The Sarbanes-Oxley Debacle

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The Future: Regulatory Hubris or Greater Humility?

So far, we have shown the high costs and dubious benefits of SOX, as well as the powerful political forces that push for SOX and other corporate reforms. These problems do not represent a one-time regulatory quirk, but rather are inherent in corporate governance regulation. The forces that produced SOX have converged before and can be expected to converge again. The lesson from this discussion is that policy analysts and corporate law scholars need to be prepared for them.

Failure to be prepared can result in much more intrusive regulation with the next generation of "reform." As bad as SOX has been in many respects, it clearly could have gone further. SOX relies mostly on disclosure provisions that can have significant substantive governance implications. Its most invasive provisions, such as the executive loan prohibition, relate only to specific pockets of activities rather than spreading across the range of corporate decision-making.

What might be next? In a recent paper, James Fanto serves up a sobering vision of the future of the largest business firms being saddled with "monitors" employed by the SEC, who keep a close eye on the firm's management.[1] Fanto bases his suggestion on the regulations that already govern banks. This sort of invasive regulation is obviously inappropriate for entrepreneurial business corporations that are not subject to federal deposit insurance. The risk of failure and even fraud is built into any successful capitalist system, and can be shouldered by investors holding diversified portfolios of

shares priced by efficient markets to reflect risk. But while the proposal flops as normative prescription, it might be worth a look as prediction. As long as our political leaders accept the idea that the law should strive to eliminate all risk of fraud to the extent possible—even at excessive cost—we should brace for the next set of reforms when the current ones fail at their impossible task.

It is entirely possible that the next boom and bust will bring the next regulatory panic, and with it another demand that Congress "restore confidence" in the market. The reformers will again step up, forgetting that SOX was supposed to be the law that ends all laws, ignoring the futility of trying to regulate away fraud, and urging yet another try. This time they will have Fanto's, or some similar proposal, queued up and ready to go.

Will the business community put up a united front against further encroachment, as it did not do against SOX? Not necessarily, because, as Fanto points out, it may be better for executives to accept a monitor who tells them what to do every step of the way than to accept the risk of liability when they do not follow the increasingly extensive rules. Fanto says:

> The business community may even find that it is in its interest not to oppose the corporate monitor, if it only recognizes that the regulation of public firm management is already a long way down the paternalistic road, but, at least with regards to enforcement, in a way that is not favorable to this management. Executives and board members are now sanctioned harshly for their faults by the SEC and federal prosecutors without having the kind of relationship with a regulator that might make unnecessary the sting of enforcement.

So the business community may be willing, next time, to accept a long-term "relationship" with regulators, rather than just the casual dating that occurs now.

There is a possible alternative to this dismal scenario. We can try to understand the true costs and benefits of regulation, and regulate

in light of that understanding. This would involve regulators appreciating the significant limitations on government's ability both to eliminate fraud and to anticipate the full consequences of regulation. The following presents some suggestions of what regulating in light of this understanding might look like.

Periodic Review and Sunset Provisions

We have articulated the consequences and costs of SOX that Congress undoubtedly did not expect. These costs may become evident only after the effects of such an act are carefully tested. Important new legislation like SOX provides a sort of laboratory for financial economists. Although some of SOX's consequences and costs should have come as no surprise to dispassionate academic observers, chapter 1 demonstrates that Congress does not act in anything like the relaxed conditions of the ivory tower. Moreover, any legislation poses the risk of costs that no one can anticipate, including that business developments will render legal controls unnecessary.

For these reasons, significant new financial and governance regulation like SOX that displaces and supplements prior regulatory approaches should be subject to periodic review and sunset provisions. Although Congress, of course, can always undertake such reviews, prior experience indicates that it will not. Legislation is a one-way regulatory ratchet. It arises when the conditions for reform are ripe for a regulatory panic. The conditions for a "deregulatory panic" are less likely to develop. Firms learn to live with the extra costs and may not be willing or able to bear the costs of lobbying for repeal, at least in the absence of a regulatory cataclysm. Thus, it is not surprising that SOX sponsor Michael Oxley, despite recognizing that SOX was "excessive" in some respects, and admitting that it had been rushed through Congress, suggested that Congress would not be revisiting the issue, even as to the seriously affected small companies. He said, "If I had another crack at it I would have provided a bit more flexibility for small- and medium-sized companies."[2] In other words, Congress normally does not have "another crack" at regulation. A sunset or review mechanism would change that.

Perhaps Congress can learn some lessons from itself. The USA Patriot Act was passed less than one year before SOX and, like SOX, was passed by an overwhelming majority. Unlike SOX, the USA Patriot Act includes sunset provisions for some of its most controversial provisions.[3]

The Patriot Act's sunset provision forced Congress and the president to reevaluate and debate those provisions, in an atmosphere far removed from the immediate post-9/11 panic. American investors would benefit from a sober reevaluation of SOX. Perhaps the courts will provide that opportunity. For future regulatory panics, Congress would do well to remember the lessons of the Patriot Act.

Certification and Opt-Out Approaches

The law might regulate "humbly" by imposing optional rather than mandatory rules. For example, it could supplement market or private fraud-prevention mechanisms by prescribing a certification regime, and let firms decide whether they want to certify.[4] The government function here would be to provide an organization that could provide a signal of honesty that investors could rely on. But firms can decide for themselves whether the signal costs too much to send. Similarly, the government could prescribe a regulatory scheme but permit firms to opt out as long as they get the requisite approval from their owners and make the appropriate disclosures to investors.[5] For example, the law might, as in the United Kingdom, let firms "comply or explain"—that is, opt out of compliance as long as they explain that they are doing so and why.[6]

Nuanced Regulation

Regulation should take account of differences among firms and regulatory contexts. The best way to do that is to make the regulation optional. If mandatory rules are deemed necessary to fix significant market defects, Congress should focus them on the specific problems that cannot be dealt with by optional rules. It should also design the

rules taking into account differences among firms as to the need for regulation and the costs of compliance. For example, Congress clearly should have scaled costs by firm size, as well as take into account the different internal governance structure of foreign firms subject to SOX.[7]

Investor Education

The corporate frauds addressed by SOX happened in part because of investors' willingness to ignore indications of questionable accounting and to accept extravagant claims about unproven business plans. These problems might be mitigated more cost-effectively by providing some minimal training in the basics of finance.[8] This education might help offset some judgment biases of investors, teach the rudiments of efficient markets and how hard it is for ordinary investors to "outsmart" the market, and warn them of the folly of not investing in diversified portfolios or index funds. Even if investors continue to fall for scams, at least they could be persuaded not to bet their life savings and retirements. For example, instead of trying to rid the market of all potential conflicts, including those that have net benefits for investors and firms, investors might be alerted to the problems of conflicts and then allowed to make their own judgments.[9]

Congress and the SEC could start this education process by ensuring that their own regulatory efforts do not mislead investors into believing that markets are safer than they are.[10] For example, moves toward subsidizing securities research for ordinary investors imply that they should be researching and investing in individual stocks. Shareholders are better off diversified and rationally ignorant.

Deregulation

Some problems in the securities markets could be mitigated by reducing the amount of regulation that already exists. An example is the SEC's regulation of disclosure to securities analysts. Analysts have strong incentives to ferret out information about firms, including information about potential fraud. Congress recognized the

importance of their monitoring role by adding provisions to SOX concerning analyst conflicts.

Yet, prior to Enron, the SEC promulgated regulation FD, which had the effect of hobbling analysts' ability to get information. Regulation FD requires firms that disclose information privately to analysts also to make the information public.[11] This reduces analysts' incentives and ability to research by denying them the ability to have one-on-one conversations with corporate executives. It also reduces firms' incentives to disclose, since there is some information they need not make public, and they would rather not do so. For example, some pieces of information disclosed to trusted analysts might be subject to misinterpretation if released piecemeal to the market.[12] There is evidence that, in fact, some firms have chosen to stop disclosing information rather than disclose publicly.[13] Indeed, regulation FD may have given insiders an excuse to hide from inquiring analysts, where before they would trigger negative inferences by doing so. Thirty years ago, insurance industry analyst Ray Dirks broke the notorious Equity Funding scandal. Regulation FD may have inhibited him from performing a similar function today. Not surprisingly, there is evidence that analysts' forecasts have declined following regulation FD.[14]

Regulation FD is part of the SEC's and former chairman Arthur Levitt's quixotic quest to ensure "fairness" in information. This effort is doomed to failure because inequality of information is a basic fact of the securities markets. If one group is denied the information, another will get it.[15] The main effect of forced sharing of information is not to eliminate inequality but to weaken the incentives to gather and create information on which efficient securities markets rely. Although regulation FD may reduce firms' ability to "buy" analysts' support with exclusive information, it is far from clear that this is a serious problem, given the market's ability to punish biased analysts.