

The Sarbanes-Oxley Debacle

Immediate Policy Implications

The preceding analysis supports the overwhelming conclusion that SOX was a colossal mistake. By any reasonable standards of public policy analysis, the act should be repealed. In a recent survey, 58 percent of corporate directors in the United States favored repealing or overhauling SOX.¹ However, despite the mounting evidence and criticism, repeal is highly unlikely. Even if society is losing, the act retains the support of influential interest groups and the press. The big losers, such as entrepreneurs, are less organized and therefore less influential.

There is, however, a possible avenue to change. A favorable court decision in a recently filed lawsuit could provide the leverage to enact some major changes in SOX. On February 8, 2006, the Free Enterprise Fund filed a lawsuit alleging that the PCAOB violates the appointments clause of the Constitution because its members need to be appointed by the president or heads of executive branch departments rather than the SEC.² This suit has the potential to overturn all of SOX, which lacks a severability clause. If the plaintiff prevails, however, the courts are likely to give Congress a window of opportunity to fix the act. Although political reality makes it unlikely Congress will repeal SOX, lawmakers may be able to seize the opportunity to fix the act's worst flaws.

It is, therefore, worth discussing the changes Congress should consider if it has the opportunity or inclination. These changes might turn SOX from a debacle into a model for future federal regulation, along the lines of suggestions we will offer in chapter 8. Although some changes could be adopted by the SEC—and, indeed, Congress could be expected to delegate significant authority

to the SEC—the SEC needs Congress to authorize and guide significant revisions.³ Indeed, it is not even clear that the SEC has the authority under current law to adopt the changes it is considering.⁴

Defuse the Litigation Time Bomb

As detailed in chapter 5, SOX created a litigation time bomb that will explode with the next major market downturn. All of the perverse incentives of SOX are exacerbated by this threat. Congress can prevent this by amending the act to provide that violations of SOX cannot be redressed by private lawsuits.

Congress has acted before to curb excessive litigation against corporations. For example, in 1995, Congress passed the Private Securities Litigation Reform Act, which attempted to curb abuses in securities class action litigation by eliminating so-called “professional plaintiffs” and instituting pleading standards that were more stringent. In 2005, Congress passed the Class Action Fairness Act, which attempted to control forum-shopping in favorable “magnet” state courts by permitting removal of many class actions to federal courts.⁵

In support of an amendment addressing the litigation risk from SOX, Congress can cite language in the Supreme Court’s recent *Dura* opinion.⁶ The Court noted:

Allowing a plaintiff to forgo giving any indication of the economic loss and proximate cause that the plaintiff has in mind would bring about harm of the very sort the statutes seek to avoid. . . . It would permit a plaintiff “with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an in terrorem increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence.” *Blue Chip Stamps*, 421 U.S., at 741, 95 S.Ct. 1917. Such a rule would tend to transform a private securities action into a partial downside insurance policy.⁷

Thus, removing the litigation time bomb—a modest, but very important, reform of SOX—may have significant political and legal traction.

Allow Opt-Outs or Opt-Ins

Congress demonstrated in SOX that it simply could not foresee the full effects of sweeping corporate reforms. This is an important reason corporate governance has generally been controlled by state, rather than federal, law. If a state makes a mistake, firms can, in effect, opt out by reincorporating in another state. If Congress makes a mistake, firms can avoid it only by the far more costly route of moving their activities and capital-raising offshore. This suggests that Congress might minimize the risk of imposing unanticipated costs—that is, the costs of miscalculating the impact of its regulation—by permitting firms to opt into or opt out of at least some of SOX's provisions. Leading candidates for opt-out would be the section 404 internal controls provision and the section 402 prohibition on executive loans.

The argument against opt-out is that this is contrary to the rationale for regulating disclosure through mandatory federal laws. Investors arguably need a certain minimum amount of information to make investment choices, including choices based on applicable governance rules. So, the argument goes, shareholder choice does not work for the very rules that make this choice effective. A problem with this argument, however, is that investors would not be making this choice about disclosure in the dark; they would know, at least, that they would be making a riskier investment because of what the firm may choose not to tell them. Indeed, risk-averse investors might tend to place an unrealistically high weight on this consideration, thereby giving firms an incentive to opt for disclosure. There are more sophisticated arguments for mandatory disclosure, but they do not tell us precisely what disclosures should be required.⁸

Two considerations support making some provisions of SOX, including those noted above, optional. First, as emphasized throughout this monograph, the optimal amount of fraud is not zero. At some point, regulation of fraud and disclosure is so costly

that it is inefficient. The question is, who should decide when that is the case? Even if some mandatory disclosure is efficient, there may be significant debate at the margins. In these situations, it makes sense to let the shareholders decide. The debate raging over the internal controls disclosures indicates that this should be one of the marginal provisions for which opt-out is appropriate. Moreover, this public debate highlights for the shareholders both the costs and benefits of opting out of this particular disclosure provision.

Second, it is important to keep in mind that what is most significant about SOX is the way it veers off from the federal government's traditional concern with disclosure and into the sort of substantive governance provisions that traditionally have been the province of state corporate law. This is certainly true of the executive loan provision. It is also arguably true of some ostensibly disclosure-oriented provisions, like the internal controls provision, that effectively regulate governance. While the provision says only that the firm must disclose internal controls problems, in substance it not only strongly encourages firms to have controls, but effectively requires them to set up an internal framework that enables them to make the disclosure. This is regulation of governance and not merely of disclosure. In at least these cases, and probably others, shareholders should have the same opportunity they have under state law to decide the terms of their investments.

The specific mechanism for opt-out or opt-in could be the very proxy framework that Congress has approved as the basis for enabling shareholder choice. Thus, directors could propose the option in the proxy materials, and would be required by the proxy rules to give full disclosure of the reasons for and consequences of the proposal. Alternatively, shareholders could make an opt-in or opt-out proposal either by sending out their own proxy materials, or by taking advantage of the shareholder proposal rule.⁹

There are additional questions whether any options should be provisions that apply by default unless the firm opts out or that apply only if the firm opts in; the specific procedural requirements for opt-out or opt-in; which provisions would be subject to opt-out or opt-in; and which companies would have the options. Congress

might delegate some of these questions to the SEC, to be determined through rulemaking after notice and comment.¹⁰

Foreign Firms

Prior to the Enron and WorldCom imbroglios, American capital markets were widely considered the strongest in the world. As discussed in chapter 4, SOX has made American markets less attractive to foreign companies, in part by imposing substantive governance provisions that conflict with these firms' home-country laws. This has provided a significant competitive opening for other securities markets, particularly London.

Congress can address this problem by exempting foreign firms either from SOX generally or from specific provisions, such as the audit committee and internal controls provisions that are so troublesome for many foreign firms. Alternatively, assuming Congress does not make these provisions or the act itself optional for all firms, it can make them optional for foreign firms. This might be the best approach, since some cross-listing foreign firms might actually prefer to "bond" their disclosures by subjecting themselves to the highest level of U.S. regulation.¹¹

A potential problem with SOX exemptions and opt-outs for foreign firms is that they might give a significant advantage to the foreign firms over their U.S. competitors, particularly given the high costs of SOX discussed throughout this monograph. One response is that the different treatment is justified on the ground that foreign firms are subject to regulation in their home countries. But U.S. firms might protest that this regulation is weaker—at least it does not include SOX.

This problem might be dealt with by extending the exemption or the opt-out to any firm that is subject to the governance law of another country, irrespective of where it is physically based. Under current rules, whether a firm is subject to U.S. regulation depends on both where the firm is incorporated and organized and where its business, shareholders, and management are located.¹² This would appropriately reflect the key reason for exempting foreign firms. In

other words, this change to SOX, while specifically responding to the need to treat U.S. and foreign firms comparably, might be a modest beginning toward recognizing a true regime of jurisdictional choice.¹³

Exempt Small Corporations

As discussed in chapter 4, SOX presents significant problems for small firms, since their compliance cost per dollar of capitalization is much higher than for larger firms. Moreover, SOX's disproportionate impact on these firms is entirely unwarranted, since the corporate meltdowns that led to it were a phenomenon of large corporations. To the extent that SOX addresses the problems in the latter, its provisions are not necessarily appropriate for small firms. In particular, small firms may have far less need for extensive internal controls provisions throughout the organization. Of course there will be a question as to what the dividing line should be for any "small firm" exemption. As with the provision suggested earlier in this chapter, this might be left to SEC rule.

As with foreign firms, Congress might give small firms the ability to opt into or out of SOX provisions. Small firms might be given this option only for certain provisions that are much more costly or less appropriate for them, such as the internal controls provision. Congress might also provide for a sliding scale in which the act or some of its provisions do not apply at all to the smallest firms, and allow opt-ins and opt-outs for medium-sized firms. This discussion indicates only some of the many alternatives to one-size-fits-all mandatory regulation Congress can pursue.

There is, of course, a question concerning the appropriate cutoff for smaller firms. The SEC's Advisory Committee on Smaller Public Companies has already done significant work on this issue. It has in process a general opt-in proposal that would specifically include the internal controls provision permitting opt-in for the smallest firms, defined as the smallest 1 percent by total capitalization and less than \$125 million in annual revenue, and the next smallest 5 percent by total capitalization with less than \$10 million in

revenue. The committee's careful proposals reflect consideration of not only the differential reporting burdens and benefits of smaller firms, but also the need for standards that are transparent and relatively easy to apply.

It is important, however, to keep in mind that the Advisory Committee was constrained to operate within the existing statutory framework. Congress's mandate in revising the act, and the scope of any SEC rulemaking power under a revised act, might be significantly broader than what is permitted under current law. Moreover, any proposal to exempt small firms inherently creates a risk of giving firms perverse incentives to limit growth in order to avoid SOX's onerous requirements. Accordingly, the Advisory Committee's proposals cannot solve the problems SOX creates.

Remove Criminal Penalties

As discussed in chapter 4, SOX exacerbates the increasing over-criminalization of corporate law not only by increasing criminal penalties for violation of the securities laws, but by providing new crimes, particularly including those based on certification of inadequate internal controls. The dramatic post-Enron trials and plea bargains demonstrate not only the many powerful pre-SOX criminal sanctions that prosecutors have at their disposal, but also the potential for prosecutorial abuse of these sanctions. These sanctions make the corporate suite a very dangerous place even for law-abiding executives. They may react by avoiding public firms that are subject to SOX, or engaging in conduct that is far more conservative than diversified shareholders would prefer—including excessive attention to internal controls disclosures.

Criminal liability under SOX was one of the clearest examples of Congress's attempting to appease popular sentiment and engaging in symbolic politics rather than careful lawmaking.¹⁴ But the firms and executives who must live under this regime, and the corporate criminal defendants, are not mere "symbols." If Congress has an opportunity to revisit SOX in a calmer atmosphere, one of its first responses should be to eliminate criminal liability under its provi-

sions. To be sure, this would be only a partial response to the general problem of over-criminalization. But it could be an important first step.

Limit Internal Controls Reporting

SOX section 404 goes much too far in penalizing and even criminalizing executives' failure to spot not just problems, but even risks that later happen to turn into problems. If Congress concludes that it must retain section 404, it can at least revise the provision so that it does not impose the huge costs discussed in chapters 4–6. The revised law should clarify that managers can exercise reasonable business judgment about risks to report, and that these risks will be assessed as of the time the report is completed rather than in light of subsequent events.

Leave Internal Governance to State Law

Several SOX provisions amount to a federal takeover of the internal governance of corporations, which has traditionally, and rightly, been the province of state law. These include rules mandating audit committee independence, prohibiting certain executive loans, mandating forfeiture of executive compensation when earnings are later restated, and requiring lawyer reporting of corporate wrongdoing. Congress should consider repealing these provisions and returning these matters to state law, where they belong.