The Supreme Case Against Sarbanes-Oxley

As the Justices consider its constitutionality, new evidence shows that the law's costs far outweigh its benefits.

By JAMES FREEMAN

The most powerful czar in Washington will receive some long-overdue scrutiny today when the Supreme Court hears a challenge to the constitutionality of the Public Company Accounting Oversight Board (PCAOB).

This board, created by the Sarbanes-Oxley Act of 2002, regulates the auditors of publicly-traded firms. The members are hired by the Securities and Exchange Commission (SEC) and, say the plaintiffs in Free Enterprise Fund v. PCAOB, do not answer to the president. This violates the Constitution's "appointments clause," according to which senior executive-branch officials should be appointed by the president and confirmed by the Senate.

Yet Sarbanes-Oxley, or Sarbox, itself should be subject to scrutiny. New research suggests that the costs of this legislation far outweigh its benefits to the investing public.

If you're wondering whether the members of PCAOB qualify as senior officials, consider that they have regulatory power over every public company in America. Board members fund their activities by collecting taxes, i.e., fees, from public companies based on the size of their assets.

But those fees are just the tip of the iceberg of costs imposed by PCAOB. The board is charged with making sure that Sarbox's Section 404 rules on "internal controls" over bookkeeping are implemented. These rules are so onerous that companies have had to undertake exhaustive investigations of such minor issues as how many people should be required to authorize small customer refunds at a retail location.

In 2003 the SEC estimated that the average company could do much of its internal controls work for $91,000 per year. In 2007, the commission acknowledged costs had gotten out of hand, particularly for smaller companies, and told the PCAOB to make the internal controls audits more cost-effective.

In 2008, the SEC's Office of Economic Analysis launched a survey of public companies to judge the results, and it recently posted the findings on the SEC Web site, after collecting data from thousands of corporations.
Section 404 is still consuming more than $2.3 million each year in direct compliance costs at the average company. The SEC’s survey shows the long-term burden on small companies is more than seven times that imposed on large firms relative to their assets. Are the internal controls audits helpful? Among companies of all sizes, only 19% say that the benefits of Section 404 outweigh the costs. More respondents say that it has reduced the efficiency of their operations than say it has improved them. More say that Section 404 has negatively affected the timeliness of their financial reporting than say it has enhanced it.

In the years since its passage, the country has experienced an historic drought of initial public offerings. Is Sarbox to blame? Many financial pundits say no, but the SEC survey results point in the other direction. When public companies are asked whether Section 404 has motivated them to consider going private, a full 70% of smaller firms say yes, and 44% of all public companies also say yes.

Has Sarbox driven businesses out of the country? Among foreign companies, a majority in the survey say that Section 404 has motivated them to consider de-listing from U.S. exchanges, and a staggering 77% of smaller foreign firms say that the law has motivated them to consider abandoning their American listings.

In a separate survey of securities analysts, credit raters and other financial-information consumers, the SEC staff found a more favorable view of section 404, but these consumers admitted they found the "benefits . . . are inherently hard to quantify."

In fact, consumers have already participated in a much more robust and meaningful survey. University of Minnesota economist Ivy Zhang has tracked stock trading during the consideration of Sarbox in 2002 and then during periods when the SEC has considered exempting small companies from the most onerous audits. Comparing U.S.-listed companies to foreign companies free from Sarbox, she finds an increased likelihood of heavier Sarbox regulation is followed immediately by "negative abnormal returns" for U.S. stocks. On the other hand, news of potential relief from the law pushes up American stock prices.

That's not a vote of confidence from the people supposed to benefit from the law. Investors have been skeptical about this political exercise from the beginning. Little surprise that 74% of SEC survey respondents say that Section 404 has had little or no impact on investor confidence in their companies.

More troubling, a new paper in the Journal of Accounting and Economics finds that since the passage of Sarbox, U.S. firms reduced their investments in capital expenditures and research and development compared to firms in the U.K. and Canada. Authors Leonce Bargeron, Kenneth Lehn and Chad Zutter of the University of Pittsburgh count the ways the law discourages innovation: "First, by increasing the role of independent directors in corporate governance and expanding/criminalizing their liability for corporate misdeeds, [Sarbox] discourages directors from approving risky investments that are costly to monitor." The same goes for senior managers.

The authors also note that the SEC "acknowledges that the risk of financial misstatements is directly related to the complexity of a firm's operations, the extent to which it relies on specialized knowledge, and the degree to which its organizational structure is decentralized."

Where these factors are more prevalent, compliance costs will increase. In short, national policy imposes a disproportionate burden on innovative companies that delegate responsibility to highly-trained scientists. Could one devise a more destructive policy for the U.S. economy?
A glimmer of hope lies in the fact that Sarbox, drafted in the political panic following the Enron and Worldcom accounting scandals, failed to include a "severability clause." Thus if PCAOB is struck down as unconstitutional, all of Sarbanes-Oxley could come crashing down with it.

Is all this fuss about board appointments just legal hairsplitting? Sam Kazman, general counsel of the Competitive Enterprise Institute, one of the plaintiffs suing the PCAOB, doesn't think so. He notes that "responsibility for bureaucrats was a fundamental issue for the Framers," and that the appointments clause was created "as an essential check on overweening bureaucracy. As colonists of England, they had seen offices created by both the king and Parliament spawn more offices with no accountability, creating what the Declaration of Independence refers to as a ‘multitude of new offices’ and ‘swarms of officers to harass our people and eat out their substance.’"

Today, people who work at public companies—and their investors—understand this problem perfectly.

Mr. Freeman is assistant editor of the Journal's editorial page.