers the period from September 1, 2001, to June 30, 2003, it becomes clear what this was. The Dow was rising after the United States attacked Afghanistan on October 19, 2001, and as noted above it continued rising after Enron disclosed its false accounting on November 9, 2001, and *after* Bush's "Axis of Evil" speech on January 29, 2002. Then, in March 2002, four months after Enron and three months *before* WorldCom, it began a long decline, falling about 3,000 points until early September 2002. WorldCom and Sarbanes-Oxley happened during this period but did not seem to have any significant influence on the steepness of the Dow's ongoing decline at this point.

The Dow did not begin any sustained rise until it became clear that President Bush would get a strong congressional resolution in support of his Iraq policy in early October 2002 and continued rising through Harvey Pitt's resignation on November 11. This is significant, because the resignation signaled a collapse of the effort to get the Public Company Accounting Oversight Board—one of the key supposedly confidence-building elements of Sarbanes-Oxley—up and running. There was a slight decline between December 2002 and March 19, 2003, after which the Dow began a recovery of more than 2,000 points to bring it to its current level. The significance of March 19, 2003, is that it was the date on which the United States and other coalition forces invaded Iraq.

This points to the reason for the long decline in the Dow, and it has nothing to do with investor confidence.

Beginning in March 2002, well before WorldCom, investors began to anticipate the possibility of war in Iraq. After the President's "Axis of Evil" speech, speculation began in earnest about an attack on Iraq. Bob Woodward's book also dates the commencement of serious planning for an Iraq campaign to March 2002. On March 8, 2002, the *Financial Times* reported a confirmation by Prime Minister Tony Blair that the United Kingdom would support U.S. action against Iraq, and at that point investors knew that unless Saddam gave in to U.S. and British demands, war was likely. Investors famously hate uncertainty, and it seems clear that the uncertainties associated with impending Iraq war caused the 3,000-point decline in the Dow that began in March 2002. When, on March 19, 2003, the United States and Britain finally invaded Iraq, these uncertainties came to an end and the Dow began a long rise.

Figure 3: **GDP and DJIA Comparison July 2001–December 2003**



Nor can the long decline in the Dow from the beginning of March 2002 to the March 19, 2003, be attributed to weakness in the U.S. economy. As shown in figure 3, the gross domestic product of the United States was rising steadily all through this period.

The Effects of Sarbanes-Oxley

There is very little evidence, then, that Enron, WorldCom, or Sarbanes-Oxley had anything other than a short-term and insignificant effect on stock prices. And even that influence is ambiguous and unclear. If Enron and WorldCom had indeed caused a crisis in investor confidence it should show up as a sharp and sustained decline after the news. After all, investors should have been leaving the market in droves. Instead, what we see is a choppiness—with the Dow rising and falling by large percentages over a brief period after WorldCom, as Congress was legislating and the media was telling investors that they (i.e., the investors) had lost confidence in corporate America. After this period of about two months, the market resumed a long-term downward trend that seems clearly associated with the oncoming war in Iraq. If Sarbanes-Oxley had any effect in restoring investor confidence, it did not show up for almost eight months after the Act was passed.

Again, all this is important because policymakers, regulators, and pundits have been justifying additional regulation by pointing to a continuing need to restore investor confidence. For example, it was on this basis that Chairman William Donaldson of the SEC justified the commission's recent proposal to enhance shareholders' ability to nominate corporate directors.

In the future, we can expect to hear politicians, regulators, pundits, and "enlightened" business leaders tell us that Sarbanes-Oxley was a necessary step in restoring investor confidence in the stock market—and that much more needs to be done. These statements will be based on ideological positions or what they have heard others say, but they will not be based on fact. If more people understood that Sarbanes-Oxley was an inside-the-beltway phenomenon, rather than a response to a real crisis, there would be a lot less interest in more regulation and perhaps even a more critical look at Sarbanes-Oxley itself.

Notes

1. *Media Monitor* XVI, no. 5 (September/October 2002).

2. In a November 2002 poll, Voter News Service surveyed voters leaving the polls, with the following question, "Has either party been influenced too much by large corporations . . . only the Democratic Party, only the Republican Party, both parties, or neither party?" The responses were Democrats 9 percent, Republicans 13 percent, both parties 65 percent, neither 13 percent.

3. In July 2002, a survey by NBC News and the *Wall Street Journal* asked this question; "Which statement do you agree with more concerning current accounting scandals: The President and Congress should pass tough new laws and regulations to prevent corporate fraud and questionable accounting practices or should not pass new laws, but instead focus on enforcing existing laws and investigating and prosecuting firms and corporate officials that have broken the rules?" The responses: should pass new laws: 33 percent, should not pass new laws: 63 percent.