Talking Points

• Congress passed the 2002 Sarbanes-Oxley law in response to Enron and other Wall Street scandals. The complex legislation has generated unanticipated negative consequences in its attempt to clean up accounting and reporting practices.

• For example, the law mandates external audits on top of corporations’ internal audits. However, it fails to give bright-line guidance on what are good and bad accounting standards while at the same time imposing both civil and criminal penalties for wrongdoing—a Catch-22 for firms.

• The cost to the U.S. economy is enormous: $35 billion in direct costs and up to $1.4 trillion in indirect costs. Corporations mired in the Sarbanes-Oxley regulatory morass have less resources to produce goods and services that add value to the economy.

• The legislation also hits America’s lead in capital markets. London advertises itself as a “Sarbanes-Oxley–free zone.” And already numerous companies have either dropped their U.S. registration or have simply listed their companies overseas.

THE HONORABLE TOM FEENEY: As Milton Friedman said, often a congressional solution is worse than the problem. That’s another one of those truisms that has been proved by Sarbanes-Oxley. Another one is that 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.

Sarbanes-Oxley was a response by Congress to some serious scandals on Wall Street. In WorldCom, Enron, Global Crossing, and a couple other instances, a small number of executives were acting primarily for their own interests, as opposed to on behalf of the interests of shareholders. And in at least one case—Arthur Andersen, one of the Big Five accounting firms—there were some accountants that either were intentionally complicit or, more likely, sort of turning the other way in order to make their client happy. The result was some serious shenanigans by these different companies.

I would point out that Enron is the most recent one to come to trial. There were plenty of laws in place that ensured that members of boards of directors and officers of corporations acted in the best interest of shareholders and could not lie to people who were potential sellers or purchasers of their shares. There are very serious laws in effect, and in fact, we had 25 different convictions of Enron executives recently—all under laws that were in place before Sarbanes-Oxley.
Sarbanes-Oxley is about 66 pages long. I’m not really complaining much about Sections 1 through 403, which concern having corporations go through their processes for procurement to make sure that they have things in line, having corporations look at conflict of interest issues. One of the things we do to compensate executives and members of the board is to give them stock options, which creates some incentives, candidly, to artificially inflate prices of stock in the short run so there can be a big killing when the option is sold. That’s not necessarily in the long-term interest of the corporation, doing well for its shareholders, and ultimately for the American economy.

There were a lot of things about the conflict of interest—the corporate governance structures—that I think Sarbanes-Oxley has shined a light on just like the scandals themselves did, and corporations that have gone through Sarbanes-Oxley compliance tell us that there are some benefits to what they’ve done.

Then we get to Section 404. It’s only 168 words long. I’m not sure that 168 words have ever created so much mischief and counter-productivity in the American economy as these 168 words. Frankly, it’s not all Congress’s fault. (I wasn’t there at the time, so I’m not defending or killing the language of the bill.) Much of the problem is because of the way Sarbanes-Oxley has been implemented in Section 404. Section 404, essentially, requires not just an internal audit but an external audit. And Section 404, as implemented, has not given us any bright-line suggestions about what are good accounting standards and what are bad accounting standards. We don’t know what a de minimis error is, so that some accountants, for example, have looked at the newspaper subscriptions for the officers in a $2 billion or $5 billion company. We’re talking about $70 or $100 or $150 a year for newspapers in a $2 billion company, and that has generated reviews that will cost hundreds of thousands of dollars. Procurement decisions on a very minor level have triggered these things. Why is this?

You have a confluence of problems with the way Section 404 has been implemented by the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission (SEC), which the PCAOB reports to. The basic problem is that on the one hand, you’ve got total ambiguity—nobody knows what a problem is in today’s accounting world in 404 compliance. And on the other hand, after Sarbanes-Oxley we have imposed not just civil but criminal penalties on everybody involved in the process. If you’re an executive officer, a CFO, a CEO, or if you’re a member of the board of directors, the internal accountants who work for your company and give you advice about how to comply are not just civilly responsible, but they can go to jail if they make an error. We don’t know whether one box of paper clips is enough to send you to jail or to get you sued in a serious way.

On top of that you have external audit requirements. It’s totally redundant. We already require all of the officers and directors to swear their lives away; this is the equivalent of putting your neck and reputation in a guillotine. If you make a mistake as a CFO, a CEO, a director member, or internal auditor, you are civilly and potentially criminally liable. On top of all that, we now require, for the first time, a total separate accounting each and every year to be done by an outside auditor.

Now, there are a couple of problems with that. There are only four of these companies left that are able and willing to do the work. If you are Pepsi and you have to have an internal auditor and an external auditor, two separate companies, and Coke already has two wrapped up, presumably Pepsi doesn’t want its major competitor to be sharing the same auditors of all of their business practices and procurement policies. So, you’ve created this sort of quadropoly, I guess: four firms that are able to seek monopoly rents because they’re the only game in town willing and able to do this work.

Additionally, the outside auditors have interpreted their role to mean that they cannot tell the company whether it is complying with the law. So, you have to pay hundreds of thousands of dollars to these external auditors and they can’t tell you whether you’re complying or not. It’s sort of like having a teacher who is going to give you a very tough grade at the end of the year but isn’t allowed to teach you anything during the course of the year. You’ve got to go figure out what the test is. That’s exactly the way the external auditors have interpreted a 404 compliance.

Now, what’s the problem? What is the issue here? The issue is that the SEC, when this bill was being
considered, had calculated that the average company forced to comply would spend about $91,000, for a total cost in the American economy of about $1.2 billion. In fact, the total cost has been more like $35 billion of direct costs of compliance. It's been almost 30 times what the estimated costs were to comply.

On top of that, the direct costs are really the minor part of the problem. Milton Friedman, my favorite living economist, says that the biggest single factor in impeding economic growth in America today, at least from a regulatory scheme, is Sarbanes-Oxley. The fact of the matter is that we've got some of our best and brightest people spending all their time working with accountants and lawyers trying to figure out how to stay out of jail and comply with Section 404, and we have no definition of when you're complying or not. And they are not spending time building better-designed widgets, or marketing widgets, or producing goods and services that will increase the value of the American economy.

We have one estimate of the total indirect costs of Sarbanes-Oxley at somewhere between $1.1 trillion and $1.4 trillion; the American Enterprise Institute printed a study done by some professors that wrote a book referring to this. If this particular economist is anywhere close to right, this amounts to about an 8 or 9 percent regulatory tax on every good and service produced in the American economy. It's an enormous self-inflicted wound in terms of the cost, and it was totally unanticipated.

Nothing is more liquid in our world—other than air and water—than capital. It goes where it thinks it can get the best return. Investors make decisions in a very flat world all the time about where they think they can get the safest and/or best return on their profits.

So, how has capital reacted? Well, I would say this: We are outsourcing America's 100-year lead in capital formation. J.P. Morgan and others started moving their main offices from London to the United States in the early part of the 20th century. They're starting to move back, and it's not just them moving back: The New York Stock Exchange has purchased a London-based exchange so that it can send its new customers to London to avoid Sarbanes-Oxley. The NASDAQ is undergoing a purchase right now. At the time Sarbanes-Oxley was passed, 9 out of every 10 dollars raised by foreign entrepreneurs in a new, initial public offering was raised in the United States. Last year, just four years later, 90 percent of capital for new foreign companies was raised in foreign markets.

The London Stock Exchange has had over 31 different presentations for American entrepreneurs who are considering going public, or for investors, where they brag on every page of their brochure that they are Sarbanes-Oxley–free. Their biggest selling point is that you don't have to live with this terrible, onerous burden if you come to London. This is true in Hong Kong, in Shanghai, in Luxembourg, and in other exchanges. We started out in about the year 2001 in America raising 48 percent of the public capital in our country. We're down to 40 percent as of a year ago. My guess is we're going to 35 percent or 30 percent. We are outsourcing America's lead in world capital markets.

Now, maybe that's not a concern. A lot of investors, candidly, can get on the Internet as we become a flatter world and can invest in stocks in the London or the Shanghai stock exchange. You can start a bank account with Citibank and tonight, after drinking a bottle of whiskey, if you want to, you can be gambling on the price of pork bellies on the Shanghai market. So, the notion that, in the world we live in, you can protect investors from themselves is a very ancient, obsolete notion, but that's exactly the only benefit that Section 404 was designed to give us.

In addition to outsourcing our capital lead to foreign countries, there is a dramatic increase in private equity. New companies that are growing up hit the $100–150 million level and they're deciding that they want to go to private investors to raise their capital. That's not the best and most efficient way to raise capital, so there's a cost to the business. They're going to grow relatively slower than if they could have access to public markets. But more importantly for me, individual investors that I represent will not have a chance to invest in the next Dell or the next Microsoft. There's a good chance that Dell, for example, would not have ever gone public if they had had to live with section 404. They either would have gone overseas or they would have gone private. There are a lot of public companies—20 percent
according to a study by Foley and Lardner—that are now public that are considering de-listing from the exchange, going totally private. American investors will not have an opportunity to get in on the ground floor with these companies. For example, the Vermont Teddy Bear Company: unanimously their board decided to de-list because of the increasingly complex and costly public company requirements, according to the company’s Chief Executive. Toys "R" Us and AMC Entertainment, are companies that have de-listed, and I suspect that a lot of this is due to the onerous and unnecessary parts of Section 404.

What does my bill do to try to preserve what’s good about Sarbanes-Oxley and to try to rectify the problems? Number one, we say that companies with less than $700 million in market capitalization have to disclose whether they comply with Section 404 or not, but they do not have to comply with 404. Now, they’re still subject to the criminal penalties. All the officers, the directors, the internal auditors can still go to jail, but they don’t have to have this redundant annual audit when they’ve already done one in-house.

Secondly, we require that we get a definition of a de minimis accounting error. Historically, a major error that would appropriately draw the ire of your auditors was considered something that affected more than 5 percent of your gross profits for the year. Tracking down magazine subscriptions or every last box of paper clips on the planet is not a useful way to spend hundreds of thousands of dollars worth of accountants’ and lawyers’ time. So, we do require a de minimis standard that would be closer to the 5 percent of gross profits. That’s what investors really care about and need to know, rather than having their investment dollars spent on wasteful and redundant audits.

Thirdly, we allow the external audits for major companies to be done by a more random process. We let each of the stock exchanges say that maybe every third year, or every fifth year, randomly, companies will be subject to audits as long as not less than 10 percent of all the companies listed from their exchange would undergo one of these redundant external audits.

There are other important parts of this. We look at the European principles-based as opposed to rules-based accounting principles. It’s sort of a related but separate issue, and these are just some of things that we think are really good. We also allow your external auditor, who is supposed to be ensuring that you comply with the law, to tell you how to do it, as opposed to just sitting back and basically giving you a failing grade at the end.

Finally, on a collateral note, I also serve on the Judiciary Committee. The Attorney General has allowed his independent prosecutors in different regions to come up with policies. When they do an investigation of a corporation, there’s a question about whether or not the corporation has to waive attorney-client privilege. Now, unless you are an attorney or somebody who’s undergone a legal process, you may not appreciate how important the attorney-client privilege is. It doesn’t belong to the lawyer, it belongs to the client. The problem with that is if a corporation wants to be helpful to the Justice Department, which is doing the investigation, they are required right off the bat to basically waive every bit of confidential information that they have given to lawyers or that lawyers have given back to them. What this means as a practical matter is that if you’re asked to serve on a board of directors under Section 404 today and you are, in good faith, trying to comply with all of the laws of the country, you can’t talk to your auditor about the accounting laws, and you can’t talk to your attorneys in confidence because you know one day everything you say in confidence may and probably will be held against you.

We have created a real Catch-22 for members of boards who are really trying to do the right thing. With that, thanks for having me.

—The Honorable Tom Feeney, a Republican, represents the 24th District of Florida in the U.S. House of Representatives. He serves on the Judiciary, Science and Technology, and Financial Services Committees.

DAVID C. JOHN: My grandmother used to have a wide variety of old sayings that she would trot out at any possible time. One of her favorites was “Act in haste, repent at leisure.” And we are definitely in the “repent” stage of Sarbanes-Oxley right now.

What the Congressman has suggested is the least we can do. But it’s also absolutely essential to get
done sooner—very soon, actually—rather than lat-
er. The reasons are fairly clear. As the Congressman
mentioned, the New York Stock Exchange has an
agreement in principle to buy something called
“Euronext,” which is an interesting name for the
Paris, Brussels, Amsterdam, and Lisbon stock
exchanges. The NASDAQ has a 25 percent stake,
the largest stake, in the London Stock Exchange,
and once they clear their regulatory obstacles—
probably sometime in August or early September—
they will be able to make a bid to completely take
control over the London Stock Exchange.

This is the first wave of a major change. SEC
Commissioner Paul Atkins was asked on June 15
whether he thought that this was evidence that
companies were going to be leaving the United
States, and whether companies are leaving the SEC's
jurisdiction in order to avoid Sarbanes-Oxley, and
similar regulations. And he said that he was worried
by the empirical evidence but he didn't think that
was happening as yet.

Ironically, two days earlier in London's Daily Tele-
graph, Damian Reese, who is a columnist in the
business section and is very pro-business and gen-
erally pro-American, had this to say:

“They like us because we're not Americans.”
I hear this a lot these days. Americans seem
to have become riskier people to do business
with. Many of them will be surprised by that
view from over here, but the risks come not
from business but from Congress and its
agencies. The over-zealous political and reg-
ulatory reaction to the Enron scandal was the
onerous Sarbanes-Oxley legislation. It has
made American Stock Exchanges, the key
capital raising entity in any free market econ-
omy, a more expensive and difficult place to
do business. That is the big reason why U.S.
exchange operators are headed here. But if
LSE or Euronext is bought by Americans,
then won’t we become subject to a worse
regulatory regime?

And this is a question that was raised very heavily
across London at that point. It was so important to
the U.K. business community that both the chief
regulator of the financial services industry in Lon-
don and the number two elected official who serves
at the U.K. Treasury had to come out and explicitly
say, “No, foreign ownership of the London Stock
Exchange does not automatically mean that either
the London Stock Exchange or Euronext would be
subject to Sarbanes-Oxley.”

Now, there’s a little further evidence. In 2005,
the London Stock Exchange had 129 new foreign
listings. The New York Stock Exchange had six,
NASDAQ had 14. Nineteen of the London Stock
Exchange listings came from the U.S. Those were
companies who dropped their U.S. registration and
listed in London only.

A friend of mine who works for one of the big
financial services companies in London, a company
that listed very proudly on the New York Stock
Exchange a few years ago, said that if they had to
make the decision over again, they would not regis-
ter in the U.S. As a matter of fact, they would seri-
ously consider fixing it so that their stock would
never trade in the United States. Now the SEC could
deal with this problem, but they haven’t. The staff is
very powerful, and if you look at their activities you
can have no real comfort that the current staff is
going to do anything, necessarily, to lighten the reg-
ulatory load.

The Advisory Committee recommended earlier
this year exempting companies with less than $128
million in equity and $125 million in revenue com-
pletely from Section 404. For companies between
$128 million and $787 million in capital, but less
than $10 million in annual product revenue, Sec-
 tion 404 would be optional. The SEC staff promptly
pointed out that those parameters include 80 per-
cent of publicly traded companies. What they didn’t
tell you is that it represents 6 percent of market cap-
italization. So, under what the Advisory Committee
recommended, 94 percent of equity capitalization
would still be subject to Section 404. But the SEC
has chosen not to go down that line.

The fact is that Congress is probably going to have
to act on Section 404, and as I say, sooner rather than
later. There is another problem with Sarbanes-
Oxley that may force Congress to act even sooner,
and it is that the structure of the Public Company
Accounting Oversight Board is of questionable con-
stitutionality. The issue is before the Courts now.
And because Sarbanes-Oxley has no severability
clause, in the event that the courts find that the PCAOB is illegally constituted, all of Sarbanes-Oxley disappears. That's not necessarily bad news. However, the court will probably give Congress a period of time to deal with the issue. If Congress has to deal with the structure of PCAOB and has not already passed the Feeney-DeMint legislation, the least that they could do is to include Feeney-DeMint in any bill that fixes the PCAOB structure.

There are other things that they need to do that I won't mention in any detail, but the fact is that Sarbanes-Oxley over-criminalizes consenting economic acts between adults. It is likely to cause an amazing amount of litigation during the next downturn when lawyers will claim that regardless of what type of disclosure the company made, the true risks of a stock were not properly noted. And there are a variety of other things. One of the biggest worries I have is that a future Congress, controlled by a different group of people, may decide that they should “improve” the way financial institutions are regulated and place regulators within the company. Years ago, I worked for Chase Manhattan, and at that point we had representatives from every bank regulatory agency, and frankly, from some of the foreign regulatory agencies who worked in the bank full-time. They didn't exactly look over our shoulders at every available opportunity, but they sure tried.

So, in conclusion, the Feeney-DeMint Bill is an essential first step. It will fix much of what is wrong with Sarbanes-Oxley. There's probably more to do, but that legislation is the crucial change that is needed. We have our choice of either doing this and doing it quickly, or when people graduate from school with top-ranked MBAs, they can look forward to living and working in London for most of their careers. Thank you.


ALEX J. POLLOCK: Thanks to Heritage for having me over; thank you, ladies and gentlemen, for your interest in this extremely important topic; and especially thanks to you, Congressman Feeney, for your thoughtful leadership in addressing this burden on the productivity of American business and the success of American capital markets.

That thanks is both on behalf of the country as a whole, for which this is a key issue, and also personally, from somebody who has signed accounting statements and who knows how debatable accounting rules are, and how subject to all kinds of different interpretations.

John Maynard Keynes is not my favorite economist, but he did say something really intelligent: “When I discover that I have made a mistake, I change my mind.” It's pretty clear that the implementation of Section 404 of Sarbanes-Oxley has been a mistake; in fact, there's no doubt about it. So, what do we, as a country, do and what should the Congress, do? Well, how about changing our minds and fixing the mistake?

Section 404 is like the accounting standards I just referred to—it could have been interpreted in a lot of different ways. It was interpreted first by the SEC, then by the PCAOB, and finally by the assistant regulators, the accounting firms, in the most inefficient, unproductive, and expensive way possible. One of the problems here—and we've touched on the accounting firms and the “quadrupoly” (I think it's a very good coinage, by the way, Congressman)—is the combination of fear and profit. On the one hand, the accounting firms had just seen one of their brethren, Arthur Andersen, destroyed as part of these scandals, and they were under a lot of pressure. So there's a great fear not to make a mistake, but there was equally a great profit opportunity for the accounting firms, because the more burdensome, the more expensive they made all of the Section 404 implementation, the more profitable the accounting firms became. So, it was a very unfortunate combination of driving incentives. The SEC and the PCAOB have both sharply criticized the accounting firms for this behavior, and rightly so, but they haven't—either the SEC or the PCAOB—themselves directly admitted to their share in causing this mistake, which now we need to fix. Let's think about a few things, which in my opinion, are beyond doubt.

There is no doubt whatsoever that the way Section 404 was implemented by the SEC, the PCAOB,
and the accounting firms has generated a vast, unproductive, excessive amount of paperwork, bureaucracy, and expense. There is no doubt whatsoever that this expense and burden falls disproportionately on small businesses. Small businesses, by definition, don’t have internal bureaucracies to match the external bureaucracies. This is a real burden on American innovation and American competitiveness. There’s no doubt, as Congressman Feeney and David John have said, that this burden has played an important role in moving capital market activity, and initial public offerings in particular, out of the United States and into London and other foreign markets.

Finally, there is no doubt at all that all of these results were not intended by Congress. They happened through this bureaucratic set of implementation procedures and particularly by the adverse psychology of the accounting firms that we mentioned.

The bills which have been introduced are, in my opinion, very good and very focused.

I’d like just to touch on a couple of things, by way of adding to the favorable comments on them. For small companies, as the Congressman recommended, the bill takes a voluntary approach. It’s my own opinion that Section 404 ought to be voluntary for everybody, but given the disproportionate burden on the small companies, this is a very good place to start. We know for sure that all Members of Congress, when they’re in their own districts, are hearing from the businesses, and the small businesses in particular, about what a disaster and what an unproductive, unintended burden this implementation has become. As David said, the Advisory Committee to the SEC recommended exemption for small businesses. What’s in this bill is, I think, a superior concept. It says that you have to make a decision about what you’re going to do in the way of internal controls. You have the ability to opt out of having the outside accountants come in and charge you a vast amount to impose a lot of bureaucracy on your firm, but you need to tell your shareholders what you’re doing. And this gives the shareholders a chance to say what they would like. Because, who do you think is paying in the end for all the bureaucracy and paperwork? It is, of course, the shareholders. So, the shareholders ought to have a say, and the voluntary approach that’s in both of these bills is, I think, excellent.

I’d like to underline, too, how important it is to get the directions to the accounting firms right, which these bills do. To explain to them that they are not to focus, as the implementing regulation has them focus, on “other than remote” events. Once you get thinking about remote events, this unleashes an endless amount of second guessing and costs, and, of course, at the same time the accounting firm is making huge amounts of money, and they all have had their revenues and profits escalate dramatically. The combination of that with the ability to focus on remote possibilities is very pernicious, so the bill rightly directs a focus on material items, material risks of fraud or loss, as opposed to remote ones.

The bill, very rightly, reminds the accountants they are supposed to be professionals advising their clients on how this tricky, complicated, debatable application of accounting standards should take place. That’s one of the most important elements, I think. If you read interviews done in companies, one of the things managers are most frustrated about and will comment on is how they can’t get advice from their accountants who are, always historically and by profession, there to render professional judgment, because the accountants too afraid to make judgments. The bill pointedly reminds them and directs them what they’re supposed to be doing.

Finally, there is the issue of the approach to internal controls, principles-based as opposed to rules-based, and directs a study of the British approach, which is called the Turnbull Guidance. This, in my opinion, is a very sensible approach and really puts the onus on the board of directors of each company to explain to their shareholders what their approach to risk management and internal controls is.

In summary, thanks again, Congressman Feeney. I think you’re doing a great job here. I think these bills are very well focused, very sensible, and I fully agree that the Congress should be acting on this. We hope the SEC and the PCAOB will be moving, but it would help a lot if Congress is leading the way.

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