

Reflections on Sarbanes-Oxley 10 Years Later

BY JOHN A. WEINBERG

In response to the 2007-2008 financial crisis, U.S. lawmakers passed the Dodd-Frank Act (DFA), the most sweeping financial reform package in decades. Prior to the DFA, the legislation holding that title was Sarbanes-Oxley, the 2002 regulatory response to fraudulent accounting practices by several of the nation's largest companies. SOX, as it became known, heightened disclosure and auditing requirements for all publicly traded firms to enhance transparency for investors. Ten years after its passage, some reflections on its impact may be relevant as regulators continue to implement the DFA.

The expectations placed on SOX — which passed Congress with near unanimity — were extraordinary. One is that it should have prevented events like the recent financial crisis. Some of the firms that engaged in excessive risk-taking and ultimately received government support were not transparent about their true financial conditions. But the pervasive expectation of government support for systemically important firms and markets was arguably a larger catalyst for risk-taking than the more isolated instances of financial misrepresentation that occurred.

Another claim often made around the time of SOX's passage was that it would impose hugely burdensome compliance costs on firms, especially smaller firms with modestly staffed compliance departments. Data on direct compliance costs are sparse, but it is not obvious that they have been as large as predicted. John Coates of Harvard Law School suggested just five years after SOX that compliance costs were on the order of \$1 million for every \$1 billion of revenue, or about 0.1 percent of revenues, and that costs appeared to fall with firm size and over time with learning. This is evidence that U.S. firms are quite adaptable at navigating — and perhaps eventually bypassing — new regulations. Perhaps that adaptability and innovation may have been better spent on other, potentially more productive endeavors, but the quantitative impact of such diversion of effort is hard to gauge.

One way to assess whether the costs of a regulation are “too large” is to look at how the regulation changes behavior. Since SOX applies only to public companies, the burden of compliance costs could be manifested through a decline in initial public offerings (IPOs). There has been a clear decline in IPOs in the United States, from averages of 311 annually from 1980 through 2000 to 102 per year from 2001 through 2009, according to University of Florida economist Jay Ritter. The decline in IPOs is most prevalent for small firms (those with less than \$50 million in sales), which is what one might expect if oppressive compliance costs were a primary catalyst. But there are possible explanations other than SOX. For example, Ritter and co-authors of a recent

study argue that decreasing profitability of small firms, rather than compliance costs, has made it increasingly desirable for those firms to be sold to larger firms rather than to go public.

There is, however, some evidence that an increasing number of firms have gone from public to private due to SOX. Companies that go private often cite SOX as the reason, and the number of private equity deals has grown since SOX. Relatively small American firms were more likely than their European counterparts to sell to private buyers immediately following SOX, though not thereafter, suggesting rapid adjustment to the legislation. Still, this may not always be a bad thing. Going private might indicate that SOX is working by restricting riskier firms to more sophisticated investor pools. Coates suggests that the increasing use of private equity could be due to some firms exiting or avoiding the public market rather than suffering a loss in share value following increased disclosures. On the other hand, if firms that go private accept funding on less advantageous terms than they could have obtained publicly, that could make them riskier, a potential social cost of SOX.

In an ideal world, researchers could gain more clarity on the effects of new regulations by studying the counterfactual — for example, what the world would have looked like without SOX. That world would almost certainly have involved more public scrutiny as a natural byproduct of the accounting scandals. SOX may have prevented some extreme cases of fraud, but had a few firms committed such malfeasance — which no doubt would have been made more difficult by enhanced attention from investors — those actions might still have imposed fewer costs on the economy than those created by SOX.

Today there are very large expectations surrounding the DFA's ability to solve perceived problems in financial markets. At the time of its passage, SOX was thought to be an inscrutable piece of legislation, both in terms of its length and the degree to which regulators had to interpret the written statute to implement Congress' intent. Yet SOX is orders of magnitude shorter than the DFA, and the expectations placed on the DFA for preventing the next would-be crisis appear even greater. One lesson from SOX is that the indirect and even direct effects of large-scale regulations are not always obvious or expected. Ten years from now, economists will almost certainly be talking about the difficulty of interpreting the true impact of many aspects of the DFA, as they are — and may still be — with SOX. **RF**

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