University of Illinois College of Law
Law and Economics Working Papers

Year 2005 *Paper* 30

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Draft of June 20, 2005

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This article reports on the experience with the Sarbanes-Oxley Act of 2002 in the three years since its passage. In general, the costs have been significant and the benefits elusive. This suggests some lessons for future regulation.

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There is an ongoing debate between the corporate contractarians, who believe in the power of markets and the wisdom of trusting to private ordering, and anti-contractarians, who tend to favor regulatory solutions.[1] The contractarian position was challenged by the market collapse of 2001, which demonstrated the potential weakness of markets. But a full evaluation of regulation must include an understanding not only of markets' defects, but also of their potential strengths and, more importantly, regulation's limits. In other words, one must steer between a Panglossian view of markets, and the Nirvana fallacy that regulation is appropriate whenever markets fail.

These observations are supported by the regulatory aftermath of the market crash in the US – the Sarbanes-Oxley Act of 2002 (SOX).[2] This paper provides a brief overview of some issues relating to SOX. Part I gives a short history and background of the Act. Part II evaluates SOX's regulatory solutions. Part III looks at some evidence on the effects of SOX. Part IV offers some overall observations and recommendations for the future, particularly including the advisability of what I call "humble" regulation.

I. SOX IN PERSPECTIVE

This Part discusses the roots of SOX in a market bubble, and the politics that led to its enactment, which could be described as a regulatory bubble.

A. ROOTS OF SOX: ENRON

The pre-SOX market bubble exacerbated two inherent flaws

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[1] Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians,* 65 WASH. L. REV. 1 (1990).

[2] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. Many of these issues are discussed in my earlier articles: Larry E. Ribstein, *Bubble Laws,* 40 HOUS.. L. REV. 77 (2003) ("Bubble Laws"); Larry E. Ribstein, *Limited Liability of Professional Firms after Enron*, 29 J. CORP. L. 427 ("Professional Firms"); Larry E. Ribstein, *International Implications of Sarbanes-Oxley: Raising the Rent on US Law*, 3 Journal of Corporate Law Studies 299 (October, 2003) ("Raising the Rent"); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. Corp. L. 1 ("Critique"); Larry E. Ribstein, *Sarbox: The Road to Nirvana*, 2004 MICH. ST. L. REV. 279 ("Nirvana"). The current paper both summarizes and updates these earlier papers. For ongoing coverage, see the "Sarbanes-Oxley" archive of my web log, "Ideoblog," at http://busmovie.typepad.com/ideoblog/sarbanesoxley/index.html.

in corporate governance – agency costs and gatekeeper failure. These causes of SOX are discussed in the following sections.

1. The bubble

There have been many accounts of the Enron story, most notably including in the Powers Report,[3] and in the first federal court opinion on the Enron matter,[4] which exhaustively summarized the facts in ruling on securities fraud and other investor claims against banks, law firms and Arthur Andersen.

In brief, Enron created an energy market that was intended to reduce utility companies' need to engage in potentially costly vertical integration. It later extended its business model to the fiber optic cable and other markets. Enron created an impression of ever-increasing earnings and stable finances through the use of extensive derivatives trading and profitable transactions with special purpose entities (SPEs). In fact, the apparent profits for all but Enron insiders were illusory, as Enron booked speculative predictions of years of future sales, and disguised loans as prepay commodities contracts.

Several factors may have contributed to a bubble atmosphere in the Enron era.[5] First, executives at Enron and other bubble-era companies were unusually competitive, over-confident and unethical. Second, new business techniques such as derivatives, structured financing and special purpose entities made fraud hard to detect. Third, investors became less skeptical and guarded. New technologies such as the Internet opened seemingly endless opportunities. The cautious were dismissed as old-fashioned.

Before discussing the regulatory reaction to the 1990s market, it is worth considering whether there actually was a bubble. One recent paper, looking at S&P 500 earnings growth for 1951-2000, "cannot reject a rational basis" for market exuberance.[6]

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[3] William C. Powers, Jr. et al., *Report of Investigation By The Special Investigative Committee of The Board of Directors of Enron Corp.* (Feb. 1, 2002) 2002 WL 198018 ("Powers Report").

[4] Newby v. Enron Corporation, 2002 WL 31854963 (S.D. Tex. Dec. 20, 2002).

[5] *See* Ribstein, "*Critique*," *supra* note 2.

[6] *See* Jinho Bae & Charles R. Nelson, *Earnings Growth and the Bull Market of the 1990s: Is There a Case for Rational Exuberance?* (2004), available at http://papers.ssrn.com/paper.taf?abstract_id=607604.

Another paper shows that uncertainty levels plausibly supported peak Nasdaq valuations during the "bubble" period.[7] Other papers raise questions about our ability *ever* to recognize a bubble. McGratton & Prescott, co-authored by a 2004 Nobel Prize winner, shows that market fundamentals may have supported stock prices at their 1929 peak, before the Great Crash.[8] Day shows the rationality of past so-called "bubbles," the Tulip mania, the Mississippi Company and the South Sea Company.[9] These studies suggest some doubt about the need in 2002 for extreme SOX-type regulatory action.

2. Agency Costs

One of the most important inherent characteristics of publicly held firms is the separation of ownership and control, or what is commonly referred to as "agency costs."[10] Agency costs are exacerbated by the so-called "free-rider" problem, which makes small shareholders unwilling to monitor managers because they would have to share monitoring gains with their fellow investors. This is particularly a problem given the bubble mentality and opaque accounting at companies like Enron.

3. Gatekeeper failure

Since investors cannot effectively monitor managers, they have to delegate the task to others, often referred to as "gatekeepers."[11] These include senior executives, independent directors, large auditing firms, outside lawyers, securities analysts,

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[7] *See* Lubos Pastor and Pietro Veronesi, *Was There a Nasdaq Bubble in the Late 1990s?* (2004), available at http://papers.ssrn.com/paper.taf?abstract_id=557061.

[8] Ellen R. McGrattan & Edward C. Prescott, *The 1929 Stock Market: Irving Fisher was Right*, 45 INTERNATIONAL ECONOMIC REVIEW 991 (2004), http://papers.ssrn.com/ paper.taf?abstract_id=608477.

[9] Christian C. Day, *Chaos in the Markets - Moral, Legal & Economic Signals in Three Fantastic Bubbles.* available at http://papers.ssrn.com/paper.taf?abstract_id=572123.

[10] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

[11] *See* Assaf Hamdani, *Gatekeeper Liability*, 77 S. Cal. L. Rev. (2004); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. L. Econ. & Org. 53 (1986).

the financial media and debt rating agencies. In hindsight it is not surprising that these so-called gatekeepers missed the problem, since many had conflicting loyalties that caused them to overlook client misconduct, or were too remote from the misconduct to be able to spot it.

B. THE ENACTMENT AND POLITICAL CONTEXT OF SOX

Congress passed SOX in the summer of 2002. The Act was enacted hurriedly, without significant debate, in a panic atmosphere created by crumbling securities prices and daily revelations of fraud, particularly including the massive accounting fraud at WorldCom.[12] Despite the rush and lack of debate, SOX is a major piece of legislation, as indicated by the following synopsis of key aspects of the Act:[13]

1. **Internal monitoring**: requires independent board audit committee to be responsible for hiring and overseeing auditors; requires executive certification of reports and of internal controls with criminal penalties for reckless certification; prohibits fraudulently influencing or misleading auditors; mandates disclosures concerning the firm's internal control structure and a code of ethics for financial officers; and protects whistleblowers.

2. **Gatekeeper regulation:** requires attorney reporting of evidence of fraud; reducing ties between auditors and audited companies; provides for an independent Public Company Accounting Oversight Board.

3. **Regulation of insider misconduct**: prohibits insider loans and requires return of incentive-based compensation following accounting restatements.

4. **More disclosure:** requires disclosures concerning the firm's internal control structure and code of ethics, off-balance-sheet transactions and pro forma earnings and faster disclosure of material changes in financial condition.

5. **Regulating securities analysts**: ensures analysts'

[12] *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1549-68 (2005) (detailing SOX's political history, demonstrating the lack of careful attention to the costs and benefits of its reforms).

[13] *See* Ribstein, *Critique, supra* note 2 for a more comprehensive summary.

independence from their firms' investment banking activities.

SOX can be described as an example of the "Sudden Acute Regulatory Syndrome"[14] that usually follows a market panic, just as the Bubble Act was passed in the midst of the South Sea Bubble, and the US federal securities laws followed the 1929 crash.[15] When fraud is the hot media story, regulation seems to be a panacea, and markets seem impotent to protect investors. Disgruntled investors and their politicians call for immediate action, rendering ineffective industry lobbying that in normal times moderates the demands of pro-regulation interest groups.

II. REGULATORY COSTS AND BENEFITS

This Part evaluates the costs and benefits of the SOX reforms both from a theoretical perspective and in the light of the latest empirical evidence.

A. INCREASED INTERNAL MONITORING

The agency costs inherent in separation of ownership and control theoretically might be reduced through more rigorous monitoring by people within the firm, most importantly outside directors and top executives. However, the costs of such monitoring may outweigh the benefits for many firms. The following subsections discuss problems with specific SOX provisions. Beyond these problems, it is important to keep in mind that the provisions interact in complex ways with each other and with existing incentive and monitoring mechanisms. For example, there is evidence that increasing penalties on managers for overstating earnings can actually reduce the quality of outside audits of the company's earnings.[16]

1. Independent directors

Independent directors long have been a staple of corporate reformers' agenda. This device is superficially attractive, since it provides an internal method of review and accountability. However, independent directors are not a panacea, since they may lack

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[14] *See* Ribstein, *Nirvana, supra* note 2.

[15] *See* Ribstein, *Bubble, supra* note 2.

[16] *See* Ravi Singh, *Incentive Compensation and the Quality of Disclosure*, Stanford Institute for Economic Policy Research Paper No. 02-22 (August 2004), available at http://papers.ssrn.com/paper.taf?abstract_id=574281.

adequate time, incentives and information to be effective. Thus, there is ample data showing that corporate profitability is generally unrelated to the number of independent directors on the board.[17]

The specific SOX contribution to board structure concerns the independence of the board audit committee – i.e., the committee tasked with overseeing the firm's auditors. This focus is not surprising given the deficiency of the Enron audit committee's oversight of Enron's auditor, Arthur Andersen. There is, however, a significant question as to the effect of this specific fix on top of many regulators' myriad pre-SOX efforts to reform corporate boards. That is particularly so given the inherent difficulty of effective oversight of auditors, a task requiring significant information and expertise. Thus, there is little reason in theory to expect this reform to do more than increase governance costs.

The data is consistent with this theory. Roberta Romano reviews sixteen studies attempting to relate audit committee independence to various performance measures, including productivity, market value, abnormal accruals, restatements, financial fraud, and earnings informativeness, and concludes that ten fail to find that audit committee independence improves performance, one reports inconsistent results for different models, and three of the remaining studies suffer from methodological flaws.[18] For example, one study found that the effect of independence of the *audit committee* was not significant separate from the independence of the *whole board*.[19] A few of the surveyed studies adduce some evidence that it is important to have financially sophisticated audit committees – a goal that is not furthered, and that may even be compromised, by the independence requirement.

Another SOX-related reform, the Qualified Legal Compliance Committee (QLCC), also has problems. The SEC created this structure in its Rule 205 as part of its effectuation of Section 307 of SOX. That section calls for the SEC to promulgate a rule "requiring an attorney to report evidence of a material violation

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[17] *See* Ribstein, *Critique, supra* note 2 at 26-29.

[18] *See* Romano, *supra* note 12 at 1532. The studies are analyzed in detail in Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, Yale Int'l Ctr. for Fin., Working Paper No. 04-37, 2004), *available at* http://ssrn.com/abstract=596101.

[19] *See* Kirsten L. Anderson et al., *Boards of Directors, Audit Committees, and the Information Content of Earnings*, *at* http://papers.ssrn.com/sol3/papers.cfm? abstract_id=444241 (Sept. 2003).

of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof" to the chief legal counsel or chief executive officer, and, if they do not respond, to the audit committee, other independent directors, or the board. The SEC rule permits corporations to set up a QLCC as a reporting mechanism. But Fisch & Gentile observe that QLCCs "are likely to increase the cost to issuers of obtaining and retaining high quality directors, increase the demands on scarce director time, and . . . interfere with board collegiality and board-management relations."[20]

2. Monitoring by corporate executives

Corporate executives might be expected to be more effective monitors of fraud than independent directors, since they have both significant expertise and more information about the firm. SOX requires monitoring by executives in the form of certification of reports and internal controls. But it is far from clear that such certification adds significantly to the information about firms that is already reflected in share price, as indicated by the evidence reported below.[21]

3. Whistle-blowing

Another form of monitoring is to subject executives to scrutiny by their employees. This is theoretically useful, since executives cannot effectively perpetrate massive frauds like that at WorldCom their agents' help. Thus, SOX section 806, which protects whistleblowers from reprisals, might seem to help reduce fraud.

Such provisions can, however, have significant costs. Among other things, Section 806 gives shirking employees a potent way to fend off scrutiny of their performance.[22] There are also bound to be problems operationalizing a new regime of employee monitoring. With respect to Section 806, Congress delegated enforcement to safety and health regulators unsophisticated in financial fraud rather than to securities regulators.[23]

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[20] Jill E. Fisch & Caroline M. Gentile. *The Qualified Legal Compliance Committee: Using The Attorney Conduct Rules To Restructure The Board Of Directors* 53 Duke L.J. 517, 583 (2003).

[21] *See infra* text accompanying 43-46.

[22] *See* Ribstein, *Critique*, *supra* note 2 at 43.

[23] *See* Deborah Solomon, *For Financial Whistle-Blowers, New Shield is*

4. Internal controls

Perhaps the most troublesome SOX provision has been Section 404, which requires firms to report on their internal control structures. Information about these structures might potentially be useful to investors.

Reporting firms protested loudly as the requirements started to apply to financial statements released after November 15, 2004. These protests reflected the significant start-up costs involved in a new reporting regime. The main problems with the internal controls reports are, however, more subtle and may persist even after firms have established reporting procedures and infrastructures. Most importantly, SOX imposes significant new liability risks, since a clever trial lawyer might be able to trace virtually any business problem, in hindsight, to a failure to implement some internal control. Thus, the litigation risks are associated not merely with fraud or mismanagement, but with inherent business uncertainty.

The liability problem is compounded by the fact that the burden of uncertainty falls on auditors or executives who sign off on the internal control reports. These individuals or firms are less able to bear the risk than the firm's shareholders who can own the shares as part of a diversified portfolio. The internal controls reports therefore may end up negating the risk-bearing advantages of modern capital markets. Cohen, Dey and Lys find indirect evidence of the negative effects of SOX in the form of a post-SOX decline in the ratio of incentive compensation to salary after the passage of SOX and in the amount of firms' research and development expenses and capital expenditures.[24] These results indicate that SOX reduced executives' incentives, and therefore willingness, to take risks.

The effects of this reallocation of risk are likely to be greatest for start-up or innovative firms, which face more inherent uncertainty than established firms. To the extent that SOX impedes these firms from raising capital, the effect may be to reduce socially beneficial entrepreneurial activity. In other words, an effect of trying to prevent the next bubble may be to deter the next boom.

The internal controls rule also places a particularly heavy burden on smaller firms, regardless of the nature of their business. Setting up an internal controls system involves a certain minimum

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an Imperfect One, Wall St. J., October 4, 2004 at p. A1.

[24] Daniel A. Cohen, Aiyesha Day and Thomas Lys, *The Sarbanes Oxley Act of 2002: Implications for Compensation Structure and Risk-Taking Incentives of CEOs*, http://papers.ssrn.com/paper.taf?abstract_id=568483 (July 23, 2004).

level of cost regardless of the scale of the business, and therefore is likely to cost small firms more per dollar of capitalization than larger firms. This is supported by evidence that smaller and less actively traded firms reacted less favorably to events that increased the likelihood of SOX' passage.[25] It is also indirectly indicated by evidence that smaller firms are more likely than larger firms to find weaknesses in internal controls when they do set up these systems.[26] These internal controls costs are in addition to other costs of complying with SOX that may be more burdensome for small than for large firms, such as the costs of hiring more outside directors.[27] There is a potential social cost here, too, since small firms generate a significant fraction of total employment and incubate larger and more productive enterprises.

The costs associated with Section 404 are compounded by the uncertainties inherent in applying the provision. Most importantly, there is an important question of what sorts of risks must the firm's internal controls be designed to deal with? Section 404 entails developing a new standard of materiality, or "significance," through a long period of case law and SEC rulemaking.

B. DIRECT REGULATION OF INSIDER CONDUCT

SOX's direct regulation of self-interested insider conduct takes the form of prohibiting insider loans under Section 402 of the Act. The problem with this regulation is that such loans have the potential benefit of encouraging beneficial effect in increasing insider ownership of company stock, which tends to align their interests with those of the shareholders.[28]

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[25] Ellen Engel, Rachel M. Hayes, & Xue Wang, *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=546626 (2004).

[26] *See* Weili Ge & Sarah E. McVay, *On the Disclosure of Material Weaknesses in Internal Control after the Sarbanes-Oxley Act*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=724481 (2004).

[27] *See* James S. Linck, Jeffry M. Netter and Tianxia Yang, *Effects and Unintended Consequences of the Sarbanes-Oxley Act on Corporate Boards*, http://papers.ssrn.com/paper.taf?abstract_id=687496 (March 15, 2005) (showing that small firms paid $5.91 to non-employee directors per $1,000 in sales before SOX period compared with $9.76 per $1000 in sales after SOX, while large firms' costs increased only from $.13 per $1,000 in sales to $.15).

[28] *See* Ribstein, *Nirvana*, *supra* note 2.

C. GATEKEEPER REGULATION

Because internal monitors may not be fully effective, firms must rely on external "gatekeepers," including auditors and lawyers, who are in a particularly good position to spot executive fraud. The effectiveness of these gatekeepers may be compromised to the extent that they are selected and paid by insiders. On the other hand, rigid regulation intended to ensure gatekeeper independence may entail high costs, and reduce incentives, information flows and expertise.

Gatekeeper regulation presents several potential questions and problems.[29] First, since gatekeepers inherently are outsiders, they may not be able to spot fraud at a reasonable cost. For example, auditors might reduce the risk of fraud by refusing to trust insiders and doing "forensic" audits in which they check every piece of information. But it is questionable whether the benefits of routinely doing such audits in uncovering fraud would be worth the substantial cost.

Second, how many levels of monitoring does a firm need? For example, requiring firms to have an independent audit committee might be enough to ensure careful selection and monitoring of auditors without also directly regulating auditors. Auditors may be enough without requiring monitoring by outside attorneys.

Third, altering gatekeepers' incentives in order to ensure their independence might negatively affect the overall quality of services. For example, barring auditors from performing ancillary services for clients restricts their access to information about the client. Thus, Romano's survey of 25 studies on the effect of non-audit services on audit quality reports that 15 studies show no connection between the provision of non-audit services and audit quality, one finds no connection when the auditors are the big 5 accounting firms, 3 find non-audit services improve audit quality, and the leading survey of the remaining six has not held up well to subsequent testing of other relevant factors, a problem that may infect the other surveys finding that non-audit services affect quality.[30] There is also evidence of negative market reaction to the restriction on provision of non-audit services,[31] and that the market reaction to the adoption of SOX was lower for firms with a higher proportion of fees for non-audit services, supporting the hypothesis that non-audit services improve

[29] *See id.*

[30] *See* Romano, *supra* note 12 at 1535-37.

[31] *See infra* text accompanying note 42.

audit quality.[32]

Fourth, since gatekeepers must bear some of the risk of fraud or reporting errors, they may refuse to represent firms whose business is inherently riskier, such as start-ups or innovative firms, or may charge these firms prohibitively high fees. This exacerbates the especially heavy regulatory burdens SOX directly imposes on these firms. Thus, there have been reports that, following SOX, auditors are dropping clients that are "considered too small to be worth the extra work now required, as well as those judged too risky to work with under the new accounting rules."[33]

D. ANALYST CONFLICTS

Efficient securities markets are one of the most important ways to ferret out fraud and evaluate firms' monitoring and reporting mechanisms. Securities analysts are a crucial source of market efficiency. However, analysts' links with the investment banking departments of their firms have raised questions as to whether analysts were independent enough of clients to provide adequate monitoring. SOX Section 501 provides for the adoption of SEC rules intended to minimize these conflicts.

The problem with this legislation is that, as in other areas, rigid regulation of conflicts decreases information as it increases independence. Thus, one commentator argues that the costs of this regulation are likely to exceed the benefits because, among other things, ties between analysts and investment bankers signal information that is otherwise too costly to communicate given the restrictions on disclosure imposed by the Securities Act of 1933, and because such ties provide an efficient pricing mechanism.[34]

The problems concerning securities analysts' incentives and securities analysis generally might better be solved by less, rather than more, regulation. In particular, the SEC might repeal Regulation FD, which eliminates analysts' exclusive access to corporate

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[32] *See* Zabihollah Rezaee and Pankaj K. Jain, *The Sarbanes-Oxley Act of 2002 and Security Market Behavior: Early Evidence* (March 22, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=498083.

[33] *See* Lynnley Browning, *Sorry, the Auditor Said, But We Want a Divorce*, N.Y. Times, Section 3, p. 5, col. 1 (February 6, 2005).

[34] *See* James Spindler, *Conflict or Credibility: Analyst Conflicts of Interest and the Market for Underwriting Business*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=564381.

information.[35] This regulation reduces incentives of analysts to research and corporations to disclose.[36] Thus, there is evidence of reduced flow of information after Regulation FD, with some firms choosing to stop disclosing information rather than disclosing publicly.[37]

III. THE EFFECTS AND AFTERMATH OF SOX

The last three years have provided an opportunity to study the overall effects of the passage of SOX, in addition to the effects of specific provisions discussed above. Regulators also have had a chance to react to these developments. This Part summarizes some of this recent evidence and history.

A. EFFECT ON FIRMS' MARKET VALUE

The most direct evidence of the efficiency of SOX is the effect of its enactment on firms' market value. This is difficult to measure because SOX applies to all firms trading in the US markets, so its effect is difficult to distinguish from other market-wide influences on stock prices. Moreover, it may be difficult to decide the relevant date for measuring the effect of SOX given continuous media reports bearing on the likelihood of adoption.

There have been several event studies of market effects of SOX, some of which were analyzed by Romano.[38] The results of these studies have been mixed, but the studies tend to indicate that the market has reacted negatively to the adoption and implementation of SOX.

- Chhaochharia & Grinstein show that the SOX governance rules had a positive and statistically significant effect on the value of large firms, but no

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[35] Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, Aug. 15, 2000, available at 2000 WL 1201556.

[36] *See* Ribstein, *Critique, supra* note 2 at 49-50.

[37] *See* Anwer S. Ahmed & Richard Schneible, *Did Regulation Fair Disclosure Level the Playing Field? Evidence from an Analysis of Changes in Trading Volume and Stock Price Reactions to Earnings Announcements*, http://papers.ssrn.com/paper.taf?abstract_id=498002 (January 22, 2004).

[38] *See* Romano, *supra* note 12 at 1541-43.

significant effect on small firms.[39]

- Li, et al, find negative stock returns from enactment, but positive returns associated with post-enactment implementation of SOX, suggesting that the market feared SOX and was happy it was not enforced as rigorously as expected.[40] However, these results are inconclusive because of the market-wide effects of SOX. Also, the study finds no significant differences between SOX's effects on firms that had been managing earnings or had fully independent audit committees and those on firms that were not managing earnings or did not have independent audit committees. This indicates that the market did not expect SOX reforms in these areas to be meaningful.

- Rezaee & Jain found positive stock returns followed events that were "favorable" SOX's enactment, directly contradicting Li, et al.[41] The study found that SOX more favorably affected firms that were better governed before SOX. However, in order to interpret this finding favorably to SOX, one has to assume that better governed firms should benefit the most from improved regulation. This is not obvious because, while better-governed firms might have lower compliance costs than worse-governed firms, they should also have lower benefits.

- In what is probably the most extensive and persuasive study of SOX' costs, Zhang estimates the loss in total market value of firms around legislative events leading to the passage of SOX at $1.4 trillion.[42] The

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[39] Vihi Chhaochharia & Yaniv Grinstein, *Corporate Governance and Firm Value - The Impact of the 2002 Governance Rules* (June 2004).

[40] Haidan Li, Morton Pincus & Sonja Olhoft Rego, *Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002: Overall and as a Function of Earnings Management and Audit Committee Effectiveness* (manuscript Nov. 2003), available at http://papers.ssrn.com/paper.taf?abstract_id=498083.

[41] *See* Rezaee & Jain, *supra* note 32.

[42] Ivy Zhang, *Economic Consequences of the Sarbanes-Oxley Act of 2002*, available at http://w4.stern.nyu.edu/accounting/docs/speaker_papers/spring2005/Zhang_Ivy_Economic_Consequences_of_S_O.pdf.

> study specifically found negative market reaction to the restriction of the provision of non-audit services, provisions relating to corporate governance, and to the Section 404 internal controls provision. Significantly, the study finds that abnormal returns of firms with "weak" governance were *negative* as the likelihood of passing tough SOX rules increased, suggesting that investors thought that the costs of such rules to poorly governed firms would exceed the benefits.

There is also evidence of market price reaction to the SOX executive certification requirement. One study shows that there is evidence that share prices reacted, particularly those of firms with prior securities litigation.[43] Another shows that CEO certification under SOX increased the share prices of bank holding companies that certified prior to the rule's compliance deadline, and that the effect on share prices was correlated with the opacity of the firm's earnings.[44] But there is also evidence that firms' share prices did not react to certification, suggesting that the market could separate good from bad firms without certification.[45] Romano analyzes the latter two studies in detail and concludes that it is difficult to draw "any definitive conclusion" from them.[46]

B. EFFECT ON NON-U.S. FIRMS

SOX imposes significant costs on non-US firms that list or otherwise sell securities in the US.[47] These costs may be particularly

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[43] *See* Paul A. Griffin & David H. Lont, *Taking the Oath: Investor Response to SEC Certification* (ms. November 19, 2003), available at http://papers.ssrn.com/paper.taf?abstract_id=477586.

[44] Beverly Hirtle, *Stock Market Reaction to Financial Statement Certification by Bank Holding Company CEOs*, *at* http://papers.ssrn.com/sol3/papers.cfm? abstract_id=425002 (July 2003).

[45] Utpal Bhattacharya, Peter Groznik and Bruce Haslem, *Is CEO Certification Credible?* 26 REGULATION, No. 3, p. 8, Fall 2003, available at http://papers.ssrn.com/paper.taf?abstract_id=511122.

[46] *See* Romano, *supra* note 12 at 1542.

[47] *See* Erin Marks, *The Sarbanes-Oxley Act: Costs and Trade offs Relating to International Application and Convergence*, 17 Research in Accounting Regulation, __(2004); Ribstein, *Raising the Rent, supra* note 2; Larry E. Ribstein, *Cross-Listing and Regulatory Competition*, *Review of Law & Economics:* Vol. 1: No. 1, Article 7, *http://www.bepress.com/rle/vol1/iss1/art7*

high to the extent that firms with non-US-style governance, particularly including concentrated shareholdings, are forced to comply with rules designed for US-style dispersed ownership. SOX accordingly may have reduced these firms' willingness to list their securities in the US. Moreover, SOX imposes costs even on firms that do not cross-list in the US but are subsidiaries of US firms.

D. DETERRING OR REDUCING PUBLIC OWNERSHIP

Because of the particularly heavy burden SOX imposes on small firms,[48] SOX might be expected to cause these firms to reduce their public ownership so that they are not subject to SOX' requirements. They can do this either by becoming privately held, or by "going dark" – that is, remaining publicly held, but reducing the number of nominal public shareholders to below 300, the threshold for application of the Securities and Exchange Act of 1934 of which SOX is a part.[49]

There is evidence that SOX did have an effect in causing firms to eliminate or reduce public ownership. Studies have shown that 200 firms went dark in 2003, the year after SOX was enacted;[50] that going private transactions increased after the passage of SOX;[51] and that 44 of 114 firms that went private in 2004 cited SOX compliance costs as a reason.[52] Evidence of smaller firms' negative share price reactions to SOX,[53] and of more positive share price reactions to going private after enactment of SOX than before,[54]

(2005).

[48] *See supra* text accompanying notes 26-27.

[49] Securities and Exchange Act of 1934, §12(g)(5).

[50] Christian Leuz, Alexander J. Triantis, & Tracy Yue Wang, *Why do Firms go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations* (2004), University of Pennsylvania, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=592421 (2004).

[51] *See* Engel, et al, *supra* note 25.

[52] William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of 'Going Private'* http://papers.ssrn.com/paper.taf?abstract_id=672761 Emory Law and Economics Research Paper No. 05-4 (February, 2005).

[53] *See* Engel, et al, *supra* note 25.

[54] *See id;* Leuz, et al, *supra* note 50.

supports the inferences that SOX caused at least some going private transactions and that the costs of remaining public are higher after SOX.[55] There is also evidence that firms with higher audit fees were more likely to go dark, thereby linking this decision with the costs of complying with SOX.[56]

This SOX-caused avoidance of securities disclosure has potentially high social costs. First, firms may benefit from public ownership, including by enabling diversification of risk. While the costs of public ownership, including potentially higher agency costs, may outweigh the benefits for some firms, it would be inefficient to impose a regulatory "tax" that causes firms to be closely held that would be publicly held without the tax. Yet this could be the effect of SOX if the costs of compliance outweigh the benefits in terms of reducing fraud and agency costs.

Second, SOX may be encouraging publicly held firms to go dark and thereby lose disclosure transparency for the benefit of insiders and the detriment of outside shareholders who remain in the firm. Unlike going private, a firm that goes dark may continue to have a substantial number of public shareholders, since the 300 shareholder minimum for registration includes shares held in "street name" on behalf of multiple beneficial holders. Two studies show that firms lose share value when they announce that they are going dark, and that, especially after SOX, going dark transactions are positively correlated with insider ownership.[57] This data contrasts with evidence of positive price reactions to going private.[58] The loss of value could be because going dark signals loss of growth opportunities that would trigger more capital raising and therefore need for disclosure. Indeed, the studies show that firms that go dark do tend to have weaker growth potential than firms that go private, where the connection with growth opportunities is more ambiguous. But there is also evidence that firms that go dark have characteristics such as lower accounting quality and more free cash that indicate

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[55] *See* Engel, et al, *supra* note 25. Engel also finds more favorable share price reaction to going public in firms with high inside ownership, which may have had relatively low benefits from being public, and therefore larger net gains from going private.

[56] *See* Andras Marosi & Nadia Ziad Massoud, *Why Do Firms Go Dark?* University of Alberta, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=570421 (November, 2004).

[57] *See* Leuz, et al, *supra* note 50; Marosi & Massoud, *supra* note 56.

[58] *See supra* text accompanying note 54.

higher agency costs and likelihood of insider misconduct that could be exposed by disclosure.[59] SOX may have increased insiders' incentives to avoid scrutiny. Alternatively, SOX's higher disclosure costs may have provided an apparently legitimate cover for going dark. Whatever the explanation, SOX may be indirectly causing a loss of securities law protection for precisely those shareholders who need it most.

Third, there is arguably a positive social externality from public or community ownership. If firms do not fully capture the social value from public ownership, a SOX-caused increase in the costs of public ownership may cause these firms to go private, with a consequent reduction in social welfare. This is indicated by evidence that a significant percentage of firms going private in 2004 were community financial institutions, thereby causing a loss of community ownership.[60]

E. REGULATORY RETRENCHMENT

The finance studies on the effect of SOX have been accompanied by data on the costs of SOX that have fueled mounting doubt about the Act's cost-effectiveness. The biggest problem area has been the Section 404 internal controls reports. The Securities and Exchange Commission began its work in this area by estimating that its proposed rules "would impose an additional 5 burden hours per issuer in connection with each quarterly and annual report."[61] After receiving comments, including some stinging criticism of the initial estimates,[62] the SEC's final rule revised the estimate to "around . . . $91,000 per company," excluding "any additional cost burdens that a company will incur as a result of having to obtain an auditor's

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[59] *See* Leuz, et al, *supra* note 50.

[60] *See* Carney, *supra* note 52.

[61] Securities and Exchange Commission, Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Release 33-8138, http://www.sec.gov/rules/proposed/33-8138.htm (October 22, 2002).

[62] *See, e.g.*, Comment Letter - File No. S7-40-02; Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, http://www.sec.gov/rules/proposed/s74002/cklafter1.txt (November 27, 2002) (comment from Cary Klafter of Intel stating that "[b]ased on our actual experience to date, we believe that the Commission has underestimated the time and effort involved in complying with these rules by at least a factor of 100, if not a greater order of magnitude").

attestation."[63] Both estimates proved ludicrously small. As of mid-2005, Financial Executives International was estimating first year Section 404 compliance costs at $4.36 million per company.[64]

The SEC has scrambled to mollify issuers' escalating concerns about the internal controls rule. It delayed application of Section 404 to foreign and small firms,[65] held a roundtable on implementing 404,[66] and established an advisory committee to study SOX's effect on small firms.[67] The early departure of William Donaldson in favor of Christopher Cox as Chairman of the SEC may have been due at least in part to the SEC's failure to anticipate the costs and take effective action to minimize them.

IV. CAN MARKETS SELF-CORRECT?

SOX is even more clearly ill-advised given markets' ability to rebuild investor confidence even without regulation. After all, market actors are spurred by the powerful incentive to keep their customers. For example, there is evidence that firms began voluntarily expensing stock options even without accounting standards requiring them to do so, and that the firms with greater publicity exposure did so earlier and got a bigger stock price boost.[68]

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[63] Securities and Exchange Commission, Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Release No. 33-8238 at n. 174, June 11, 2003, http://www.sec.gov/rules/final/33-8238.htm.

[64] Financial Executives International, http://www.fei.org/404_survey_3_21_05.cfm.

[65] Securities and Exchange Commission, Release 33-8545, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers, March 2, 2005, http://www.sec.gov/rules/final/33-8545.htm.

[66] The results of the roundtable and a "guidance" issued by the SEC are reported in Staff Statement on Management's Report on Internal Control Over Financial Reporting, May 16, 2005, http://www.sec.gov/info/accountants/stafficreporting.htm.

[67] *See* Advisory Committee on Smaller Public Companies, http://www.sec.gov/info/smallbus/acspc.shtml.

[68] *See* Chandrakanth Seethamraju & Tzachi Zach, *Expensing Stock Options: The Role of Publicity*, at

This indicates that the market has the capacity to sort out the complex options expensing issue without enactment of a controversial accounting rule. Also, law and accounting firms need to protect their reputations for monitoring because clients pay a premium to use these firms' reputations to signal their own integrity.

There are reasons to expect that markets will do a better job than government regulators in responding to corporate fraud. Firms are much more likely than regulators to be able to balance the costs and benefits of various regulatory moves, and to react to changes in the market. Moreover, markets can relatively easily undo excessive rules or strengthen inadequate ones. On the other hand, it is unlikely that hasty, crash-induced regulation like SOX can be far-sighted enough to protect against future problems, particularly in light of the debatable efficiency of SOX's response to current market problems. Even the best regulators might err and enact regulation that is so strong that it stifles innovation and entrepreneurial activity. And once set in motion regulation is almost impossible to eliminate.

V. CONCLUSION: WHAT NOW?

The regulatory retrenchment, and mounting evidence of the costs of SOX, suggest that we are moving from the regulatory boom to a new awareness of the cost of this regulation.[69] In other words, we may be moving from the "post-Enron" era to the "post-post-Enron era." While this would be welcome, it is even more important to learn from the SOX experience in enacting future securities laws, both in the US and around the world.

Given the difficulty of finding the right regulatory balance in responding to supposed market failure, I have recommended a "humble" approach that recognizes the costs and uncertainties as well as the potential benefits of regulation.[70] This approach would take into account, among other things, that little may be known about the effect of regulatory reforms, as indicated by the SEC's problems with Section 404.[71]

Humble regulation has several specific elements. First, such

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http://papers.ssrn.com/sol3/papers.cfm?abstract_id=461760 (Oct. 2003)

69 *See* Carrie Johnson, *Trade Groups, Firms Push to Ease Tough Federal Scrutiny*, Wash. Post, January 3, 2005 at A1, available at http://www.washingtonpost.com/wp-dyn/articles/A43168-2005Jan2.html.

70 *See* Ribstein, *Nirvana, supra* note 2.

71 *See supra* subpart IV.E.

regulation would work *with* rather than *instead of* markets by, for example, permitting actors to self-define their certification level[72] or to opt-into regulation.[73]

Second, the law might impose a minimum standard but permit firms to "comply or explain" – that is, opt out of compliance as long as they explain that they are doing so. A potential problem with this approach is that it is easy for the "optional" minimum to become mandatory.

Third, humble regulation would take account of differences among firms and among markets. Thus, regulators should focus on specific problems rather than sweeping in situations that are more amenable to market solutions or can be dealt with under existing law. This is particularly true regarding application of SOX to non-US firms, including those with majority or controlling shareholders that face problems very different from those of dispersed-owner firms that lack strong internal monitors.[74]

Fourth, humble regulation should have sunset provisions. For example, if, as with Enron, disclosure abuses resulted from new devices or practices such as structured finance or derivatives, it is likely that the market will quickly adjust to the innovations. Regulation that lingers past its useful life is particularly likely to have costs exceeding benefits.

In short, the first three years of SOX strongly suggest that it was, at best, an overreaction to Enron and related problems and, at worst, ineffective and unnecessary. Hopefully we can at least learn from the experience.

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[72] See Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916 (1998).

[73] *See* Romano, *supra* note 12 at 1595-97.

[74] *See* Ribstein, *supra* note 47.