Sarbanes-Oxley: A Review of the Empirical Evidence and a Proposal for Reform

Financial Markets Reform: Taking Stock
A Conference Sponsored by the Federal Reserve Bank of Atlanta

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May 13, 2008

Sarbanes-Oxley (“SOX”)

Enacted in 2002 after flurry of high profile corporate scandals:

October 2001 – Enron
February 2002 – Qwest, Global Crossing
March 2002 -- Worldcom
April 2002 -- Adelphia
May 2002 – CMS Energy, Dynergy, El Paso, Halliburton, Tyco

Passed resoundingly by Congress in summer of 2002

- 99-0 in Senate
- 423-3 in House
- “any bill that goes through congress with that sort of vote cannot be good.”
  Alan Greenspan,

Signed by President Bush, July 30, 2002

SOX is “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt.”
President Bush, July 30, 2002

Major Provisions of SOX

- Increased disclosure requirements for public companies.
- Increased role of independent directors.
- Expanded liability of officers and directors.
- Required companies to assess and disclose adequacy of internal controls.
- Created PCAOB to regulate auditors.
- Prompted SEC and exchanges to adopt new corporate governance rules.

SOX Has Attracted Much Criticism in Recent Years

- "Sarbanes-Oxley has decreased U.S. competitive flexibility … Sarbanes-Oxley is proving unnecessarily burdensome."

  Alan Greenspan (2007)

- "Sarbanes-Oxley says to every entrepreneur, 'for God's sake, don't innovate.'"

  Milton Friedman (2006)

- "Sarbanes-Oxley unleashed batteries of lawyers across the country … [the result is] a huge preoccupation with the dangers and risks of making the slightest mistake."

  William Donaldson (2003)

- "There appears to be a worrisome trend of corporate leaders focusing inordinate time on compliance minutiae rather than innovative strategies for growth, for fear of facing personal financial penalties from overzealous regulators."

  ] Michael Bloomberg and Charles Schumer (2006)

Growing Academic Literature on SOX

- Addresses a number of questions:

  Did the adoption of SOX affect stock prices?

  Has SOX affected incentives of foreign companies to list in the U.S.?

  Has SOX affected corporate risk-taking?

  Has SOX encouraged companies to go private?

- We'll review the evidence from the literature.

A Proposal for Reforming SOX

- Allow companies conducting IPOs to opt out of SOX.
- Allow public companies to opt out of SOX subject to a shareholder vote?

Description of SOX

- 11 Titles, 67 Sections, 66 Pages
- Major Provisions Involve Regulation of:

  Structure of Corporate Boards

  Liability of Officers and Directors

  Companies' Internal Controls

  Auditors of Public Companies

SOX’s Regulation of Corporate Boards

Section 301 – directs SEC to adopt rules prohibiting national exchanges from listing companies that do not have audit committees in compliance with SOX.

audit committees must consist entirely of independent directors

Section 407 – public companies must disclose that at least one member of the audit committee is a “financial expert” as defined by the SEC. If they do not have one, they must explain why.

Change in NYSE and Nasdaq listing standards

independent directors must comprise a majority of the board for companies listed on the NYSE and Nasdaq.

SOX Expands Liability of Officers and Directors

- Section 302 – CEO, CFO must certify financial statements.
- Section 301 -- audit committees must develop procedures for handling complaints about accounting matters.
- Section 401 – increases companies' disclosure requirements regarding off balance sheet items, pro forma data and SPEs.
- Section 402 – restricts extension of personal loans to executives.

SOX Creates New Crimes

- Section 807 – creates criminal liability for knowing violations of securities laws.

  up to 25 years in prison per violation

- Sections 802 and 1102 – create new obstruction of justice crimes related to destruction/tampering of audit/other records.

  up to 20 years in prison per violation

- Section 906 – creates crime for knowingly and/or willfully violating rule related to certification of financial statements.

  up to 10 and 20 years in prison.

SOX Increases Penalties For Violations of Securities Laws

- Section 903 – increases maximum prison sentence for each mail and/or wire fraud violation from 5 to 20 years.
- Section 904 – increases fine associated with ERISA violations by twenty-fold and possible imprisonment from 1 to 10 years.
- Section 304 – CEOs and CFOs must reimburse companies for bonuses, incentive-based compensation, and profits earned on sale of securities if companies are required to restate financials because of misconduct.

SOX's Regulation of Internal Controls

- Section 404 – directs SEC to adopt rules requiring companies to evaluate/disclose effectiveness of internal controls.
- SEC adopted rules in 2003 for "accelerated filers" (i.e., firms with public equity with market value of $75 million (+)).
- Requires reports by management and external auditors.
- SEC guidance in 2007 entails two principles.

  (i) management flexibility

  (ii) greater evaluation/testing of internal controls where the risk of misstatements are higher

  "size, complexity, and organizational structure"

SOX Increases Regulation of Auditors

- Section 101 – creates PCAOB to oversee audits of public companies.
- Section 201 – prohibits auditors of public companies from providing non-audit services.
- Section 203 – prohibits lead audit partner to be someone who performed audit services for the issuer in past 5 years.
- Section 802 – creates criminal liability for auditors for knowing and willful violations of SOX's recordkeeping requirements.

  up to 10 years in prison.

Miscellaneous Provisions of SOX

- Section 307 – minimum standards of professional conduct for lawyers.
- Section 501 – directs SEC/exchanges to adopt rules related to alleged conflicts faced by securities analysts.
- Sections 601-604 – sizeable increase in SEC’s budget and authority.
- Section 806 – defines whistleblower protection for employees of public companies.

Empirical Evidence on the Effect of SOX on Stock Prices

Zhang (2007) – SOX related events had negative effect on companies stock prices.

Li, Pincus, and Rego (2006) and Jain and Rezaee (2006) – SOX related events had positive effect on companies' stock prices.

Chhaochharia and Grinstein (2007) – Stock prices of large firms not in compliance with SOX increased around SOX's passage; those of small firms not in compliance with SOX declined.

Wintoki (2007) – Stock prices of small, young, high growth companies declined around passage of SOX.

Effect of SOX on Stock Prices of Foreign Companies Cross-Listed in the U.S.

- Litvak (2007) – Stock prices of foreign firms cross-listed in the U.S. declined vis-à-vis non cross listed matched firms around key SOX events.
- Zingales (2007), Litvak (2007) – The premium for foreign firms cross-listing in the U.S. declined after SOX.
- Doidge, Karolyi, and Stulz (2007) – The premium for foreign firms cross-listing in the U.S. did not change significantly after SOX.

Effect of SOX on Corprate Risk-Taking

- Graham, Harvey, and Rajgopal (2003) – survey of CFOs finds they believe SOX impairs risk-taking.

- Cohen, Dey, and Lys (2007) – find that CEO pay became less sensitive to performance after SOX. Also find that corporate investments (R&D, capital expenditures, and acquisitions, declined significantly after SOX.

- Bargeron, Lehn, and Zutter (2008) – R&D and capital expenditures of public U.S. companies declined significantly v. public U.K. companies after SOX. Cash holdings by U.S. firms increased significantly v. U.K. firms after SOX. Stock price volatility of U.S. firms declind significantly. Cross-sectional differences are consistent with the view that SOX impairs risk-taking.

Effect of SOX on the Incentive to Go Private

- SOX has “probably been the best thing that’s happened to our business and one of the worst things that’s happened to America.”
  Stephen Schwarzman, chairman, Blackstone

- Engel, Hayes, and Wang (2007) – find increase in going private activity after SOX. Especially large effect on incentives of small firms to go private.

- Leuz, Triantis, and Wang (2007) – “going dark,” not “going private” activity increases significantly after SOX.

- Kamar, Karaca-Mandic, and talley (2005) – small U.S. firms are more likely to be acquired by private versus public companies after SOX as compared with small foreign firms.

- Bartlett (2008) – rate of going private activity has increased since SOX but proportion that remain SEC-reporting companies has remained relatively constant.

Summary of Empirical Evidence

- Overall, mixed results
- Evidence suggests risk-taking has been impaired by SOX.
- Evidence suggests that small firms are adversely affected by SOX.
- At a minimum, evidence seems clear that for some firms, SOX involves more costs than benefits.

A Proposal for Reforming SOX

- SEC/Congress should consider market-based reform.
- Allow companies doing IPOs to opt out of SOX.
- Firms doing IPOs have strong incentives to “get it right.”
- As long as shares are efficiently priced, investors in IPOs are protected.
- Precedence with respect to multiple classes of stock with different voting rights.
- Would provide regulators with important information about efficacy of SOX.
- Allow public companies to opt out of SOX with requisite shareholder vote?