

## Introduction

### **Sarbanes-Oxley: A Review**

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Today's conference provides an opportunity to review the Sarbanes-Oxley Act almost two years after its enactment. The Act has had a profoundly important role in what is turning into a vast restructuring of corporate America, and for that reason alone whether these changes are good or bad should be studied carefully. Today's conference will consider two very significant aspects of the Act—its effect, if any, on how corporations are managed and how they perform, and the additional costs for public companies associated with the Act.

In this Introduction, I would like to raise a broader question—the justification for the hasty adoption of the Act. The Act was rushed through Congress in July 2002, amid claims that Enron, WorldCom and other so-called corporate scandals had caused a dramatic loss of confidence by investors in the honesty of corporate America and the accuracy of financial reports. It's very difficult to be definitive about the state of mind of a group as large as investors without extensive polling, and so many other things are happening that no one factor can be deemed determinative, but if we look only at what actually took place in the stock market during the relevant period, the results are more consistent with a loss of confidence by the media and the political class than 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 we will see the market was largely unaffected. 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. There was a much more far-reaching bill in the Senate Banking Committee, then chaired by Senator Sarbanes, but most observers thought it was not going anywhere.

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. The Dow fell 6 points that day, and then rose 149 points the following day. Investors seemed to take the revelation in stride. Over the next five trading days, the net change in the Dow was an *increase* of five 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. 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. Indeed, the market was quite stable until the President and Congress began to press forward on tough legislation.

The Senate Banking Committee rushed out a bill that ultimately became the Sarbanes-Oxley Act; on July 9, the President called for immediate action to deal with corporate fraud; and on July 10 the Senate passed the bill almost unanimously. The Dow fell 178 points on the day the President spoke, and another 282 points the next day when the Senate passed the bill. The Senate action was a clear signal that there was going to be a tough and heavily re-regulatory bill, but the Dow fell another 1000 points from July 10 until July 24.

The Dow regained most of this ground between July 24 and July 29, rising 936 points. Although this might seem to be a result of the fact that the Act had finally passed Congress, shortly after the President signed the bill on July 30 the Dow fell another 700 points. So it is unlikely that the President's signing the Act into law restored much confidence. And thereafter, with the usual ups and downs along the way, the Dow fell another 1000 points between July 30 and the end of September.

All this suggests that there was something else, and not a loss of investor confidence, that was affecting the market. If we look at a chart for the period from September 1, 2001 to June 30, 2003, it becomes clear what this was. What we see is that the Dow was rising after the US attacked Afghanistan on October 19, 2001. It continued rising after Enron admitted 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 3000 points until early September 2002. WorldCom and Sarbanes-Oxley happened during this period, but are not even a blip on the chart.

The Dow began to rise when Bush asked for UN support against Iraq a year after 9/11, 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 2000 points to bring it to its current level. The significance of March 19, 2003, is that it was the date on which the US and other coalition forces invaded Iraq.

Looking at this chart, it is clear where the correlation is. Beginning in March 2002, well before WorldCom, investors began to anticipate the possibility of war in Iraq. On March 8, 2002, Tony Blair declared that the UK would support US action against Iraq, and at that point investors knew that unless Saddam gave in to US and UK demands war was likely. The uncertainties associated with war caused the 3000 point decline in the Dow between March 2002, when the possibility of war first became clear, and March 19, 2003, when the US and Britain finally invaded Iraq. When the invasion came, the uncertainty ended, and the Dow began a long rise.

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. 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 8 months after the Act was passed.

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 the Chairman of the SEC justified the recent SEC proposal to enhance shareholders' ability to nominate directors. However, in looking closely at the movement of stock prices at the critical junctures where investors might have been discouraged by WorldCom or encouraged by Sarbanes-Oxley, we find that neither occurred.

It appears instead that it was not the confidence of investors that was lost, but the confidence of the media and Washington policy-makers in corporate America. Maybe they thought that investors *should* have lost confidence. 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.