American Enterprise Institute for Public Policy Research

Regulation Outlook

No. 1 • November 2009

Sarbanes-Oxley in the Light of the Financial Crisis

By Alex J. Pollock

It has been seven years since the passage of the Sarbanes-Oxley Act. As it is fading into history, we ought to be able to get some perspective on it. For example, as AEI senior fellow Newt Gingrich has asked, is it consistent with the factors that make for a successful, energetic, growing, entrepreneurial society? There are three sets of photos in my office that sometimes amuse visitors. They depict three pairs of distinguished, serious gentlemen. One pair is Senator Reed Smoot and Congressman Willis C. Hawley, authors of the infamous Smoot-Hawley Tariff Act of 1929. The second pair is Senator Jake Garn and Congressman Fernand St. Germaine, authors of the Garn-St. Germaine Act, which made the 1980s savings and loan collapse much worse. The third pair is Senator Paul Sarbanes and Congressman Michael Oxley. My motto for the three sets of paired photos is, "It seemed like a good idea at the time."

What Did Sarbanes-Oxley Achieve?

What do we know about the Sarbanes-Oxley Act? 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. We also know it succeeded in creating a vast effort around identifying, documenting, and managing risk and risk factors.

But what was the result? Discussing Ernst & Young's recent study, "The Future of Risk," an Ernst & Young partner is asked: "Is there too much risk management going on now? Are there so many processes and complexities that the actual processes of mitigating and assessing risk get in each other's way and are counterproductive?" The partner replies, "That was a key finding." Yes, that is where we are.

All Sarbanes-Oxley's efforts to control risk did not avoid the tremendous financial bubble and bust of the last several years. With that in mind, I asked two advisers of mine, both of whom are knowledgeable and competent managers in the area of mortgage finance, what they thought about Sarbanes-Oxley's results.

One of them, a specialist in hedging and related accounting issues, wrote, "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." Then he listed a number of examples that we all know: New Century, GMAC, Fannie Mae, Freddie Mac, IndyMac, Washington Mutual, Wachovia Bank, and Countrywide. All are or were

Key points in this *Outlook*:

- All Sarbanes-Oxley's efforts to control risk did not avoid the tremendous financial bubble and bust of the last several years.
- Sarbanes-Oxley overemphasized the idea of "independence" and woefully underemphasized the centrality of knowledge and its application to problems.
- The Financial Accounting Standards Board wants to expand fair value accounting even further; if it succeeds, it will make us even more vulnerable to future panics.

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public companies, subject to the processes and structures that Sarbanes-Oxley requires.

He continued, "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." This is his peroration: "Where was Sarbanes-Oxley? Supporters of Sarbanes-Oxley should be required to point out at least one success story. I can't think of one."

I shared that with another friend, who is a talented operating manager in finance and mortgages. He wrote back, "[He]'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."

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The hedging specialist replied, "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."

We also know that Sarbanes-Oxley succeeded in placing huge emphasis on the notion of "independence." Independence sounds like a fine idea, but independence all by itself is a rather dangerous notion. This includes independence in boards of directors of companies and also in government-sponsored bodies, specifically the Public Company Accounting Oversight Board (PCAOB) and the Financial Accounting Standards Board (FASB). Sarbanes-Oxley overemphasized the idea of independence and woefully underemphasized, or did not even think of, the centrality of knowledge and its application to problems.

It is sobering in retrospect that Sarbanes-Oxley passed 99–0 in the U.S. Senate and 423–3 in the U.S. House of Representatives for a total of five hundred and twenty-two in favor and three opposed. These votes make me think of a story from General Motors when it was one of the greatest companies in the world and being run by Alfred P. Sloan. At a management committee meeting one day, according to the story, Sloan said, "We're all agreed?" Everybody said yes. Sloan: "No one is opposed?" Everybody said no. Sloan: "No worries or dissent?" Everybody said no. Sloan's conclusion was, "Then we're going to table this question until we can get some wholesome disagreement and maybe we'll know what we are doing." Similarly, perhaps we should worry whenever Congress is uniformly in favor of something, especially in the wake of a political panic.

"Faith" in Accounting and Independence

What was Congress trying to do in Sarbanes-Oxley? Here is what Sarbanes said in his 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." So Sarbanes-Oxley was passed to establish "confidence" and "trust." Did it achieve its objective? From the perspective of the subsequent financial panic of 2007–2009, Sarbanes's idea of what the act would achieve needs no further comment.

Further to the purpose of Sarbanes-Oxley, Senator Mike Enzi at that time said, "My hope is that this new oversight structure will renew the faith that the public has in auditors and in the financial statements that they help to prepare." Personally, I do not have too much "faith" in auditors or accounting, nor do I wish to have such faith. I think most auditors are honest, hardworking people who make mistakes like everybody else. Inevitably, the mistakes are sometimes very large.

Accounting mistakes and scandals are nothing new. The profession of auditing and accounting has often been in serious trouble. Accounting firms were in trouble in the 1930s, 1950s, 1960s, 1970s, 1980s, and, once again, in the 2000s. We should not be surprised by their travails or wish to have too much faith in auditors.

Here are some specifics of their history. After the stock market bubble of the 1920s, accountants were charged with producing deceptive and misleading financial statements. In 1938, there was a massive scandal—the Enron of its day—the McKesson & Robbins accounting scandal,

"greatly embarrassing the profession." About this, an accounting journal wrote, "Like a torrent of cold water, the wave of publicity has shocked the accountancy profession into breathlessness."

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In the 1950s, the accounting profession was subjected to a "barrage of criticism." In 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, a barrage of public criticism has landed on the profession." The late 1960s were called a period of "unprecedented stress" for accounting.

Then in 1970 came the largest bankruptcy in history up to that point, the Penn Central Railroad. Today we could call Penn Central a "systemically important railroad." Its failure and the subsequent panic in the commercial paper market naturally called into question the effectiveness of the auditors. By the late 1970s, highly publicized bankruptcies were creating calls for government intervention in accounting. In the 1980s, accountants were entangled in the savings and loan collapse and were the objects of numerous congressional hearings. In short, it is hard to find any extended period in which accounting has not found itself in some kind of hot water. The answer has always been more rules and independence, yet the problems continue.

Let us turn to the notion of independence relative to boards of directors. Of course, there was a very large push in Sarbanes-Oxley for independence. We need to think about the difference, or perhaps the balance, between independence and knowledge. Naturally, we want people of independent minds; however, if you have a very independent mind, but you do not know much about the topic, what good is your independence?

Over 130 years ago, Walter Bagehot in *Lombard Street* pointed out the problems with boards. The fundamental problem is that directors are, by definition, part time, but 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 ten hours per day every day? Bagehot posed this problem: how can the board ever know as much as management? The only way they could is if they were themselves full time, in which case they would cease to be the board.

At an AEI conference, I was discussing this problem of management and boards and knowledge versus independence. A very successful retired chief executive officer (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 continued, "That's the board I'd like to have! I'd be the only one who actually knows anything, and I'd be able to do whatever I want."

This brings me to a quote from Senator Phil Gramm, who voted for Sarbanes-Oxley but offered this warning, "For the record, I submit that in the approach of this bill, 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.

Nobody Should Be Fully Independent

Now let us turn to government-sponsored bodies. Over the years, many AEI financial conferences have focused on government-sponsored enterprises like Fannie Mae and Freddie Mac. We also need to address government-sponsored bodies like the PCAOB or the FASB. When the notion of independence is applied in an unbalanced way to such bodies, as Sarbanes-Oxley did, organizations are created subject to few or no checks and balances. A key point of Sarbanes-Oxley, for example, was to create an independent funding source for the FASB, what is functionally a tax levied on all public companies, so they would not have to worry about whether people think they are worth it. The same kind of funding tax was set up for the PCAOB.

No one should be fully independent. Everybody should be subject to checks and balances. Here is a good example of what happens with such mistaken independence: so-called fair value or mark-to-market accounting. There is no doubt that this kind of accounting in a panic makes the panic worse and drives the financial system down. This is no surprise to anybody who has ever thought about it. In 1999, for example, former chairman of the Federal Reserve Board Paul Volker said, "Marking to market can be a great recipe for

accelerating crises." He was right, and we have experienced it once again in the panic of 2007–2009.

Fair value accounting is conceptually flawed and not a very good theory. But even if you like the theory, you cannot deny that it heightened the panic. When collapse was threatening, Congress finally intervened and forced the FASB to overrule itself. This was subject to some hand-wringing criticism—"Oh dear, you overruled the experts"—but anybody who believes in democracy and in checks and balances ought to see this as a very good step. The elected representatives of the people had to defend the people from the theoretical accountants.

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The second thing that helped overrule fair value accounting was that the Federal Reserve and the Treasury Department invented public "stress tests" for large banks. This was a magnificent piece of political theater. The stress tests completely bypassed fair value accounting and made it irrelevant. When the accountants were checked and balanced, by Congress and by the stress tests, financial markets started to recover.

The fact that the market recovery followed these events closely may not indicate causality, but it may. In any case, the capital markets recovered. The FASB has since counterattacked, wanting to expand fair value accounting even further. If it succeeds, it will make us even more vulnerable to future panics. I repeat: nobody should be completely independent. Everybody should have checks and balances. Thus, a fundamental assumption of Sarbanes-Oxley is deeply flawed.

Let me come to the PCAOB and its dubious constitutional standing. Is this a private or a government body? It is neither. It was set up as a hybrid to avoid two kinds of discipline: the market discipline of being fully private and the discipline of being a government body, that is, the processes of appointments and appropriations and the apparatus of being part of the government. This avoidance of discipline was fully intentional on the part of Sarbanes-Oxley's creators. As mentioned, the PCAOB is supported by what is functionally a tax on public companies, and it is obviously a regulatory body. But, like the FASB, it claims that it is "private."

The PCAOB should have to decide either to be public, a part of the government with all that implies, or to be private with all that implies, but not both. This is the same logic many of us would apply to Fannie Mae and Freddie Mac. Such government-sponsored hybrids, which avoid the discipline of being private and avoid the discipline of being part of the government, should not exist.

So I return to the fact that five hundred twenty-two members of the U.S. Congress voted for the Sarbanes-Oxley Act, and three voted against. Seven years later, we have to tip our hats to the three.