Punishing the Innocent: The Sarbanes-Oxley Act

BY BARBARA HUNTER

If any person or any group had set itself the task of creating a law whose purpose was to destroy the American free-enterprise system, it could not have done a better job than what has been produced by the Sarbanes-Oxley Act of 2002. The law is predicated on the principle that all companies are inherently evil and untrustworthy and thus must be governed from above by benevolent bureaucrats with both dictatorial and second-guessing powers.

What brought on this draconian law? In all likelihood, anyone born before 2000 who has been living in anything other than a deep cave is familiar with the name Enron, which is emblematic of corrupt corporate dealing and disastrous losses to employees and stockholders. It is significant, however, that the fraudulent acts of the principals of that company were prosecuted under existing law and within the then-existing rules of the public stock exchanges. It follows that new laws were not in fact necessary either for punishment of the malefactors or for prevention of further criminal acts. What was needed, however, at least from the view of members of Congress, was some evidence of their "doing something"; that is, not a legal solution but a political solution.

What then has Sarbanes-Oxley accomplished? So far, the history of the law has been an endless list of compliance requirements that (with few exceptions) have been of no productive benefit but that have inflicted enormous losses on the affected companies both in dollars and time.

Sarbanes-Oxley imposes such draconian demands that everybody's money is affected—including yours. The full text of the law essentially turns much of the nation's corporate governance on its head. Its effect is to place a new government agency—the Public Company Accounting Oversight Board (PCAOB)—in charge of the financial, accounting, reporting, procedural, and security operations of every corporation registered with the Securities and Exchange Commission (SEC). The Board is authorized in effect to look over every corporation's shoulder, decide whether the firm "complies" with the Board's own interpretations of law, and even punish the principals (such as the chief operating officer, chief financial officer, and chief information officer) with fines and, incredibly, incarceration for such infractions as failure of sufficient supervision. As noted in a "white paper" (informational document) prepared for a prominent software company, Sarbanes-Oxley "significantly increases penalties . . . with maximum jail terms that now exceed the penalties for crimes such as armed robbery, assault with a deadly weapon and negligent homicide."

Congress can pass laws pretty much at will, with little concern for the associated costs on those who must comply. It should come as no surprise that former government employees are valued, even sought after, by companies forced to deal with the new bureaucracy. For many companies, compliance skills now trump an understanding of corporate goals.

Sarbanes-Oxley empowers the Board with the most authoritarian powers imaginable. It can conduct investigations and disciplinary proceedings at will and can impose fines and otherwise discipline companies and the accounting firms they employ. In effect, it is prosecutor,

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judge, jury, and executioner. The notorious Section 404 requires that any "process" that could in any way affect financial results be audited and reported and, further, that the chief executive of the company must personally accept responsibility for the accuracy of all reports, under penalty of up to 20 years in prison. Exhaustive procedures required have entailed thousands of hours of work and expenditures in the billions of dollars. Because these requirements affect all publicly traded corporations, large and small, the law has had the perverse result of according large companies an unfair advantage over their smaller rivals, which must devote a larger percentage of their time, money, and human assets to obeying the law.

To add insult to injury, the Board is permitted to make any changes it wishes, which places companies in the position of forever trying to hit a moving target. The changes issued last November, eliminating some of the minutely detailed auditing requisites, were widely hailed as good news. Unfortunately, this does not take into account that both the companies and the auditing firms had already instituted these procedures at enormous cost in money and computer-design talent, and thus would be unlikely to expend even more of the same to undo these efforts. (This is explained further below.)

The law prohibits auditors from providing any other services, such as bookkeeping, financial information-systems design and implementation, appraisal or valuation services, fairness opinions, or other advisory services. The result is that auditors must report whatever may be amiss but are forbidden to advise the company how to correct it and thereby comply. Also thanks to the new law, audit continuity will be a thing of the past, because an accounting firm can provide audit services for no more than five years. And in a provision that sets up the Board as final arbiter of corporate America, it is authorized to prohibit national securities exchanges and associations from listing any stock from a corporation that fails to meet its audit rules.

According to the Board's rules, every e-mail and even every instant message must be preserved permanently, giving rise to a whole new industry offering products (both hardware and software) that can store almost inconceivable quantities of data. One effect is likely to be that more communications, especially simple questions or comments, will be made by telephone or in person. The perverse effect is to make information less available.

Field Day for Law Firms

Sarbanes-Oxley has contributed mightily to the demand for lawyers at all levels of government, as well as for legal assistance for the companies themselves. To make things even worse, the stock exchanges (NYSE, ASE, and NASDAQ), at the behest of Sarbanes-Oxley, have mandated that the majority of company directors be "independent"; that is, directors can have no material relation to the firm itself, either directly or indirectly, within the previous five years. It appears the requirement for director independence would exclude anyone who knows anything about the company.

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The accounting firms that haven't already been sued out of existence have more work than they can handle. However, the law is certainly doing corporations, and by implication their shareholders, no favors. The now-overburdened larger accounting firms can cherry-pick the most lucrative clients, leaving the other companies to find whatever they can among the second-string firms.

If Sarbanes-Oxley has been difficult for publicly listed companies, it has been positively sunshiny for consultants and producers of software dealing with sales, financial reporting, and document storage. It is all but impossible for corporations to comply with the various rules, or even to determine whether they have complied, without the purchase of pricey software. Trade publications and websites are replete with advertisements for products to assist in both complying and testing compliance. Consulting services have been raking in abundant revenue based in part on the sheer difficulty of knowing how to meet requirements.

In addition to the quandary faced in locating independent auditors, the hefty filing fees embodied in the new law, similar to the other expenses detailed above, have hit small companies especially hard.

The hope that the law's requirements would eventually provide payback in more effective company management once the initial measures were put in place has been illusive for most firms. This effort and expense is especially galling to the majority of companies, which have striven throughout their existence to maintain the highest standards of business ethics. For them Sarbanes-Oxley has been an endless series of repetitions of what they already knew and were already doing in principle, if not in precise form.

But the costs are tremendous. According to CNNMoney.com last year: "A recent study conducted by the Securities Industry Association estimated that the cost of compliance has nearly doubled in the past three years to an estimated annual total of more than $25 billion in 2005, up from $13 billion in 2002." Note that the costs were supposed to go *down* with time.

The law's toll on time, talent, and productivity has affected virtually every publicly listed company. It isn't bad enough that the actual productive activities of companies have been delayed to the detriment of both profitability and competitive advantage. Once they actually get started on the postponed work, the Sarbanes-Oxley hammer is wielded anew. Company projects, especially those involving information technology and other computer-related activity, must now document the same type of internal controls as are mandated for the company as a whole. The effect on project life-cycles in many cases has been little short of disastrous with regard to meeting deadlines, which are the heart of profitability.

Effects of the Data-Retention Rules

The requirements of retaining all data (every change, every correction, every previous version) in unerasable form has created an information behemoth that is not only massively expensive to create and run, but is also far more difficult to search and otherwise use than anything required heretofore. If one multiplies the size of such documentation by the number of companies affected by the law, it becomes evident that no matter how massive a bureaucracy may be created, there is close to zero possibility that any of this will benefit companies, shareholders, or the public.

With Sarbanes-Oxley bureaucrats watching everyone in corporate America, there can be no doubt that companies are practicing defensive management. The chairman of a large software house has commented, "We might have killed the goose that lays the golden egg. . . . You're mitigating every possible risk that can be conceived. Risk didn't use to be a bad thing." This person has suggested that, as a result, the biggest opportunities for private equity companies over the next ten years will be in China and India.

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In light of the foregoing, it may seem attractive for publicly listed companies simply to go private, and in fact the rush to do so has become a torrent—almost 200 companies as of mid-2005. However, it may not be either as simple or as helpful as it might seem. There is a significant possibility that even privately held companies may come within the Sarbanes-Oxley sway in the future. While on the surface this may seem remote, it should be borne in mind that all incorporated companies are subject to many state and federal laws, not just publicly listed ones. In this case, the PCAOB has been delegated enormous powers by Congress, and at least so far, most of those powers have not been challenged either for legality or constitutionality.

In 2004 the full force of the law took effect for foreign firms listed on U.S. exchanges, and the result has been an unmitigated disaster. Bearing in mind that other countries, as well as the EU, already have their own requirements, Sarbanes-Oxley has only heaped more burdens on the backs of foreign entities. According to the law, a foreign company listed on a U.S. exchange must meet all the Sarbanes-Oxley requirements if its shareholders include at least 300 Americans (even if they are merely invested indirectly through funds). Thus we see the phenomenon of U.S. law being enforceable on non-U.S. companies. As noted in a French-language paper directed to U.S. readers:

> The largest European conglomerates want to leave Wall Street but are having a hard time making this move happen. The French Association of Privatized Industry, a powerful group of corporate heads, has just joined their German, British, Greek, Dutch, Italian, Austrian, Swiss and Polish counterparts in an effort to persuade the Securities and Exchange Commission (SEC), the federal regulatory agency of the American securities market, to liberate them. . . . In other words, these corporations are trapped, held captive by their American shareholders, whose interest is protected above all else. As of 2002, or more specifically, since the Sarbanes-Oxley Law was passed . . ., this law has become increasingly repressive and costly to foreign owned companies.

It is indeed sad that foreign firms now view the U.S. financial markets, which were once the shining example of freedom and opportunity in the world, as something from which to be "liberate[d]," "allowed to leave," but are "trapped," "held captive" by "repressive" U.S. laws. How far we have come! Some foreign firms have already decided to do the obvious: They are buying out U.S. shareholders.

The other effect of the demands on foreign firms (which certainly should have been understood and anticipated) is that their new listings on U.S. exchanges have been reduced almost to zero. As a *Wall Street Journal* editorial succinctly expressed it: "In 2000, nine out of every 10 dollars raised by foreign companies through new stock offerings were done in the U.S. . . . [L]ast year [2005] not one of the top 10 initial public offerings (IPOs) measured by market capitalization was registered in a U.S. market."

Is There Hope for Meaningful Change?

What has Sarbanes-Oxley accomplished? The answer is that it is just what would be expected of a law that was thrown together in great haste in order to "do something" about corporate malfeasance. Everyone pays the price, although, as noted, the price is larger for some.

By the usual standards by which the federal bureaucracy is judged, we might be tempted to throw in the towel and live with whatever Sarbanes-Oxley sends our way. There is, however, one faint ray of light: a legal challenge to the PCAOB from a Washington D.C.-based lobbying group that has joined with a small Nevada-based accounting firm. The basis of the suit is that the Board has government-like powers, such as the ability to levy fines, but little oversight by the government and thus is a violation of the Constitution's separation-of-powers clause.

It is also possible (though not likely) that the powers that be in Congress will realize that Sarbanes-Oxley has been one giant mistake brought about by misguided notions of where such qualities as honesty and ethics come from and will revisit the law and its reason for existing. It makes sense, but don't hold your breath.

The full extent of the destructiveness of this law may not be known for years. However, there is no denying that the bloom of creative possibilities has been replaced by the blight of endless fears of compliance violations. Will the Law of Unintended Consequences eventually be recognized and the effects ameliorated? Only time will tell.