

Introduction

Is Sarbanes-Oxley Impairing Corporate Risk-taking?

June 18, 2007

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If you follow the debate about Sarbanes-Oxley, most of what you hear is that section 404 of SOX—which requires companies to install internal controls and requires auditors to certify the adequacy of these controls—has turned out to be substantially more costly to companies than anyone anticipated. The reason that this is the focus of the debate over SOX is that there are readily quotable numbers involved. They run into millions and billions, and are thus fodder for publication and pronouncements.

But an ill-conceived regulation can have unintended effects that extend well beyond the tangible dollars and cents costs that economists, accountants and policymakers may focus on. One of these unintended effects could be the gradual migration of financial transactions and securities offering overseas, especially to London. The London Stock Exchange advertises that it is a SOX-free environment, which certainly signals that they regard the absence of SOX restrictions as a selling point for listings. And it seems to be working. Not only are London's listings up, but the New York Stock Exchange has acquired a major European exchange and NASDAQ is trying to do the same. In both cases, they seem to be trying to follow their customers, admitting in effect that it is unlikely that foreign companies will be seeking U.S. listings any time soon.

There are many other indications that our public securities markets—where SOX applies—are suffering losses vis-à-vis private markets. In 2006, foreign companies raised more equity through 144A transactions in the United States than they did on all our public securities exchanges combined. In addition, the private equities market is booming, with many well known companies agreeing to be acquired by private equity firms and thus exit from the public securities market entirely. Finally, several weeks ago, we sponsored a conference that discussed the effect of SOX on financing start-ups and innovation. The discussion there indicated that the tangible costs of being a public company since the enactment of SOX are having an adverse effect on the financing of innovation—another unintended, unwanted and intangible adverse result.

In today's conference, we will focus on another of these unintended adverse effects, and a serious one—the question whether SOX may be causing a decline in risk-taking by public companies. If so, this would be a serious problem for our economy over the long term. Almost all economists would agree that it is risk-taking—the willingness to develop new products and seek new markets, among other things—that powers the competition, innovation and growth in our economy. If risk-taking is reduced, over the long term our economy will produce less in goods and services for all of us.

The paper that Ken Lehn and his colleagues have produced makes a strong empirical case that there is an association between the advent of SOX and a decline in risk-taking by U.S. public companies.

I chose the word “association” carefully. The fact that there is a decline in risk-taking after SOX does not prove that SOX caused this decline. It is only very rarely in the social sciences that we can know *why* events occur as opposed to the fact that they *do* occur. Empirical researchers like Professor Lehn and his colleagues do the hard work to show us an association between two or more facts. Then it falls to the rest of us to figure out whether this relationship is meaningful.

Ronald Reagan used to say that an economist is someone who sees that something works in fact and wants to know whether it will work in theory. That sounds very funny, but it’s really a serious point. It’s also a little ironic because Reagan proved the importance of theories himself when he disregarded all the advice from conventional economists and refused to raise taxes when his original tax program—plus a big recession—caused enormous deficits.

Reagan thought that the supply side theory was correct—that if taxes were cut it would stimulate economic activity and reduce the deficit—rather than the conventional view that the deficits caused high interest rates and would impede an economic recovery. Although there was little direct evidence for this, it seemed plausible to Reagan and he stayed the course through the recession of 1982-83.

Reagan’s theory proved to be right, and this provided the conceptual basis for the Bush tax cuts in 2001 and 2003. Since the Reagan administration and Reagan’s tax policies there have been only a few months of recession in the United States, and those recessions have been much milder than recessions that occurred in earlier years. Moreover, the deficit today as a percentage of the economy is minuscule compared to the average of the post-war period.

Well, then, what *is* the relationship between SOX and corporate risk-taking? And is that relationship persuasive enough for us to say plausibly that SOX is a *cause* of a decline in corporate risk-taking, rather than the less affirmative statement that SOX is *associated with* a decline in corporate risk-taking?

I think there is a cause and effect relationship, and it runs through the newly empowered independent majorities on the boards of directors of public companies. After Enron, WorldCom and SOX, all companies listed on the securities exchanges were required to have independent majorities on their boards of directors. In addition, many boards, on the recommendation of corporate governance reformers, adopted nominating committees made up of independent directors to assure that CEOs don’t mix in the process of selection, and arranged for independent directors to meet separately from the CEO and other officers in order to talk over their issues. In some cases, they have engaged consultants and counsel to help them in this effort. The message is that the independent directors are to take an active role in the management of the company.

What does that mean? It means that the independent directors—at the very least—were expected to exercise their judgment not only with respect to the adequacy of the company's financial disclosures but also with respect to how the company carries on its business. This fundamentally changed the role of the board, which had previously functioned as a sounding board for management, a source of advice and counsel, but not as a body with a significant role in passing upon the company's operations or its risk-taking.

When independent directors take on this new responsibility, what are their incentives? Independent directors have few incentives to take risks. Their compensation arrangements are generally not tied to the success of the company. Stock options—one way of aligning the interests of directors with corporate growth and performance—are now disfavored because of changes in accounting rules that charge the value of stock options against earnings. Not only that, but risk-taking can result in wide swings in earnings, which in turn can bring wide swings in stock prices and precipitate lawsuits in which the independent directors can become involved as defendants.

Finally, the independent directors of a company are part-timers and unfamiliar with the details of the company's business. Lack of knowledge naturally breeds caution and conservatism. When asked to choose between a risky course that could result in substantial increases in company profits, or a more cautious approach that has a greater chance to produce the steady gains of the past, independent directors are very likely to choose the safe and sure. They have little incentive to take risk and multiple reasons to avoid it.

Contrast this with the incentives of management. Management's compensation is tied to corporate performance. In addition, they have a natural desire to beat the competition, to take market share, and to show themselves as superior performers. Finally, they know far more about the details of the company's operations than directors and are not subject to the conservative impulses that come from uncertainty or lack of knowledge.

What may be happening is that management, at the margin, does not want to confront the independent majority of the board with projects or investments—including acquisitions, expensive new R&D, or expansion into new markets—that might be seen by the independent directors as excessively risky. The result is less risk-taking, and accounts not only for the data on risk reduction that we will hear today but also for the academic studies that show an association between lower corporate performance and supermajorities of independent directors on corporate boards.