NEED TO KNOW

AMERICANS FOR PROSPERITY FOUNDATION

SARBANES-OXLEY

On December 2, 2001 Enron filed for bankruptcy, the largest in U.S. history to that point. The energy company had once been praised as one of the most innovative in the world, but fraudulent accounting methods that hid billions in debt from investors eventually led to its downfall (not to mention numerous criminal prosecutions). The public was outraged, but pressure for lawmakers to act didn't reach its peak until the following summer when WorldCom also collapsed under the weight of massive fraud. Sarbanes-Oxley was Congress's hastily-enacted response.

The Sarbanes-Oxley Act of 2002 (SOX) increases penalties for corporate officers engaged in securities fraud and requires more intensive auditing of public companies to improve accounting statements. Named after Sen. Paul Sarbanes, a Democrat from Maryland, and Rep. Mike Oxley, a Republican from Ohio, the law has been extremely controversial, with complaints from the business community that the law imposes huge costs on the economy with very little benefit of additional fraud protection.

QUICK FACTS

- When the law was passed in 2002, the SEC estimated that complying with just one of the Act's sections (Section 404) would cost companies an average of $91,000 per year. In fact, compliance costs turned out to be many multiples of this – in the range of millions of dollars per company per year (1).

NOTABLE & QUOTABLE

"Sarbanes-Oxley is terrible. It's costing the country a great deal. [It] says to every entrepreneur, 'For God's sake don't innovate. Don't take chances because down will come the hatchet.' "

\- **Milton Friedman** (2)

THE ONEROUS SOX SECTION 404

The most frequent complaints target the Act's Section 404, which requires that each year companies produce a detailed report and an extensive audit on the firm's "internal controls" – processes and protocols in place to prevent fraud, theft, or other accounting misconduct within the company. Managers are held personally liable (and face strict criminal penalties) for any misstatements or mistakes, forcing them to waste an excessive amount of time and resources to ensure that the company's internal controls are flawless down to every last detail.

Obviously this is a distraction for management, turning their focus away from running and growing their business successfully. As the Heritage Foundation's David Addington explains, it also creates a lot of paperwork and an enormous headache. "To acquire and verify the accuracy of information needed to write an assessment of internal controls in an organization of any significant size and, further, to get an auditing firm to attest to that assessment, costs money – lots of it," he writes (3). Such compliance costs fall especially hard on small businesses that lack the resources large corporations have. It may also prevent successful start-ups from accessing the capital they need to grow and create jobs: it is now four times more expensive to "go public" today than it was before SOX's enactment, largely due to costly regulations like Section 404 (4).

Congress hasn't been blind to these concerns; small companies worth up to $75 million were exempted from Section 404 in last year's Dodd-Frank financial regulatory overhaul. But as big as $75 million sounds to you and me, it's still quite small in the corporate world, leaving the costly requirements in place for all but the smallest public companies. The Obama administration's own Council on Jobs and Competitiveness recently recommended increasing that exemption to $1 billion, but proposals to adopt additional exemptions have stalled (5).

OTHER COSTLY PROVISIONS

Other SOX provisions waste company resources performing duplicative audit work, reduce the flow of information and trust in firms, constrain or dis-incentivize managerial risk-taking, and set a “litigation time bomb” that exposes managers to ruinous lawsuits questioning their every move as soon as their company’s share prices go down (6).

These costly new burdens have reduced the competitiveness of U.S. capital markets, one of the greatest strengths of our economy.

SOX is very expensive for American businesses. Some costs are falling as companies get used to the law and its new requirements, but nevertheless a recent SEC survey shows the average public company still spends $2 million every year on Section 404 compliance alone (7). Once you include indirect costs such as risks averted, opportunities missed, and managers’ time wasted, the impact really adds up. One estimate puts the total loss in U.S. market value due to SOX at over $1 trillion (8).

These costly new burdens have reduced the competitiveness of U.S. capital markets – one of our country’s greatest strengths – encouraging innovative new companies to list on exchanges in London and Hong Kong instead of New York. There is clear evidence that the U.S. is losing its standing as the premier destination to build and exchange capital. In 2000, two years prior to SOX, 50 percent of all the funds raised in IPOs worldwide were raised in the U.S. By 2005, three years after SOX, that number declined to only five percent (9). Non-American firms are increasingly de-listing from the NYSE; many public companies already in America are considering going private, all to avoid the law’s hefty compliance costs.

Perhaps this costly intervention would be justified if there were proven benefits of reduced fraud or increased investor protection. But SOX adds little in terms of preventing Enron-style accounting scandals or improving “investor confidence” in the markets – SOX’s failure to prevent the shenanigans at the root of the 2008 financial crisis is a case in point (10). And in any event, Enron’s nefarious managers were thrown in jail using the authority of laws that were already in place well before SOX was enacted.

CONCLUSION

This story is just another example of government rushing to create a new law, instead of properly enforcing the laws already on the books. As former Florida Rep. Tom Feeney explains:

Congress tends to have two speeds—zero and overreact. In the case of Sarbanes-Oxley, we clearly overreacted. And most importantly, I think, Sarbanes-Oxley proves the rule that the unanticipated, unintended consequences of complex legislation are often much, much worse than the positive effects that you intended (11).

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