

## Introduction

Is Sarbanes-Oxley Impairing Corporate Risk-taking (Cont.)?

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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 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.

Incidentally, the latest arresting numbers, published in the September issue of *Corporate Secretary* magazine, show continuing increases in compliance costs for 2006, on a year-over-year basis, for companies of all sizes. One of the constituents of the increase is truly astonishing. Between fiscal 2001 and fiscal 2006, audit fees increased 311% for S&P small cap companies, 251% for S&P mid-caps, and 189% for the S&P 500. See what I mean?

But ill-conceived legislation and 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 is 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.

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, at least until the recent credit crunch, the private equity market was very active, with many well known companies agreeing to be acquired by private equity firms and thus exit from the public securities market entirely. The survey in *Corporate Secretary* showed that an astounding 25% of the companies surveyed were looking to go private in order to reduce their compliance costs.

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 drives 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.

In order to test whether SOX is impairing risk-taking, AEI's affiliate, the National Research Institute, commissioned two studies by respected academics. The first of these papers was presented this past June by Professor Kenneth Lehn and his colleagues at the University of Pittsburgh's Katz School of Business. Lehn's paper compared over 4000 US companies matched with almost 1000 UK companies that were not subject to Sarbanes-Oxley and found that there is

a strong association between the advent of SOX and a decline in risk-taking by US 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 cause and effect.

Kate Litvak’s paper goes a significant distance toward drawing a causal connection between SOX and reduced risk-taking. In something of a feat of scholarship, she has managed to compare risk-taking by companies that are subject to SOX with matched companies from *the same country* that are not subject to SOX, and even with companies from the same country that have accessed the US securities market but are not subject to SOX. Again, these comparisons show that companies subject to SOX are taking less risk than their counterparts. This finding, together with the Lehn paper, creates a very strong inference that SOX is in fact causing reduced corporate risk-taking.

How and why does SOX have this effect? I think the causal relationship 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 director selection, and arranged for independent directors to meet separately from the CEO and other officers 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. Instead of a sounding board for management, independent directors now seem to believe that as a board majority they have a real role in management.

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, which accounts not only for the data on risk reduction that we will hear today but also for the other academic studies—which we will also present at later conferences—that show an association between lower corporate performance and supermajorities of independent directors on corporate boards.

At some point, thoughtful people will recognize that, whatever benefits SOX might have produced, they are outweighed by the act's tangible and intangible costs. When that realization takes hold, there will be a constituency for reform.