

The Uncertain Future of the Sarbanes-Oxley Act

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Overview

- There has been a sea change in the perception of the efficacy of the Sarbanes-Oxley Act that would not have been expected a few years ago
- Presentation will focus on whether/when SOX will be rolled back
 - Proponents of SOX are presently in a defensive mode, but the diffusion of political power with multiple veto points in the U.S. political system makes reversing federal legislation difficult

Outline of Presentation

- Review four prominent commissioned reports critiquing 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)

Summary of Reports

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?

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

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 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)

Congress Responds

- Activity by legislators 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

Senate Action on SOX

- Sen. DeMint offers amendment to S. 761 America Competes Act to exempt small firms from §404
- Sen. Dodd (banking 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 97:0
- Sen. Dodd moves to table DeMint amendment, Sen. Shelby supports; motion passes 62:35
 - 69% of Republicans and 1 Democrat opposed motion (SOX had been unanimously adopted)
 - Dodd-Shelby amendment enabled expression of empathy over problem (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 to other landmark securities laws, legitimacy put in question not just in academic circles but in political arena

House action on SOX

- FY2008 Appropriations bill for financial services and general government passed 6/28/2007
- Amendment prohibiting SEC from expending funds to enforce §404 against small firms passed 267:154
 - Offered by Rep. Garrett (R -NJ)
 - 72 Democrats joined virtually all Republicans (only 1 no, 8 non-voting) in support

Prognosis on SOX's Future

- Difficult to modify financial regulation with recognized 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)
- For revision of SOX to occur more rapidly than examples would need major shift in political environment (Republican control of Congress)
- Effect of dramatic deterioration in economy less predictable: would need to be able to link to SOX

Prognosis Given Current Environment

- Most likely change: exemption for small firms (or community banks) 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

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
- 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

