

American Enterprise Institute for Public Policy Research
Sarbanes-Oxley and the Financial Crisis
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Presentations by Newt Gingrich and Alex J. Pollock

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Newt Gingrich: Let me start and say I want to thank Alex Pollock in particular, but also Brady Cassis and Emily Renwick, who, in order to make sure that I would not be totally embarrassing, decided that I would have this Labor Day weekend opportunity to get caught up with everything that Alex and others have written, so I'm really honored to be here.

This is a topic I have been working on for the last couple of years and that I got into in part in a series of trips to Silicon Valley in 2007 and early 2008, in which, again and again, venture capitalists said that Sarbanes-Oxley had become a disaster in the development of new companies and new jobs; and had extended the length of time it took to get a company to go from initial start-up to public offering by at least four or five years, because in order to sustain the accounting cost and compliance cost, you had to have an inherently bigger company; otherwise, you couldn't afford to bear the cost. And so they were literally now doubling the length of time they were telling entrepreneurs it would take them to move a company from initial capitalization to public offering.

That got me intrigued. Then I was in a series of meetings in New York with Mayor Bloomberg who had sponsored a project by McKinsey and who is faced with a very real danger of New York substantially losing its competitive edge as a financial center. And when you realize the scale of the New York Financial Center for New York City, it's about a third of the revenue of the city of New York, you can begin to understand why he was rather aggressively concerned.

But I want to back out and put all of these concerns about Sarbanes-Oxley into a much broader framework. I just came back from 16 days in Tokyo, Seoul, Beijing and then northeast China. When you are out of the United States and particularly when you are in Asia and you are dealing with countries -- and it was the first time I've been to China where no Chinese -- some fairly long series of meetings over 10 days, no Chinese raised Taiwan. All of them raised jobs. All of them talked about the economy.

All of them were concerned about the fact that they have to produce an enormous number of new jobs every year just to stay even and that that will remain true probably for another 12 to 15 years because even when they peak out, which is around 2015 in the size of their workforce, they still have probably 150 million rural population migration that will occur, that will continue to bring more people into the urban workplace. So their passion every morning, I mean, the very survival of the regime is what are we going to do about the economy? How do we keep people busy? And it was fascinating to be with them and to see how absolutely pragmatic they were.

In the early 1990s, Deng Xiaoping went in what was called the southern tour in 1992. And there, if you go to Nanjing, there are two giant cats that are on the end of a bridge. On one side of the bridge is a black cat and on the other side of the bridge is a white cat. They are I think about 20 or 25 feet tall. And they came from a phrase of his, when people were arguing ideologically and theoretically about communism, he said, "Look, I don't care if it is a black cat or a white cat as long as it catches the mouse." And his whole thematic was, quit telling me about, you know, Mao's ideology and about Lenin's writing and about Carl Marx's thoughts. None of them are relevant to creating jobs and if you don't create jobs, the Chinese system is going to collapse.

And they first adopted this actually 30 years ago this year. In 1979, at a Communist Party Congress, Deng got them to adopt a very dramatic shift towards the market economy, but they faltered about halfway through the process. And it was his southern tour where he adamantly, basically ran like a presidential campaign. I mean he went around the country saying, look, I mean, we have got to get practical about the world market. We've got to learn how to do this. We've got to create companies and we got to learn to work.

Now I take that level of pragmatism. I go to visit Japan, a country we beat decisively in three years and eight months and I think back to -- I've written two novels, *Pearl Harbor* and *Days of Infamy*, about 1941 and I think about the relentless pragmatic innovation of the American system, that from December the 7th, 1941 to August 1945 could mobilize the nation, produce military capability and defeat Italy, Germany and Japan simultaneously. And now I look at the Atlanta Airport, which took 23 years to add a fifth runway.

And we have become a country incapable of being ourselves. I talked yesterday with Bob Kerrey, the former Democratic senator from Nebraska and the president of the new school in New York who had just read a study of the opening of the Erie Canal as a nation building event. And he said, "If you imagine today's litigation and today's regulation, we would still not have completed the Erie Canal." And it's a very interesting process.

So I bring a different -- here's my test for you all to think about as we discuss Sarbanes-Oxley. It actually applies much more widely but at least you understand how I apply it relentlessly in this case. I'm trying to design the kind of economic policy we need, which I believe includes litigation, regulation, taxation, education, health, energy and infrastructure to enable my two grandchildren, Maggie who is about to be 10 and Robert who is eight, when they're in their 40s or 50s to be in the most productive country in the world, because if we are not the most productive country in the world, we will not be able to sustain our national security and we will not be the leading country in the world.

So if you start there and say, okay, let's measure Sarbanes-Oxley against the objective question: Does it optimize the American ability to create the next product, invent the next company, create the next thousand jobs, maintain the highest value-added capability in order to have the best paid people? Now, measured against that test, Sarbanes-Oxley is a disaster. And allow me to just give you some examples and it is fascinating to me how hard it is to get the political system to look at itself.

Let me start with the original estimate that it would cost \$91,000 for a small business to comply with Sarbanes-Oxley. It turns out that was off by a factor of 10 - not 10 percent - a thousand percent. At the current estimate it is always about \$900,000, not \$91,000. Now, you might imagine a rule that says if Congress is off by more than 100 percent, then the bill is null and void and they need to rewrite it, but to be off by 1,000 percent and ignore the fact that they were totally wrong -- and Senator Dodd has sort of cheerfully ignored the fact that the bill he's defending is in fact stunningly destructive of small business.

Second, it is very anti-startup, and if you're drifting towards 10 percent unemployment and if you count those who quit looking for work and those who have part time work but would like full time work, our current unemployment rate is really around 16.7 percent. It is very possible it will pass 20 percent in terms of accounting everybody who can't find a full time job by sometime next year. In that environment, to

have a regulation, which inhibits the development of the next generation of venture capital, the next generation of startups, the next generation of new technologies is suicidal.

The fact is, in addition to what it does to startups in places like Silicon Valley, it is clearly weakening us in competing in the world market. Remember, London is our temporary competitor. London is not our long term competitor. Our long term competitor is going to be in Asia and they are not going to be encumbered by slow, bureaucratic, centralized -- the statement is bizarre, the communist dictatorship is going to be more open to capitalism than the American system.

And if you think about it, it's almost inconceivably reversed the world in 30 years. And it just seems to me, if you take a serious look at what will it take for us to be the leading financial center in the world, which has a huge impact on capital flow, it has an enormous impact on your ability to finance the future, an enormous impact on your ability to sustain the debt, and yet we capriciously are throwing it away.

In addition, I think Sarbanes-Oxley fundamentally misdirects the attention of management and of their boards of directors. I've talked to a number of very sophisticated people who have said that, one, they won't serve on boards anymore because they're not going to risk criminal liability; two, the people they talk to who are serving on boards spend 80 percent of their time on compliance and no longer think strategically about the company's future, no longer think about solving the management problems.

Listen, in a worldwide competitive marketplace, the last thing you want to do is have your senior strategic advisors on the board of directors and your CEO totally immersed in accounting principles and unable to think strategically about competing with China and India, and yet Sarbanes-Oxley has fundamentally misdirected the attention -- Bernie Marcus who founded Home Depot says flatly -- and I'm trying to convince Bernie to finish writing a book on Sarbanes-Oxley because he hates the bill so much. He says flatly he could never have created Home Depot under Sarbanes-Oxley. It wouldn't have happened. That gives you some sense of how destructive we're currently being.

Two last points on my side - I think that it is ironic that one of the great effects of Sarbanes-Oxley is going to be to actually drive more and more companies into the private sector where they cease to be public companies, so we actually have less and less economic activity in the open because the rules for being in the open are now so dangerous and involve such criminal potential that people have decided they'd rather sell

their company go into being privately held. So you are actually going to have fewer companies available to be regulated because you now have too much regulation. There's a point there when that alone should have been sort of a key signal that we had tipped past the point of rational behavior.

Finally, Sarbanes-Oxley, and I just want to make this comment because it relates exactly to what's going on in Capitol Hill right now in health care and what went on with the Waxman-Markey Bill. We are in a cycle where really smart people of really limited knowledge sit in rooms in Capitol Hill with word processors and they can write extraordinarily complex ideas into stunningly powerful aggregations of government power with zero understanding of the world they live in. And if you read the section in here on the small business application and you go out and talk to anybody who actually runs a small business, I run a series of small or for-profit small businesses, we have four of them, and if I -- and I'm not big enough yet to go public so it's not a direct threat to me right now, but if I were trying to run my small businesses under the aegis of Sarbanes-Oxley, it would fundamentally cripple all of my advantages.

My advantages are we can move very fast, we are very flexible, we have a fluidity of delegation, we have a very lean organization, and we'd spend very little time on red tape. We measure very rigorously whether or not we're making money every month but we don't measure all the process things that are required by Sarbanes-Oxley. And so it was written by people who clearly had never run a small business on behalf of members who had never run a small business, in response to a news media panic which gets me to my final point.

To the best of my knowledge - and I've done a fair amount of looking and asking - to the best of my knowledge, Sarbanes-Oxley produced no information during the meltdown. I mean there was no net advantage at AIG, at Lehman Brothers, at Merrill Lynch, at Bank of America, at Citibank. There was no net advantage to Sarbanes-Oxley. So we've imposed all of this extra cost, distorted our entire entrepreneurial activity, crippled our creation of new jobs for zero net public gain. Now that is truly one of the more amazing congressional achievements in the last decade and I think it's worthy of being repealed.

Comments by Alex J. Pollock

Alex J. Pollock: Thank you very much, Ken, for organizing this conference and thank you, Newt, for those very insightful comments. Let me start off by disagreeing with you on one point. You said the net public gain is zero. I think the net public gain of Sarbanes-Oxley is a large negative number.

Newt Gingrich: I stand corrected.

Alex J. Pollock: Well, it is, as Ken pointed out, seven years since the enactment of Sarbanes-Oxley and it is in one sense fading into history so that we ought to be able to get some perspective on it such as thinking about Newt's point of what are the combination of factors that make for a successful, energetic, growing entrepreneurial society in the long run.

I have three sets of photos in my office which amuse me greatly and sometimes amuse visitors. One -- and it's three pairs of distinguished serious gentlemen. One pair is Senator Smoot and Congressman Hawley, authors of the famous Smoot-Hawley Tariff of 1929. Another one is Senator Garn and Congressman St. Germaine, authors of the Garn-St. Germaine Act, which everyone knows made the 1980s savings and loan collapse much worse. And of course, the third pair is Senator Sarbanes and Congressman Oxley. My motto for three sets of paired photos is, "It seemed like a good idea at the time."

Now, what do we know about the Sarbanes-Oxley Act? Well, we know it succeeded in creating vast cost and bureaucracy. We know it succeeded in creating a financial bonanza for the partners of accounting firms; best thing that ever happened to them. We know it succeeded in creating a vast effort around identifying and managing risk and risk factors.

Here's an interesting quote. Ernst & Young did a recent study, "The Future of Risk." One of the Ernst & Young partners has asked: Is there too much risk management going on now? Are there so many processes and complexities that the actual process of mitigating and assessing risk get in each other's way and are counterproductive? And the fellow from Ernst & Young says, "That was a key finding of the survey," yes, so that's where we are.

Well, of course we know that Sarbanes-Oxley did not avoid the tremendous financial bubble and bust of the last several years and I -- with that in mind I asked a couple of informal advisers of mine, both of whom are very knowledgeable and competent operating managers in the area of mortgage finance, what

they thought about Sarbanes-Oxley. Here's what one of them wrote me - he is an entrepreneur now, by the way. He has his own firm in a very technical part of mortgage finance.

He said, "The mortgage meltdown has proven that Sarbanes-Oxley had absolutely no impact on corporate behavior. Any improved investor confidence was sorely misplaced as we can see." And then he lists a number of examples which we all know: New Century, GMAC, Fannie Mae, Freddie Mac, IndyMac, Washington Mutual, Wachovia Bank, Countrywide and we could go on. Note these are all public companies, all subject to the processes that Sarbanes-Oxley requires.

He goes on to say, "Besides doing Sarbanes-Oxley reviews, the big four accountants were busy reviewing securitization models. They would opine as to the mathematical accuracy of the models but not as to the assumptions. Well, you couldn't audit the securities you were reviewing because of the need created by Sarbanes-Oxley to separate consulting from auditing," he says. And his peroration is, "Where was Sarbanes-Oxley? Supporters of Sarbanes-Oxley," he says, "should be required to point out at least one success story. I can't think of one," he concludes.

I shared that with another friend of mine who is a really talented operating manager in finance and in mortgages. He wrote back, "Dave's mistaken when he says Sarbanes-Oxley had no impact. It had a big impact: keeping managers focused on trivial mechanics and investors focused on the bogus management assessments of risk that were the voluminous output of the trivial mechanics which are still occupying loads of managerial time," similar to a point you made, Newt.

And Dave replies, "Well, it's hard to disagree. In this case, no one gained anything other than the accounting firm partners as previously mentioned. No loss was prevented so it was all a big waste of time and money signifying nothing."

Now, something else we know about Sarbanes-Oxley is that it succeeded in creating a huge emphasis on the notion of independence. Independence is a fine idea but independence by itself, in my view, is a rather dangerous notion. And I'm going to speak later about independence in boards of directors of companies in which I have some experience, and also in government sponsored bodies, specifically the PCAOB and the FASB respectively. And I will suggest that Sarbanes-Oxley overemphasized the idea of

independence and woefully underemphasized or didn't even think of the concept of knowledge and the application of knowledge to problems.

Now, it's sobering that the votes passing Sarbanes-Oxley were 99 to 0 in the Senate of the United States and 423 to 3 in the House of Representatives. If you add these two together, that gives you 522 votes in favor from the elected representatives of the people and three opposed. Now these votes make me think of the story of General Motors when it was one of the greatest companies in the world and being run by Alfred P. Sloan who had the management committee addressing some problem and he said, "We're all agreed?" And they said yes. He said, "No one is opposed?" And they said no. He said, "No worries or dissent?" They said no. Sloan, according to the story, said then we're going to table this question until next month when we can get some wholesome disagreement and maybe we'll know what we're doing." And perhaps, we should worry whenever the Congress is so uniformly in favor of something especially in the wake of a panic.

Now, what were we trying to do in Sarbanes-Oxley? Here is what Senator Sarbanes said in his formal address to the Senate when the bill was about ready to be passed, "It is becoming increasingly clear that something has gone wrong, seriously wrong, with respect to our capital markets. We confront an increasing crisis of confidence that's eroding the public's trust in those markets." And so Sarbanes-Oxley was passed and from the perspective of the subsequent panic of 2008 and 2009 I think Senator Sarbanes' comment needs no further comment.

Now, further to the purpose of Sarbanes-Oxley, Senator Enzi at that time said this, "My hope is that this new oversight structure," he said, "will renew the faith that the public has in auditors and in the financial statements that they help to prepare." Well, personally, I don't feel too much faith in auditors or accounting as a concept and nor do I wish to have such faith. I think most auditors are honest, hardworking people and they make mistakes like everybody else makes mistakes and sometimes the mistakes are very large.

Accounting mistakes and scandals are nothing new. The profession of auditing and accounting has been often in trouble, more or less once a decade. They were in trouble in the 1920s, in the 1930s - a

specific case in 1938 I'll mention - the 1950s, 1960s, 1970s, 1980s and, again, in the 2000s, so I don't know why we should be surprised by this or feel too much faith.

Let me just give you a few details. Of course the 1920s, the stock market bubble of the day, accountants were charged with deceptive and misleading financial statements. In the 1930s there were pressing concerns about financial reporting.

Of course in 1938, there was a massive collapse. It was the Enron of the day, McKesson & Robbins accounting scandal about which it was written, "Like a torrent of cold water, the wave of publicity has shocked the accountancy profession into breathlessness." That's in an accounting journal. In 1950s, the accounting profession was subjected to a barrage of criticism. In the 1960s, here's a quote from 1967, "Now all at once there are more than 50 lawsuits pending against the major accounting firms which handle 80 percent of the U.S. auditing business of listed companies charging irregularities and negligence with equal suddenness of barrage of public criticism has landed on the profession."

Then in 1970, we had the up till then largest bankruptcy in history, the Penn Central Railroad. We would call that today a systemically important railroad, and this called into question not only the regulators but also the auditors' effectiveness. And by the later -- in the 1970s highly publicized bankruptcies were creating calls for government intervention in accounting. And, of course, in the '80s we had the accountants involved in the savings and loan scandals and up to our current day.

So it's hard to find any period in which accounting has not found itself in some kind of serious trouble over the decades and the answer has always been more rule. Let's have more rules, more accounting rules and let's have more "independence" and yet the problems continue. Well, did the Sarbanes-Oxley rules improve this? It doesn't look like it.

Let me talk for a little bit about this notion of independence on boards of directors and, of course, there was a very large push in Sarbanes-Oxley for independence. And here's where I suggest we need to think about the difference or perhaps the balance between independence and knowledge. Of course, we want people of independent minds but if you have a very independent mind but you don't know anything about the topic or your knowledge is shallow, what good is your independence?

One hundred forty years ago or so, Walter Bagehot in his great classic - which I love to quote - *Lombard Street*, the greatest book ever written on banking, pointed out the problems with boards, a fundamental problem which is directors are, by definition, part-time with the company and management is full time. Ask yourself this question: Who knows more, somebody who works on something one day every two months or somebody who works on something 10 hours a day every day? And so Bagehot proposed this problem: How can the board ever know as much as management? Well, the only way they could is if they were themselves full time, in which case they would cease to be the board.

And I was discussing this one time at an AEI group and discussing this problem of management and boards and knowledge versus independence, and a very successful retired CEO of a Fortune 100 company said, "Yes, from the point of view of the CEO, the ideal board is 100 percent independent directors except for the CEO." He said, "That's the board I'd like to have because I'm the only one who'll actually know anything and I'll do whatever I want."

This brings me to a quote from Senator Graham. Senator Graham voted for Sarbanes-Oxley but he did say this, "For the record, I submit that in the approach of this bill," he said, "we are probably going too far in putting people in positions where they're going to have massive unchecked authority when they have no real expertise in the subject area." I think that was a fair comment.

Now let me turn to government-sponsored bodies. If you come to AEI you've heard a lot about government-sponsored enterprises like Fannie Mae and Freddie Mac. I'm speaking of government-sponsored bodies like the Public Company Accounting Oversight Board or the Financial Accounting Standards Board, PCAOB or FASB. When you apply, as Sarbanes-Oxley did, the notion of independence in an unbalanced way to such bodies, you result in bodies with subject to few or no checks and balances. It was a key point of Sarbanes-Oxley, for example, to create an independent funding source for the FASB, that is what is functionally a tax levied on all public companies so they wouldn't have to worry about making someone willing to give the money, and the same thing was set up, same kind of funding mechanism for the PCAOB.

Well, it seems to me the fundamental Madisonian precept that we all ought to live by is that nobody should be fully independent. Everybody should be subject to checks and balances. And here is a good example, so-called fair value or mark to market accounting. There's no doubt whatsoever that this kind of

accounting in a panic makes the panic worse and drives everything down. For example, this is no surprise to anybody, whoever thought about it, in 1999, Paul Volker said, "Marking to market can be a great recipe for accelerating crises." Well, he was right and we just experienced it.

So what happened with these two independent? FASB stuck to its theoretical guns and I -- my own view, so-called fair value accounting is conceptually flawed and not a very good theory, but even if you liked the theory as it drove the panic closer and closer to really going over the edge until the Congress finally did intervene and basically forced FASB to overrule itself. This was subject to a lot of criticism, saying, "Oh, you overruled the experts," but anybody who really believes in democracy and checks and balances ought to see this as a very good step.

The second thing that helped overrule them was the Fed and the Treasury Department dreamed up stress tests for large banks, which as some of you may know, I think was probably the most magnificent piece of political theater played in this country in a long time. And a key point of the stress test is they completely bypassed fair value accounting and made it irrelevant. That was the genius of the way they did the stress test. And when the accountants found themselves checked and balanced in this fashion, guess what, financial markets started to recover last spring.

That's, I understand, the fact that it happened at the same time may not indicate causality but it may, and the capital markets recovered. The FASB has since then counterattacked, wanting to expand fair value accounting even further, making us, in my view, if they succeed, even more vulnerable to a renewed panic. And my conclusion of this is that nobody should be fully independent. Everybody should have checks and balances so this fundamental idea of Sarbanes-Oxley is flawed.

Now, let me come to the PCAOB if you want to hear more about its dubious constitutional standing. Is this a private or a government body? Well, it's neither. It was set up to be a hybrid to avoid two sets of disciplines. The discipline of being fully private was avoided and the discipline of being really a government body. Appointments, appropriations and all of the apparatus of being part of the government was also avoided, and as I mentioned, was also supported by what is functionally a tax on public companies.

Functionally, it's obviously a regulatory body and it's my view that PCAOB should have to decide. Either you're really going to be public, a part of the government with all that implies or you really be private

with all that implies but not both. Same logic unsurprisingly as we -- as many of us at least would apply to Fanny Mae and Freddie Mac. These government-sponsored hybrids that avoid the disciplines of being really private and avoid the disciplines of being really part of the government should be not allowed.

So I come around to the fact that there were 522 members of the Congress of the United States who voted for the Sarbanes-Oxley Act and three who voted against. And seven years later I think we really have to tip our hats to the three.