

The Sarbanes-Oxley Act at a Crossroads

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Lessons from SOX Act and
Perspectives on J-SOX

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Overview

- There has been a sea change in the perception of the efficacy of the Sarbanes-Oxley Act (SOX)
- Paper tries to gauge whether/how SOX will be rolled back by examining media and congressional responses to critiques
- Although SOX proponents are in a defensive mode, multiple veto points in U.S. political process make undoing legislation difficult

Outline of Remarks

- Review four prominent commissioned reports and their critiques of SOX
 - Disproportionately high compliance costs for small firms
 - Adverse impact on U.S. capital markets' competitiveness
- Review media coverage and political responses to SOX critiques
- Conclude with prognosis on SOX's future

Post-SOX Reporting Entities

SEC Advisory Comm. on Smaller Public Companies	SEC chairman established under statute (focus on small firm costs)
Comm. on Capital Market Regulation	Private group associated with Treas. Sec. Paulson (focus on market competitiveness)
McKinsey & Co. study	NYC Mayor Bloomberg and Senator Schumer sponsored (focus on market competitiveness)
Com'n on Regulation of Capital Markets in the 21 st Century	Created by U.S. Chamber of Commerce (focus on market competitiveness)

Evidence on Implementation Costs

- Costs of § 404 compliance considerable and greater than expected despite some decrease over time
 - 2d year average \$900,000 compared to SEC's estimated \$91,000 for compliant firms (SEC Adv. Comm., 2006)
 - External audit fees tripled as % of revenue from .4 to 1.4 over 2000-04 (SEC Adv. Comm., 2006)
 - Threshold firms audit fees doubled from approx. \$370k to \$880k (Iliev, 2007)
- Increase in total director compensation post-SOX
 - Small firms increased from \$2.35 to 3.19; medium firms from \$1.23 to 2.05; and large firms from \$0.25 to 0.32 (per \$1000 sales; from 2001 to 2004) (Linck, Netter & Yang, 2007)
- Overall cost of being public company increased
 - Doubled post-Sox from \$900,000 to \$1.95 million (Block, 2004)

U.S. Market Trends Post-SOX

- Decrease in new foreign listings (Piotroski & Srinivasan, 2007; Doidge et al., 2007)
- Decrease in IPOs (CMR Comm., 2006; Zingales, 2006)
- Increase in going private transactions (Block, 2004; Engel et al., 2004; Kamar et al., 2007)
- Increase in director costs and audit fees (Linck et al., 2007; Iliev, 2007)
- Adverse impact on cross-listed foreign firms (Litvak, 2007; Smith, 2007)

Report Recommendations

Entity	Date	Key Recommendations on § 404
Adv. Comm. Final Report	4/06	Exempt smallest firms (rev < \$125m) entirely and small firms (rev < \$250m) from auditor attestation (78.5% public cos)
CMR Comm. Interim Report	11/06	Revise materiality; increase guidance; rotational testing
McKinsey Study	1/07	Revise materiality; risk-based approach; consider foreign exemption and small firm opt out
CoC Com'n Report	3/07	Incorporate § 404 into 1934 Act (SEC's exemptive power applies)

SEC Response to Reports

- Rejected recommendation to exempt small firms; announced instead review of § 404 implementation to reduce burden and delayed effective date for small and foreign issuers to 2007 (2008 for auditor attestation)
- Chairman Cox also stated there was no need for legislation to revise SOX, problem was implementation, which would be solved by issuing new guidance

SEC Regulatory Responses

- New interpretive guidance for § 404 (5/23/07): risk-based approach to increase flexibility; following guidance creates compliance safe harbor
 - Emphasizes internal controls are responsibility of management
 - Auditors attestation limited to effectiveness of controls and not management's assessment of controls
- Foreign issuers' deregistration eased (Rule 12h-6, effective 6/4/07)
 - US average daily trading volume < 5% (old req. < 300 US shareholders, kept as alternative)
 - Conditions: maintenance of foreign exchange listing for 1 year; having been registered in U.S. for 1 year and having filed 1 annual report; no sale of securities in U.S. preceding 12 months

Why Study Media Responses to Post-SOX Pushback?

- Theoretical and empirical political science literature finds legislators and officials respond to issues whose salience is heightened by media
- To gauge political climate for revising SOX, frequency of coverage of SOX critiques and commissioned reports tracked in national and regional print media from 12/1/04 to 6/10/07

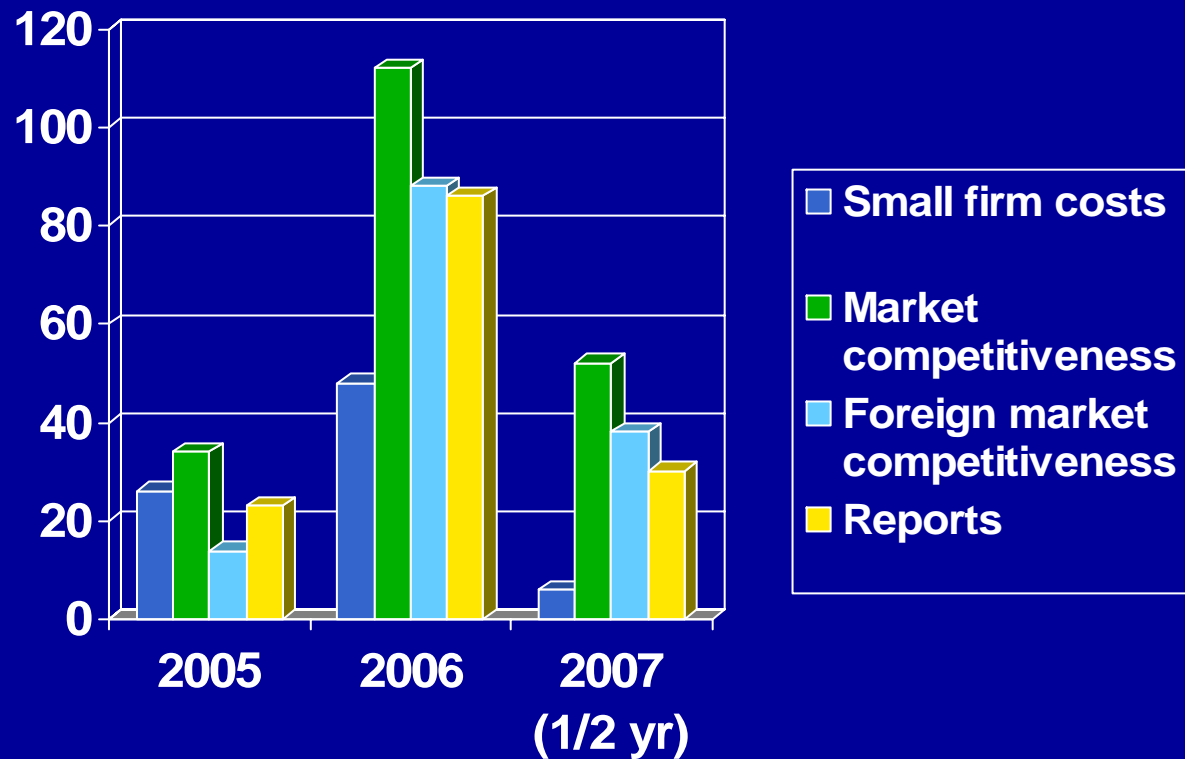
Media Tracked

- National business journalists (1/1/01-6/10/07)
 - Abelson (Barrons), Jenkins (WSJ), Morgenson (NYT), Murray (WSJ), Norris (NYT), Sloan (Newsweek) and WSJ editorial page
- National Newspapers (12/1/04-6/10/07)
 - NYT, WSJ, Washington Post
- Regional Newspapers (12/1/04-6/10/07)
 - Birmingham News, Boston Globe, Houston Chronicle, San Francisco Chronicle
 - Geographical and ideological (*Gentzow & Shapiro, 2007*) diversity

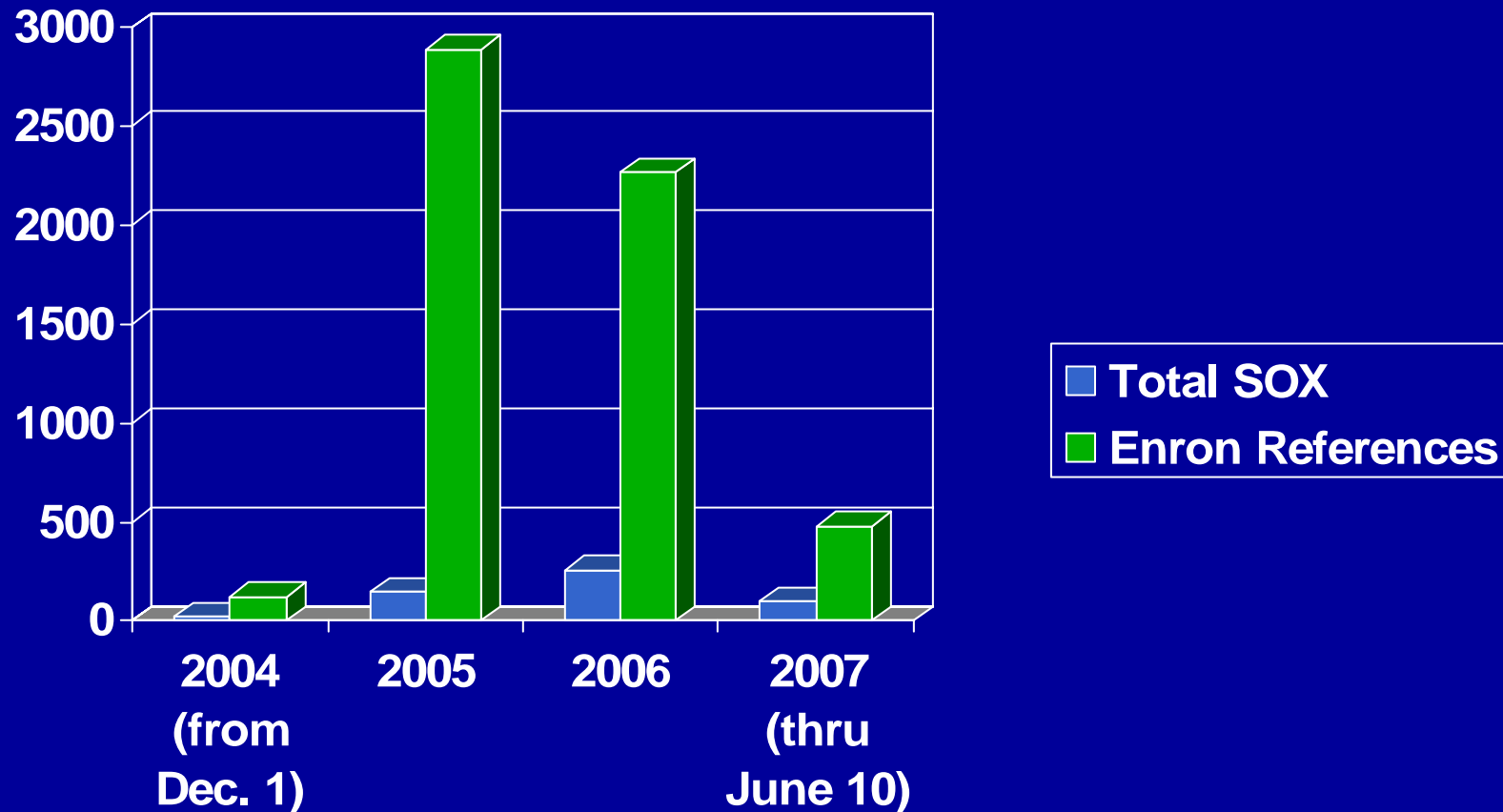
Media Coverage of Post-SOX Pushback

- Coverage Trends
 - Increasing over time
 - But trivial compared to stories referencing Enron
 - Difference in emphasis:
 - National newspapers and journalists pay more attention to market competitiveness than small firm costs
 - Regional newspapers' (and non-NY-based national paper) cover small firms relatively more frequently than national press
 - Similar pattern regarding coverage of commissioned reports
- Import for prognosis: Media impact studies find regional (vs. national) newspapers influence elections
 - Indian states: Besley & Burgess (2002); Brazilian cities: Finan & Ferraz (2007)

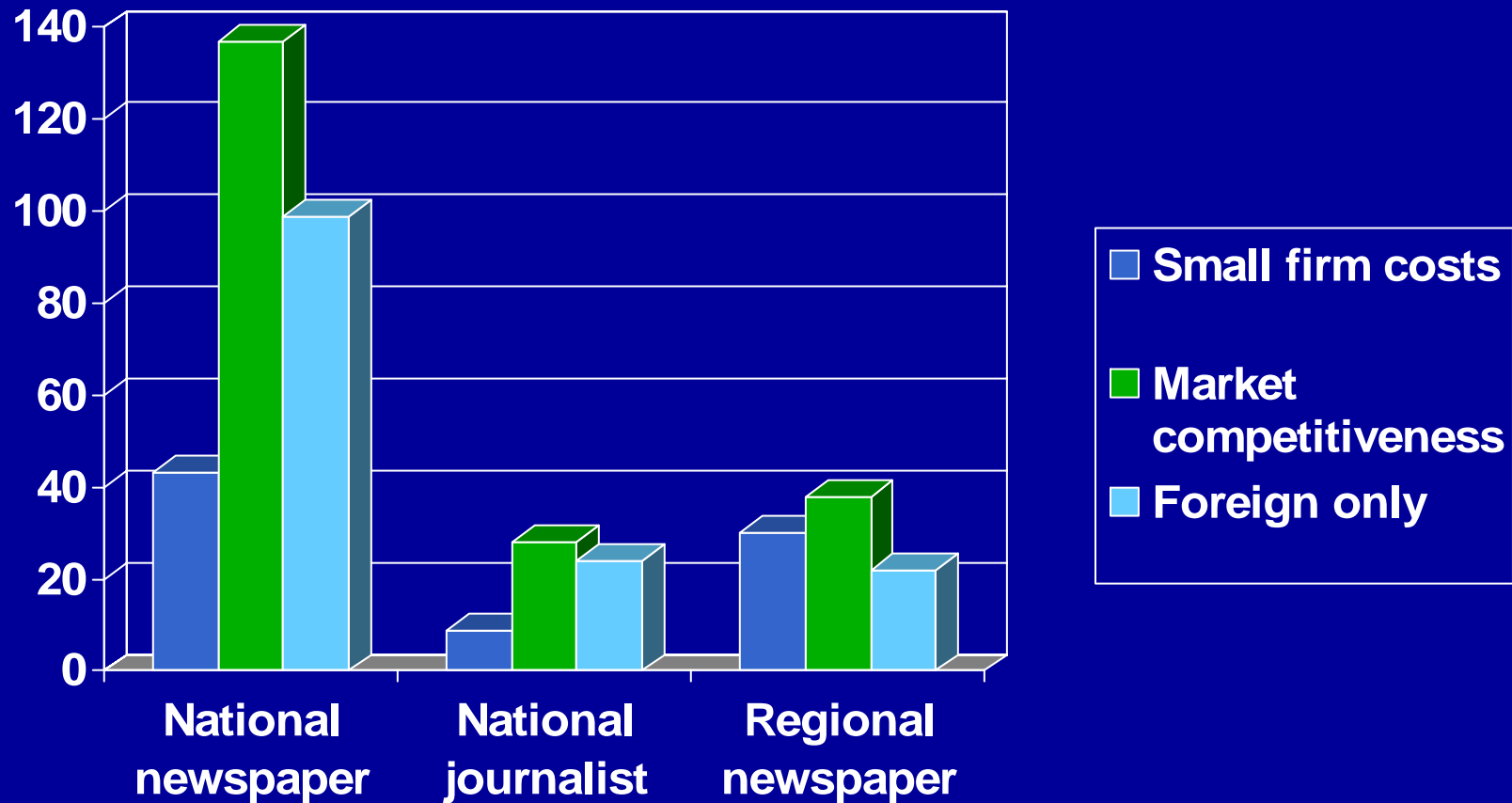
Time Trend in Media Coverage of SOX Critiques



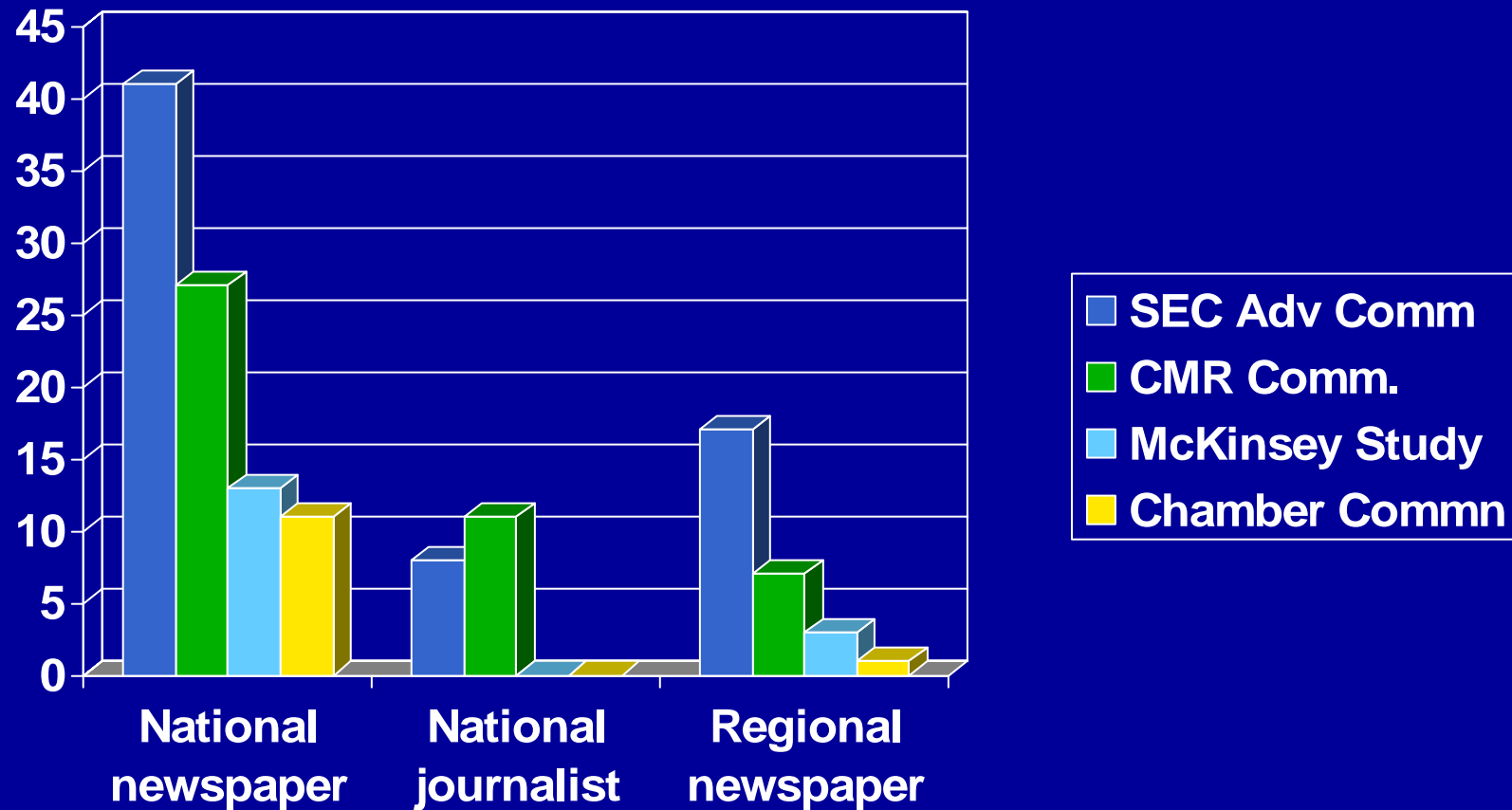
Salience Benchmark: SOX v. Enron



Media Coverage of SOX Critiques



Media Coverage of Reports



Media Coverage

	2004 (Dec.)	2005	2006	2007 (thru 6/10)
Small firm costs: National	2	16	21	4
Small firm costs: Regional	0	7	21	2
Small firm costs: Journalists	0	3	6	0
Market competitiveness (foreign only): National	4 (3)	22 (9)	75 (57)	36 (30)
Market competitiveness (foreign only): Regional	1 (0)	4 (0)	23 (17)	11 (6)
Market competitiveness (foreign only): Journalists	0 (0)	8 (6)	15 (14)	5 (2)
Reports: National	3	16	50	23
Reports: Regional	0	6	19	3
Reports: Journalists	0	1	17	4

Congress Responds

- Activity to loosen SOX's strictures begins 2005, paralleling increased media attention
 - Uptick in bill introductions and hearings criticizing SOX
- Legislators, similar to regional newspapers, are responsive to small firms' concerns
 - Majority of this session's bills directed at small firms
 - Three floor votes on SOX in 2007

Bills to Alter § 404 Introduced 2007

Bill #; date introduced	Short Description (Imp st = implementation standard)	Sponsor Party; # Cosponsor (# Republican)
HR 1049; 2/14	Imp st; reorganize PCAOB	Rep; 20 (20)
HR 1508; 3/13	Imp st; exempt small firms	Dem; 28 (27)
HR 1550; 3/15	Exempt certain financial institutions	Rep; 0 (0)
HR 1780; 3/30	Imp st; special rules for small firms	Rep; 5 (4)
HR 1869; 4/17	Exempt community banks	Dem; 25 (13)
HR 2727; 6/14	Delay imp for small firms	Rep; 52 (48)
S 869; 3/14	Imp st; exempt small firms	Rep; 2 (2)
S. 1405; 5/16	Exempt community banks	Rep; 3(3)

Deregulatory Bills on SOX

Congress	# Bills	# with Republican sponsor	# Cosponsors (# Republicans)
108th (2003-04)	0	0	0
109th (2005-06)	7	7	146 (125)
110th, 1st sess. (through 6/07)	8	6	135 (117)

Hearings on SOX

Congress	# House Hearings	# Senate Hearings
108 th , 1 st sess. (2003)	1	2
108 th , 2 nd sess. (2004)	2	2
109 th , 1 st sess, (2005)	2	1
109 th , 2 nd sess. (2006)	7	1
110 th , 1 st sess. (through June 2007)	3	2

Senate Action on SOX

- Sen. DeMint offers amendment to S. 761 America Competes Act to exempt small firms from § 404 (had sponsored similar bill)
- Sen. Dodd (Banking comm. chair) and Sen. Shelby (ranking member) sponsor amendment that takes priority:
 - Findings on SOX: enhanced governance; SEC found burdens small firms but chairman says legislation unnecessary
 - Sense of Senate: SEC should promulgate final rules implementing § 404

Senate Votes on SOX

- Dodd-Shelby amendment passes 4/24/07 by vote of 97:0
- Sen. Dodd moves to table DeMint amendment, with support of Sen. Shelby; motion passes 62:35
 - 34 (69%) Republicans and 1 Democrat opposed motion
- Dodd-Shelby amendment and motion to table strategy
 - Senators did not want to be on record on the “wrong” side of the issue
- Core of Republican party willing to go on record to roll back chunk of SOX
 - In contrast with other landmark securities laws, legitimacy put in question not just in academic circles but in political arena relatively soon after enactment

- *“A motion to table is a procedural motion. It obfuscates the issue, and it makes possible an explanation by a Senator to his constituents, if he wishes to do so, that his vote was not on the merits of the issue. He can claim that he might have voted this way or that way, if the Senate had voted up or down on the issue itself. But on a procedural motion, he can state he voted to table the amendment, and he can assign any number of reasons therefor, one of which would be that he did so in order that the Senate would get on with its work or about its business.”*

[Comment of Senator Robert Byrd](#)

Analyzing the Senate vote

- Who supported the DeMint amendment?
 - Stronger small firm constituent connection: number of business establishments,* local chambers of commerce
 - Greater electoral concern: term in office, election margin
 - Chamber contributions
 - SOX bill cosponsor*
- Consistent with regional media inference that spark for legislative action will be small firm costs

* Significant in univariate and multivariate analyses

Summary Statistics: Senate Vote

	Republicans against tabling (34)	Republicans for tabling (14)	Democrats for tabling (47)
Ideology	.50	.42	-.42 ^a
Small Bus. Comm.	.18	.21	.17
Banking Comm.	.18	.29	.21
Up for election in 2008	.44	.43	.19 ^b
Years in office	12	18 ^a	16
Electoral Margin	.22	.39 ^a	.23 ^b
Age	63	67	61
Leadership position	.12	0 ^a	.11
# Local chambers	53.7	30 ^a	56 ^a
# Establishments	119,526	48,477 ^a	143,219 ^a
Bill cosponsorship	.47	.07 ^a	0
% Bus. PAC contrib.	.82	.85	.56 ^a
% Sec/Invnt contrib.	.03	.04	.04
\$ Chamber contrib.	\$2588	\$679 ^a	\$651
Chamber contrib.	.5	.21 ^c	.15

Note: a= t-statistic for difference in mean across Republicans or for difference in mean across Republicans and Democrats voting to table, significant at less than 5 percent; b= t-statistic for difference in mean significant at 10 percent

Explaining the Senate Vote

	Senate vote	Senate vote
Ideology	4.1 (4.9)	-
Years in office	.03 (.07)	-.015 (.07)
Age	-.04 (.06)	-.024 (.07)
Small Bus. Comm.	-2.6 (1.6)	-2.6 (1.6)
Banking Comm.	.7 (1.4)	.87 (1.4)
% Bus. PAC contrib	-2.0 (7.9)	-.36 (7.2)
% Sec/Invnt contrib.	-41.4 (45.4)	-55.9 (46.7)
Electoral margin	-.09 (1.9)	-.55 (2.0)
Up for election in 2008	.267 (1.0)	-.24 (.86)
Bill sponsorship	1.7 (.81) ^a	1.9 (.82) ^a
# Establishments	.00004 (.00002) ^a	.0001 (.00002) ^a
# Local chambers	-.02 (.05)	-.04 (.05)
\$ Chamber contrib.	.001 (.0003) ^b	.001(.0003) ^b
Constant	.93 (7.5)	2.4 (7.0)
Number of observations	47	48
Log pseudolikelihood	-16.0	-16.6
Pseudo R2	.4406	.4270

House action on SOX

- Rep. Garrett (R-NJ) offers amendment to FY2008 Appropriations bill for financial services prohibiting SEC from spending funds to implement § 404 for small firms (had sponsored similar bill)
- Amendment approved by vote of 267:154 on June 28, 2007
- Votes in favor: virtually all Republicans (1 no) and 74 (32%) Democrats

Analyzing the House Vote

- Who voted for the Garrett Amendment?
 - Closer small firm constituent connection: small firm business lobby contributions,* small business committee vs. financial services committee membership*
 - Stronger electoral concern: term in office,* electoral margin
 - Ideology: Blue Dog coalition, nominate scores
- * Significant in univariate and multivariate analyses

Summary Statistics : House Vote

	Democrats for (74)	Democrats against (150)	Republicans (193)
Ideology	-.26	-.45 ^a	.52 ^a
Small Bus. Comm.	.12	.05 ^b	.08
Fin. Serv. Comm.	.14	.18	.17
First elected 110 th Cong.	.34	.11 ^a	.06 ^a
First year elected	1999	1995 ^a	1996
Electoral Margin	31%	50% ^a	25% ^b
Age	53	58 ^a	55
Blue Dog Coalition	.46	.09 ^a	n.a.
Leadership position	.01	.09 ^a	.05
% Urban district	.70	.90 ^a	.74
Median income district	\$38,605	\$43,769 ^a	\$44,780 ^a
% Bus. PAC contrib.	.48	.52	.81 ^a
% Sec/Invnt contrib.	.008	.004 ^a	.005
Bus. Assoc. contrib.	.19	.02 ^a	.65 ^a

Note: a= t-statistic for difference in mean across Democrats or for difference in mean across Democrats and Republicans voting for amendment, significant at less than 5 percent; b= t-statistic for difference in mean significant at 10 percent

Explaining the House Vote

	House vote	House vote
Ideology	3.98 (2.50)	-
First elected in 110 th cong.	-	1.43 (.67) ^a
Years in office	-.016 (.04)	-.034 (.04)
Age	-.047 (.03)	-.03 (.02)
Small Bus. Comm.	1.97 (.94) ^a	.30 (.91)
Fin.Serv.Comm.	-1.12 (.72)	-1.12 (.55) ^a
% Bus. PAC contrib	2.58 (1.7)	2.52 (1.5) ^b
% Sec/Invt contrib.	8.13 (12.8)	19.7 (12.8)
Electoral margin	-2.38 (1.3) ^b	-3.34 (1.2)
Leadership position	-2.1 (.75) ^a	-2.5 (.71) ^a
Blue dog coalition	.088 (.74)	.864 (.53)
% Urban district	-2.4 (1.6)	-2.1 (1.1) ^b
Median income district	-.00004 (.00003)	-.0001(.00002) ^a
Bus. Assoc. contrib.	2.08 (.73) ^a	2.4 (.71) ^a
Constant	6.38 (2.1) ^a	4.79 (1.7) ^a
Number of observations	181	223
Log pseudolikelihood	-60.8	-86.7
Pseudo R2	.4192	.3851

Aftermath of House Vote

- SEC Chairman Cox states at House small business committee hearing 12/12/07 that he will propose delaying implementation for small firms while staff undertakes cost-benefit review of section 404
 - SEC noticed proposed one-year delay in Feb. 2008
- Consolidated spending bill enacted 12/19/07 without Garrett amendment

Note on Enacted Spending Bill

- Committee print includes directives:
 - Approves SEC's implementation delay and instructs it to solicit small business views in agency's cost-benefit study of § 404
 - Instructs SEC department to serve as small firm 'ombudsman' to see that their needs are reflected in agency rules
- Nonstatutory oversight common in budget legislation
 - Appropriations committees control, not legislative committees (which were not moving on SOX)

Explaining the Difference across Chamber Votes

- House more attuned to public sentiment given biennial election of all members – consistent with literature on salience
 - Party maintenance of control issue: few Democratic Senate seats up in 2008 vs. many newly elected House Democrats represent swing districts
- Substantive not procedural vote
 - More transparent vote to constituents
- Substance more modest
- Change in circumstance: SEC's completed revision of § 404 guidelines still perceived to be inadequate to reduce small firm costs

Prognosis on SOX's Future

- Difficult to modify financial regulation with widely perceived flaws in decentralized political system with separation of powers, multiple veto points
 - Glass-Steagall Act: took over 60 years to repeal
 - FCPA of 1977: took 11 years to revise (a priority of Reagan administration on taking office in 1981 but not accomplished until 1988)
- Extent of revision of SOX will coincide with extent of Republican control of Congress
- Effect of financial shock ambiguous
 - Dependent on ability to connect to SOX as a cause

Prognosis Given Current Environment

- Most likely change: exemption for small firms from all or part of § 404
- Politically attractive
 - Constituent connection (cf. regional newspaper coverage)
 - Public opinion more supportive of small business
 - SEC guidance not likely to resolve small firm problem

Why Guidance Unlikely to Work

- SEC Adv. Comm.: small firm problem is a function of organizational and operational differences regarding relation between management, operations and internal control systems between small and large firms
 - Decisional authority concentrated in top management
 - Fewer resources, personnel to segregate tasks for internal controls
 - Fluidity and flexibility of processes and tasks shifting with changing business needs as firm grows render SOX compliance difficult (do not have static processes with well-defined boundaries to document in internal control system)

What about Market Competitiveness Concerns?

- Congressional interest exists:
 - Members in key leadership positions from most adversely affected areas
 - Sense of Senate added unanimously to America Competes Act cited McKinsey study and urged regulators not to impose costs disproportionate to benefits, but also to ensure investor protection (but did not refer to SOX)
- SEC initiatives could alter issue space
 - Eliminated US GAAP reconciliation for foreign firms that follow IAS standards (11/07)
 - Roundtable to explore concept of selective mutual recognition (6/07)

Conclusion: Does SOX Have a Future?

- Despite increasing dissatisfaction with SOX, which has seeped into the political arena, it could take considerable time before most serious flaws addressed
 - Checks and balances and separation of powers render political power diffuse, status quo difficult to alter
 - 2008 electoral prospects look dim for Republicans, who are most receptive to regulatory rollback, to regain congressional control
 - Interest in regulatory reform of some influential Northeast Democrats, who represent financial services industry states, is more related to newly proposed SEC initiatives on foreign firms' accounting and regulation than to SOX

Political Dynamics of SOX: Background

- Inputs:
 - Party control split across chambers
 - Widening corporate accounting and self-dealing scandals led to media frenzy
 - Public confidence appears to be declining along with stock market
 - Congressional election year
- Output:
 - Restricted legislative debate
 - Progressively lopsided votes for increased regulation

Comparison to Foreign Corrupt Practices Act (FCPA): Background

- Enacted Dec. 1977; prohibited payments to foreign officials and required keeping of accurate books & records
- Unanimously adopted after high profile series of corporate accounting scandals (foreign bribes from slush accts)
- Stock market not at a low; not an election year
- Not enacted in a hurried atmosphere: 18 months after receipt of SEC report (5/76) that Congress had requested in 1974

FCPA Pushback: Business raises concerns

- Shortly after enacted, concerns voiced
 - Uncertainty of application and cost of accounting provisions
 - Adverse impact on U.S. firms' ability to compete against foreign firms, esp. small firms
- FCPA impact on competitiveness becomes focus of legislative agenda of newly elected Reagan Administration (legislative proposal early 1981)

Lessons from FCPA Experience

- Took a long time to amend
 - Almost 11 years (7 years from initiation of serious effort to revise)
 - SEC Chairman's interpretative guidance stemmed immediate action but in the long run considered insufficient
- Contextual issue: difficult to be in favor of "bribery"