

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

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SOX's chaotic birth

- Corporate fraud!! +
- The market is collapsing! +
- The media is feasting +
- Who speaks for business? +
- Arthur Levitt rises again +
- Everybody's busy big business bashing +
- The regulatory cycle =
- Shoot first, then ask questions

The Politics of SOX

Pro

- Populists
- Reformers
- Big business
- Republicans
- Democrats
- Media
- Professionals

Con

- Small business
- Entrepreneurs
- Investors

How much fraud liability?

- The optimal amount of fraud >0
- Investors can diversify the risk of fraud
- Agents can't diversify liability risk
- Fraud liability negates benefits of public ownership

Other defenses against fraud

- Existing liability
- Signaling and reputation
- Analysts look for information
- Hedge funds
- State (Delaware) law

Direct compliance costs

- SEC had no clue: 5 hrs- \$91k - \$4.36 million
- Internal controls
- Auditing
- Independent directors: Big burdens, elusive benefits
- Insider loans: What does it mean?
- Lawyers as watchdogs
 - Report to whom? And when?
 - Changing the attorney-client relationship
- Killing trees
- More risk for executives
- SOX as employment law

Indirect costs

- Diverting managerial resources
- Squelching startups
- Taxing public ownership
- Discouraging risk
- Conservative accounting/disclosure
- Messing with the merger market

Big problems for small firms

- Increasing overhead
- Reducing flexibility
- Dubious benefits of internal controls
- Hitting the wrong target
- Discouraging public ownership

Turning business people into criminals

- The new criminal: failing to take precautions
- Diluting the force of the criminal law
- New weapons for over-zealous prosecutors

Auditor regulation

- Triplicating costs
 - Layers of monitors
 - Ancillary services → consultants
- More inefficient risk-bearing
- Who gets hurt
 - Auditing costs
 - Small firms
 - Risky firms

Federalizing corporate law

Specific rules

- Director independence
- Executive compensation: Bonuses, loan prohibition
- Audit committee power
- Lawyer reporting
- Managing internal controls
- Do we need federal law?
- The “genius” of state competition
 - Expert courts
 - Evolving case law: independent directors; Caremark
 - Alternative approaches: rules, principles, ordinary investor

Foreign firms

- Conflicting laws
- Conflicting systems
- Impact on US stock markets
- Litvak study

The litigation time bomb

- Executives must certify that they
 - Designed and evaluated internal controls
 - Disclosed “significant” deficiencies
 - Identified “material weaknesses”
 - Identified *any* fraud by employees with “significant role” in internal controls
 - Indicated significant changes in controls or other factors
- → Private class actions under 10(b) and 10b-5, for false certifications
- Shareholders can’t diversify this

Effects of the litigation time bomb

- Hindsight evaluation of risks
- Judges can't or won't adjust for this
- Litigators' incentives to sue: costs don't count
- “Blackmail” by litigation
 - Heavy damages
 - Discovery and internal controls
 - New liabilities
 - Incentives to settle

Summary of SOX costs

- Managing in a “climate of fear”
- Restricting executive compensation
- Opportunity costs of diverting executives’ time
- Burdens on small firms
- Reducing public ownership and entrepreneurial activity.
- Reducing information flow and trust
- Undoing efficient risk diversification
- Increasing criminalization of agency costs
- Auditing costs
- Reducing incentives for securities research
- Interfering with state regulation of corporate governance
- Discouraging foreign firms from trading in the U.S.
- Setting a litigation time bomb

Some recent data on SOX effects

- \$1.4 trillion market loss (Zhang)
- 2006 SOX Spending >\$6B (AMR Research)
- Higher independent director cost: small firms \$3.85/\$1k sales, large \$.02/\$1k (Linck)
- Decline in r & d (Cohen)
- Increased accounting conservatism (Lobo)
- Smaller firms' stocks reacted worse to SOX (Engel)
- Internal controls costs (A.R.C. Morgan)
 - <\$250 million sales= \$1.56 million
 - 1-2 billion = \$2.4 million
- Going private worth more (Engel, Leuz)
- More firms going private (Engel, Carney, Kamar)
- More firms going dark (Leuz, Marosi)
- Negative market reaction to restricting non-audit services (Rezaee)
- Cross-listed stocks declined in reaction to SOX (Litvak)
- Little or no effect of internal controls weakness disclosures (Ogneva)

Has SOX been worth it?

- Big direct costs
- Huge indirect costs: 1.4 trillion – 300 billion
- Investors diversify
- Other defenses against fraud
- Can't prevent fraud or the next "bubble":
Refco

Amending SOX

- Control internal controls reporting
 - Limit or eliminate civil damages
 - Limit or eliminate individual civil and criminal liability
 - Narrower duty: “materiality” and business judgment
- Leave internal governance to state law
 - Director independence
 - Executive loans and bonus forfeit provisions
 - Lawyer reporting
- Flexibility: opt-in, opt-out, minimum standards
- Exemptions: small and foreign firms

Avoiding the next SOX

- The continuing pressure for more regulation
- Reversing the ratchet: Periodic review and sunsets
- Certification vs. regulation
- Respecting state law
- Flexibility
- Tailoring
- De-regulation: increasing the power of markets