Introduction

The Sarbanes-Oxley Act of 2002 (SOX) emerged from the spectacular crashes of Enron, WorldCom, and other corporations after the bursting of the dot.com stock market bubble. Enron and WorldCom became poster children for the supposed "separation of ownership and control" problems first publicized seventy years earlier by Adolf Berle and Gardiner Means and echoed by generations of corporate scholars ever since.[1] After the millennial frauds, the usual proponents of reform argued for regulation that would restore "investor confidence" in the securities markets. Congress responded with the most sweeping federal securities legislation since the original laws in 1933 and 1934.

Since 2003, the direct costs of SOX have become evident. Despite, or perhaps because of, the significant indications of costs and problems related to SOX, many journalists in prominent magazines have rushed to the act's defense in its fourth year of life.[2] Their argument goes something like this: There was fraud; SOX was designed to reduce fraud by requiring more honesty and disclosure; therefore, SOX is good. For example, *The New Yorker*'s James Surowiecki acknowledges SOX's significant costs, but emphasizes the social costs of fraud—that WorldCom made its rivals look less efficient than they were, resulting in misallocation of resources. Joe Nocera of the *New York Times* stresses that accountants now have a regulator, the U.S. Securities and Exchange Commission (SEC) has more money, CEOs must vouch for their firms' financial statements, corporate loans are outlawed, directors must be more independent, and the internal controls disclosures are revealing useful information.[3] Nocera also acknowledges the

expenses under SOX, but says the costs are starting to drop, and that the SEC is working to reduce the burden on smaller companies. *Business Week* has blithely asserted that SOX "is enabling businesses to cut costs and boosts productivity." Perhaps Congress should apply its managerial prowess more broadly.[4]

Praise for SOX is also pouring in from those who participated in its creation. Representative Michael Oxley, who shepherded the House version of SOX and provided its surname, says, "The system is much better now. . . . We have come a long way since the economic dark days that are only a couple of years behind us." Investors once were "losing confidence in the American markets." Now, he says,

> boards are working harder, playing more of the role that they were designed for. They are responding to shareholders and increasing dividends and buybacks. Audit committees are more active and more independent. They are using their authority to engage independent counsel. The PCAOB [Public Company Accounting Oversight Board] is up and running and is actively reviewing auditing firms.[5]

As a result, he says, corporate profits, jobs, stock prices, venture capital, and research and development spending are up, and bankruptcies are down. In other words, Oxley attributes to SOX the turn in the business cycle. Next, like Lear, he will be crediting it with atmospheric phenomena. While it is understandable that Oxley would overstate the benefits of his namesake, one should be skeptical of his self-serving assessment.

Former SEC chairman Arthur Levitt, a key proponent of several of SOX's provisions, wrote in the *Wall Street Journal* to oppose SOX exemptions for small public firms proposed in December by an SEC advisory committee.[6] Levitt insists, remarkably, that "the small-business lobby" is seeking changes that "would make it more difficult for smaller companies to attract capital needed for growth and undermine confidence in the markets." In other words, he is so sure

of the wisdom of the changes he helped adopt that he is willing to assume that the "small-business lobby" is lobbying against its own interests. Levitt ignores the fact that this supposedly powerful lobby was too weak to prevent passage of the act.[7] Moreover, it is hard to accept that exempting firms constituting only 7 percent of the capitalization of the market would undermine investor confidence in the entire market.

No one can deny that there have been some benefits from SOX, including the increased information revealed by the internal controls disclosures. Moreover, the business world is clearly performing better now than in the chaotic days before SOX. The relevant policy questions are whether the benefits exceed the costs, and whether the business world is better now *because* of SOX.

While proponents in Congress and the media have been creative in finding social benefits deriving from SOX, they have not been equally thorough in understanding its full costs. SOX defenders focus on direct costs, such as increased audit fees. But while these are substantial (approximately $6 billion per year), they are only the tip of the iceberg—with much larger but less obvious costs accruing beneath the surface. Indeed, the best evidence indicates that SOX imposes additional net losses of $1.1 trillion. This monograph demonstrates that its supporters are utterly misguided in their assessment: Both logic and evidence make it clear that SOX was a costly mistake.

As we will discuss in chapter 1, SOX's problems are unsurprising, given the circumstances of its birth. Enron may or may not have helped set off a market panic, but what ensued was clearly a Code Red regulatory panic. When one combines the efforts of proregulatory interest groups with the avid news media reports of corporate fraud, it is not surprising either that SOX was enacted, or that it still has many defenders. Although there were significant ambiguities about precisely what, if any, problems needed fixing, Congress was in no mood for ambiguities. The prevailing regulatory philosophy was "shoot first and ask questions later." We are only now asking the right questions and getting the correct, if depressing, answers.

Chapter 2 provides a good starting point for asking these questions by considering what investors—the putative beneficiaries of SOX—desire in antifraud regulations. Clearly, investors do not like to be defrauded. To the extent government regulation can prevent fraud, shareholders benefit. But shareholders will find such regulation valuable only if the benefit from reduced fraud is greater than the cost of regulatory compliance. SOX's attempt to create a perfect world with zero fraud goes too far. Moreover, it is well-accepted in the financial economics literature that the costs and benefits of securities regulation should be evaluated from the perspective of typical shareholders who can avoid some costs of fraud by investing in diversified portfolios of shares. By imposing the costs of eliminating fraud on all firms in investors' portfolios, the SOX mandates are a terrible deal for the ordinary investors it purports to protect.

Although the act's defenders assert that the business world is better off now than before SOX, chapter 3 makes it clear that the relevant question is whether the business world is better *because* of SOX. The American corporate governance system is incredibly dynamic—for over a hundred years, it has demonstrated its resilience and ability to evolve in response to dramatic structural changes and external shocks. Even if there were a problem that needed solving, it is likely that existing institutions and the market could have solved it without a massive new dose of one-size-fits-all regulation from the federal government. Moreover, given the dynamism and success of our system, the proponents of massive new regulation logically should bear the burden of justifying it. To frame the question of whether SOX was necessary, we consider what would have happened if there had been no SOX. American markets would not simply have turned into a costly casino with careful investors stuffing their money in mattresses. Existing market devices and regulation have already worked to punish the pre-SOX frauds and, thus, to deter future fraud. If new rules had been necessary, capital-hungry companies, stock exchanges, states, and professional groups would have had ample incentive to provide them, and thereby to demonstrate their integrity to investors. They also had better information than politicians and regulators about

what to do. It is highly unlikely that Congress could outthink this dynamic system, particularly during the frenzied regulatory panic of 2002.

The costs of SOX are described in chapters 4 and 5. In general, defenders have limited their calculations to the act's most direct compliance costs. They, like Congress in 2002, ignore indirect and possibly hidden—but still quite substantial—costs. Chapter 4 surveys the mounting evidence on the direct costs of SOX—particularly those of complying with the notorious section 404 internal controls—that have triggered so much interest in the media, and then discusses in detail some of the less obvious costs, including interference with business management, distraction of managers, risk aversion by independent directors, over-criminalization of agency costs, reduced access to capital markets, and the crippling of the dynamic federalism that has created the best corporate governance structure in the world.

Chapter 5 describes the ticking litigation time bomb SOX has created. The first major market correction will be painful for investors, but it will be a gigantic litigation festival for trial lawyers. SOX gives litigators the benefit of 20/20 hindsight to identify minor or technical reporting mistakes as the basis for lawsuits against corporations, officers, and directors. The threat of litigation on this scale should in no way be construed as investor protection.

Chapter 6 compares the small benefits of SOX discussed in chapter 3 with the large costs discussed in chapters 4 and 5. Based upon the best available evidence, it concludes that SOX has imposed a net loss on the American economy of $1.4 trillion. A widely cited study of the annual direct costs of complying with SOX indicates that firms will spend a total of $6 billion in 2006.[8] Even if annual direct costs of this magnitude were going to continue in perpetuity, the present value of those costs would amount to only a small fraction of $1.4 trillion net loss. A conservative estimate is that the indirect costs of SOX are greater than $1.1 trillion.[9]

Chapter 7 considers the potential policy implications of our conclusion that SOX is a colossal mistake. 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 accounting oversight board SOX created violates the appointments clause of the Constitution because its members should be appointed by the president or heads of executive branch departments rather than by the SEC.[10] This suit has the potential to overturn all of SOX, which lacks a severability clause. However, if the Free Enterprise Fund prevails, the courts are likely to give Congress a window of opportunity to fix it. Although political reality makes it unlikely that Congress will repeal SOX, it may have the incentive to respond to the increasing criticism of SOX and fix its most egregious flaws.

Several relatively minor changes in the statute could greatly reduce the burden that SOX imposes on the American economy. First, SOX should be amended to prohibit private lawsuits. Second, it should be amended to exempt securities of foreign corporations. Third, it should be amended to exempt all but the largest corporations. Fourth, it should be amended to allow shareholder opt-out of at least some provisions through shareholder proxy proposals. Finally, the criminal sanctions in SOX should be removed.

Chapter 8 takes a longer view. The post-SOX era offers real opportunities to assess what we have learned about policymaking from the Sarbanes-Oxley fiasco. Given policymakers' tendency to overreact in market panics, doubts about the efficacy and costs of federal regulation, and the availability of other mechanisms for controlling corporate fraud, there is much to be said for a careful approach to federal regulation that, among other things, allows for alternatives and limits the scope of regulation. Perhaps something can be salvaged from the SOX fiasco.