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

By Henry N. Butler and Larry E. Ribstein

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The 2002 Sarbanes-Oxley Act (SOX) was enacted following revelations of corporate misconduct and the collapse of the Enron Corporation. In an effort to protect investors by improving the accuracy and reliability of corporate disclosures, Congress introduced stringent new rules affecting financial practices and corporate governance regulation. But is SOX worth the huge direct and indirect compliance costs paid by firms and passed onto investors?

Authors Henry N. Butler and Larry E. Ribstein say that it is not. In their new book, *The Sarbanes-Oxley Debacle: What We've Learned; How to Fix It* (AEI Press, 2006), Butler and Ribstein demonstrate that SOX has been a colossal failure since its enactment four years ago. The act's unintended consequences, the authors argue, have been onerous for firms that must comply with the new regulations and harmful to the ordinary investors it means to protect, whose portfolios now bear the costs of eliminating fraud in all firms.

The authors find that although direct costs are currently estimated at $6 billion per year, the indirect costs of SOX are, in fact, even greater. The best evidence to date, according to Butler and Ribstein, indicates that SOX imposes additional net losses to financial markets totaling $1.4 trillion. Indirect costs include creating opportunities for excessive litigation; diverting executives' attention from maximizing shareholder value; increasing risk aversion by managers; distorting executives' and directors' incentives and investment decisions; reducing access to capital markets by entrepreneurs who now have to deal with the increasing startup and ongoing costs of compliance; and crippling our federalist corporate governance structure which allows firms to choose between several distinct approaches.

While Butler and Ribstein advocate repealing SOX, they realize that political reality suggests that Congress will not abandon SOX, but most likely will respond to the mounting criticism by fixing the act's most egregious faults. Congress should have an opportunity to do just that if a lawsuit alleging the unconstitutionality of the Public Company

Accounting Oversight Board—created by SOX to oversee the auditors of public companies—is successful. The authors propose the following changes to SOX:

- Defuse the litigation time bomb by prohibiting private lawsuits;
- Allow firms to opt into or opt out of some of SOX's provisions;
- Exempt foreign firms either from SOX generally or from specific provisions;
- Exempt all but the largest corporations;
- Remove criminal penalties to avoid the potential for prosecutorial abuse of criminal sanctions;
- Revise and soften section 404—known as the internal control provision—which penalizes and even criminalizes the failure of executives to disclose even remote risks that might later turn into problems.

Butler and Ribstein conclude, "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 the 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."

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