SARBANES-OXLEY – CONTEXT & THEORY: MARKET FAILURE, INFORMATION ASYMMETRY & THE CASE FOR REGULATION

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ABSTRACT

On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002. At the heart of the Act is the mandate for corporate reform from the massive financial and leadership fraud of the late 1990s and early 2000s. This paper is part of a series of essays that attempts to look deep into the soul of the Act not only evaluating the efficacy of the policy, but also to verify the heralding for a new dedication to the ethical and moral boardroom in the public corporation. The larger project consults legislative, legal, historical, and philosophical primary and secondary research to confirm the big question, 'Does Good Behavior Pay Off?' In this installment, I look to the Act itself recognizing that the literature on Sarbanes-Oxley (SOX) to date has lacked the theoretical framework necessary for fully understanding its public policy domain. The only consistent criticism on SOX from its inception has been from management, economic, and political scholarship predominantly targeting its financial impact upon the corporation through its rigid compliance mandates. The primary objective here is to understand Sarbanes-Oxley as public policy in response to market failure – that is, when the market stops providing efficient and ethical solutions to society.

Key words: Sarbanes-Oxley; Market Failure; Information Asymmetry; Public Policy Analysis; Regulatory Environment; Benefits and Costs; Theory of Commerce; Ethics; Corporate Governance.

1. INTRODUCTION

This paper addresses the questions *how does the concept of market failure apply to ethical corporate governance? Are corporate ethics authentic in the modern corporation or just lip service? Will Sarbanes-Oxley achieve results?* To attend to these questions the essay is organized in three sections. First, I address the historical and philosophical context of the firm as depicted both by Aristotle and Adam Smith, both leading thinkers on the concept of commerce and its impact on society. Second, I examine the issue of market failure and information asymmetry, the theories guiding the reactive regulatory measures of SOX attributed to corporate bad behavior. Third, I analyze the Sarbanes-Oxley Act from the perspective of the policy analyst following the politics that designed the bill to the implementation agencies that oversee its mandates.

The ultimate objective is to provide a better understanding of the regulatory connection between government and the corporation. The guiding hypothesis is that Sarbanes-Oxley *is* effective legislation implemented at the right time to not only protect the investor from corporate fraud and to force executives to strengthen corporate ethical standards, but moreover, to solidify that the US market remains strong and that it is not only open for business, but it is a safe place to work and invest. I argue that SOX is the necessary policy tool to achieve these goals.

2. ON THE THEORY OF COMMERCE

2.1 A Philosophical Analysis

As stated in the abstract, we look to the market for *solutions* such as products, services, jobs, and investment opportunities. Why the market? The market in a capitalistic economy offers ownership of the factors of production: traditionally land, labor, capital, resources, knowledge, and entrepreneurship. This ownership is immensely personal, and through ownership, the capitalist is driven to sustain certain freedoms associated with his independence and wealth maximization. In contrast to the capitalistic system, a socialist system or the extreme of communism diminishes and eventually removes personal ownership of market factors and transfers them to the government, whereby the government allocates the production of *the solutions* described above. Ownership can be attributed to self-interest, a guiding theme in the discourse of commerce, trade, and the accumulation of wealth.

It is in fact, the self-interest theory that is at the root of the modern corporation – an institution that personifies the American culture where the combination of entrepreneurship, capital investment, commitment to quality and customer responsiveness has produced many of society's great achievements as well as its profound wealth. Unfortunately, self-interest has also contributed to some of society's greatest misfortunes such as the unchecked market of the 1920s to the fraudulent and greed infested corporation of the 1990s. Notwithstanding some of business' unfavorable history, our teachers from Aristotle to Adam Smith recognize that the enterprise is intended to be good for society. For example, according to Calhoun, "…the function of business [or commerce] as 'service'… [is] its aim as the betterment of human life" (1926, p. 5). Here Calhoun is describing the ancient Greek concept of business as a direct service provider of improving the human condition from the products and services of trade, commerce, and exchange. Often referred to as the father of the 'self-interest' ideal is Adam Smith, and Morrow adds to the betterment theme and its connection to business describing,

> The two main causes of the productivity of modern industry are the division of labor and the accumulation of capital. Self-interest is the explanation of both these key facts. The individual finds it more to his interest to exercise his strength and develop his skill in one occupation and exchange the surplus of what he produces for the products of other men's skill than to attempt to supply all his various needs by the labor of his own hands; hence the division of labor. Likewise, the accumulation of capital: 'The principle which prompts to save is the desire of bettering our condition, a desire which, though generally calm and dispassionate, comes with us from the womb and never leaves us until we go into the grave.' Thus, by following his own interest, as the individual sees it, he is furthering the progress of his neighbors and his nation toward wealth and prosperity…with Adam Smith, the material resources of the modern world, and the human traits which have created it, and attempts to determine under these conditions 'wherein consists the happiness and perfection of a man, not only as an individual, but as a member of the family, and of the great society of mankind (1927, p. 327).

I highlight some of the older discussion pieces from the early part of the 20th Century primarily to illustrate that the problems and opportunities associated with commerce are the themes of fairness and the distribution of wealth, which, consequently, are themes business, government, and society contend with today. For example, at the turn of the century Howerth asserts "the social question [of the present day] is always a question of the many against the few, and manifests itself invariably in a struggle over some form of institution; that is to say, a class struggle" (1906, p. 257).

Howerth is correct in his observation of such a struggle, given that class tiers are a fact of life one hundred years after his publication. Nevertheless, another fact of life is that Adam Smith is often misunderstood and the *invisible hand* theory among the self-interest theme is too often perceived as a discouragement for the poor as well as an association with amoral domination of the elite few monopolizing the acquisition of wealth. The fact is that Smith believed in the promise of business exemplified by Harpham that "the call for a 'system of natural liberty' is not a rejection of the modern commercial order and the economic growth that was an essential part of it; it is an affirmation of the commercial order and a call to place future economic growth on more secure foundations" (1984, p. 768). Smith would be content with the institutions that grow wealth among nations such as the Western banking systems and their associated capital markets. Smith would also find pleasure in the liberty associated with the ongoing political trend of free trade, with its primary objective of satisfying a consumer driven society. Smith would also find satisfaction from his initial inferences on capitalism that the institutions of commerce have rigorous fiscal and monetary policy oversight on the stabilization of this sensitive, robust, and resilient market of the modern day.

Indeed, a prosperous economy relies on another often criticized attribute of commerce: the maximization of profit. Profit maximization, as the central focus for the firm is not immoral simply due to the fact that profitability is a measurement of sustainability and growth potential. After all, growth expands demand, requires more factors of productions such as labor, and often brings wealth opportunities to developing communities. Nevertheless, profit maximization is also one of the central culprits in this discussion on Sarbanes-Oxley, as greed of the owning and managing elite brings the corporation tumbling down along with the many stakeholders who rely on the *solutions* the firm is meant to offer.

The interrelated characteristics of business and society are also the leading criticisms of business power namely the theories described above – self-interest, the invisible hand, and profit maximization. Additional theories include dominance models, where business as a dominant player is portrayed as the most influential and powerful institution in society, in contrast to the pluralistic model, where business is in balance with government and other social institutions (Steiner & Steiner, 2006, p. 13). These models are helpful because they set the stage for the reality of the pre- and post-Sarbanes-Oxley era. We see the 1990s, especially the final years of the decade as well as the first years of the 2000s, as a boom era, evidenced by significant technological innovation, exceptional economic growth, as well as a turnover in American political leadership. Sadly, among all of this energy influencing the dynamics of business, government, and society appears to be the germinating nucleus of immoral behavior – most directly in the corporate boardrooms of large, publicly held corporations. Perhaps the most infamous scandal associated with this stream of unethical activities is the collapse of Enron Corporation. Enron has become the epitome case study for teaching ethics – or more appropriately, the teaching of what ethics is not. In the following section I describe the theoretical framework that characterizes the scandals associated with Enron and the many others that shared the headlines. But first, some Enron statistics to underscore the consequences of market failure and information asymmetry:

- Bankruptcy facts:
  - 20,000 employees lost their jobs and health insurance
  - average severance pay $4500
  - top executives were paid bonuses totaling $55M
- In 2001:
  - Employees lost $1.2B in retirement funds
  - Retirees lost $2B in retirement funds
  - Enron's top executives cashed in $116M in stock
- Criminal Charges
  - Guilty pleas: 15
  - Convictions: 6
  - Acquittals: 1
  - Pending cases: 11
- Three California traders pled guilty to wire fraud
- Four Merrill Lynch executives pled guilty to fraud in the Nigerian Barge case
- Aug 23, 2000 stock hits high of $90
- Nov 28, 2001 stock drops to $1
- 29,000 Arthur Andersen employees lost their jobs (Enron's CPA firm)
- Enron shareholders suing Enron and their banks for $20B (Elkind & McLean, 2003).

3. PUBLIC POLICY THEORY OF SOX

3.1 A Framework for Corporate Bad Behavior

One of the guiding themes of this paper is the concept of the market as provider of solutions. It is a competitive market, traditionally described as the economic environment of many buyers and sellers, easy entry and exit for new and old firms, price taking as the standard pricing strategy, as well as the measurement of economic success when marginal revenues are equal to marginal costs. Additional assumptions and expectations of the competitive market include a level playing field for industries competing for customers – customers who assume that they are privy to all relevant information possible for buying decision making as well as investment decisions for the capital consumer. As described above in the Enron collapse, something that seemed so entirely right about this Fortune 15 Corporation was in fact so profoundly wrong. In the domain of economics and public policy, Enron represents a *market failure* under the theory of *information asymmetry*. It is much easier, perhaps, to analyze a market or firm that declines or fails because of outlying economic indicators – diminishing product demand, failure to innovate, global competition, natural disaster to name a few. However, what is so morally frustrating, and what drives the basis of this study, is that the root of the Enron collapse is simply, yet profoundly, bad behavior.

Recently, Hendry described the concept of market failure within the paradigm of the American enterprise:

> …even in America, for long the spiritual home of free enterprise and individual achievement, the values that drive that enterprise and achievement have been called into question, as businesses have been treated with a degree of suspicion not seen for nearly a hundred years…Traditional moral principles still matter, and for some people and in some areas they still matter deeply. But for most people, in most areas of life, they are no longer the only or dominant consideration. Increasingly, it seems, we weigh our perceptions of moral duty and obligation against perceptions of our own legitimate self-interest (2004, p. 1).

The problem at its most basic level is that somewhere along the road of success, a handful of corporate executives let greed, risk, the thrill of deception, and the lure of excessive and secretive profitability obscure their ethical guidance system. This paper does not look closely into the soul of the person to unveil this problem – I reserve this study for my other collection of essays on the future manager. However, in order to understand more fully the nature of the problem of bad behavior and the regulatory windfall by way of Sarbanes-Oxley, we must first examine the theoretical context of the public policy field.

3.2 Market Failure and Information Asymmetry

I refer to the traditional approaches to SOX from what is now the standard in the field - the text of Weimer and Vining's *Policy Analysis: Concepts and Practice, 3rd Ed.* The authors approach the understanding of government regulations such as SOX by analyzing the problem from the policy analyst's standpoint – that is, client-based. Weimer and Vining affirm, "the product of policy analysis is advice… relevant to public decisions and informed by social values" (1999, p. 1). With regards to our problem of market failure and SOX, Weimer and Vining say that policy analysts

> ...need a perspective for putting perceived social problems in context. When is it legitimate for government to intervene in private affairs? In the United States, the normative answer to this question has usually been based on the concept of *market failure* – a circumstance in which the pursuit of private interest does not lead to an efficient use of society's resources or a fair distribution of society's goods [Additionally], analysts must have an understanding of political and organizational behavior to predict, and perhaps influence, the feasibility of adoption and successful implementation of policies. Also, understanding the world views of clients and potential opponents enables the analyst to marshal evidence and arguments more effectively. [The analyst would ask] the basic question…when considering any market failure why doesn't the market allocate this particular good efficiently? The simplest approach to providing answers involves contrasting public goods with private goods (1999, pg. 74).

Public goods are identified as nonrivalrous in consumption and nonexcludable in use, or both – the authors refer to the ocean or national defense as a public good. Private goods on the other hand, are rivalrous in consumption and excludable in ownership use. The authors refer to shoes as private – you purchased them and no one else except you will use/consume your pair of shoes unless of course you transfer the ownership to another. With regards to the corporate scandals and the government response through regulation, the situation pertaining to public goods might refer to the free information available to the potential investor, such as a 10K report easily obtainable using online databases that specifically publish the financial reports of public companies. With regards to the private goods associated with the corporate product, consider the private ownership of stock.

Market failure is described as the pursuit of private interest (such as an investor or other stakeholder of a corporation) that does not lead to an efficient use of society's resources (exemplified by fraudulent use of investor funds for illegal corporate and executive gain) (Dierkens, 1991). Other leaders in the public policy field connect the issues of market failure to the concept of externalities permeating the consumer and provider relationship. Externalities such as information deficits enable competitive failures (Bozeman, 2002). This information deficit, in the case of corporate fraud, is simply lying, cheating, and stealing. Weimer and Vining put the information problem into the theoretical context of *information asymmetry*, in essence, the centerpiece for Sarbanes-Oxley:

> Information is involved in *market failure* in at least two distinct ways. First, information itself has public good characteristics. Consumption of information is nonrivalrous – one person's consumption does not interfere with another's; the relevant analytical question is primarily whether exclusion is or is not possible. Thus, in the public goods context, we are interested in the production and consumption of information itself. Second – and the subject of our discussion here there may be situations where the amount of information about the characteristics of a good varies in relevant ways across persons. The buyer and the seller in a market transaction, for example may have different information about the quality of the good being traded (1999, p. 107).

Within the scope of Enron and other similar scandals, the product and service being 'traded' here is not simply shoes or bread or a used car for that matter, but a multiple stakeholder, market centered product: employment, 401Ks, money management accounts, investment banking and capital accounts – it is assumed that all of these purchases involve fair information and that the exchange transpired between corporation and stakeholder/investor in a way such that the money used is in good faith for the growth and innovation of the firm. In the case of the corporate fraud of the late 1990s and the early 2000s, all of these professional assumptions are in fact null and void, and the consequences are not simply market failure, but the collapse of organizations, livelihoods, retirement funds, and, most importantly, the collapse of investor confidence in the American capital market – a place that was traditionally a good place for positive self-interest where buyers and sellers would grow capital, wealth, and the future.

4. THE SARBANES-OXLEY ACT – Costs, Politics, and Policy Implementation

4.1 Costs and Critics

The domain of market failure and information asymmetry is the groundwork for understanding Sarbanes-Oxley's impact on so many areas of the investment world. Here I focus on the criticisms of the bill's costs, followed by a case study describing the politics that influence the birth of the bill, and I conclude with a theoretical and practical analysis of SOX's implementation plan. If you were to look into the historical aspects of SOX, you will generally find biased media related stories of the corporate fraud cases of Enron, WorldCom, Tyco – these are the big ones. In your search you would find feature articles highlighting the crimes of the CEOs and CFOs – the millions of dollars embezzled or the millions of dollars in phony deals, the customized balance sheets, and perhaps you would also read about the large-scale cover-ups from accounting firms such as Arthur Andersen, a one-time valiant leading CPA firm grounded in corporate ethics and social responsibility (in its founding years).

Amidst all of this bad news, which one might better understand the reason for government intervention to cure this problem, remain the critics of government that see corporate reform measures, such as the Sarbanes-Oxley Act, as unfair, too costly, or an attack on profitability. In fact, the research on SOX is predominantly critical of its costs and very soft on its benefits. For example, one recent dissertation analyzing SOX asserts that the "loss in total market value around the most significant rulemaking events amounts to $1.4T" (Zhang, 2005, p. 2). Costs and their relationship to profitability are indeed important to the financial health of the firm and the evidence is clear from the growth in consulting firms, for example, that have evolved to assist with the heavy compliance mandates of Section 404 (which I discuss in detail below) and the added staff and services required of public companies and the CPA firms who have also added cost factors to respond to more demand via SOX. According to the co-author of the bill, Rep. Michael Oxley, the "first-year costs of compliance with the internal-controls requirements [are] less than 1% of total revenue" (Burns, 2004, p.2). Oxley appears to highlight the 'less than' but the reality is any marginal cost to the firm has diminishing benefits over time. Observing the potential impact on Wal-Mart, for example, if we look at recent published revenue reports for Wal-Mart Corporation, February 2006 total sales were $25 billion. According to Oxley's estimates, the cost of compliance at 1% of revenues is approximately $250,000 additional dollars to Wal-Mart's February expenses. Wal-Mart, America's largest retailer, produces over $300 billion in annual revenues, which means SOX is costing the firm no less than $3 billion each year to comply with Sarbanes-Oxley (Wal-Mart). Certainly, Wal-Mart and other public companies would enjoy the opportunity to spend this money on profit sharing (redistribution of wealth) or on a number of capital investments targeted for growth.

However, like other regulatory mandates, such as laws implemented to minimize or remove pollution as in the Clean Air and Water Acts, these laws are costs to the firms in the form of taxes or permits. SOX, with its clear mandate to reform corporate ethical behavior, is a tax-like cost that, like pollution control, is intended to help the greater good by increasing investor confidence through stronger transparency requirements as well as strict punishments for executive fraudulent behavior. As with any regulation, corporations are compelled to innovate their systems and processes to reduce costs and stay competitive. This will be the test of time for the new and mature corporations under Sarbanes-Oxley to learn how to deal with this new cost initiative. The intrinsic value and hope, of course, is that both the firm and its stakeholders bring ethics and corporate social responsibility to the forefront of the overarching strategy and, most importantly, to the culture of the firm. Like pollution control, ethics control, for the next generation anyway, is a regulated and a new reality.

4.2 Politics of Power – Business, Government, and Society

Sarbanes-Oxley is new to the world of business, and, like many forceful regulatory mandates, many criticize the implications of why and how the law came into existence. History indicates that corporate fraud and its public policy components of market failure and information asymmetry requires some social institution to cure the problem. When the market fails, society looks to government primarily for its ability to create laws and allocate resources on a broad national and global scale. There is little argument that an Act of Congress is democracy in action to the best of the institution's ability to respond to crises like market failure. We see the Acts of Congress fueled by executive persuasion in the 1930s and 1960s, for example, to move society out of economic depression with the responses to the market failure and the Great Crash of 1929 as well as the social mandates in the 1960s for society to grow out of poverty and civil rights 'failure'. No matter how important the need for change may be, getting Congress and the President to pass and sign legislation is intended by design to be no easy task and to be political. The difficulties and opportunities lie in the politics – the struggle for power, priorities, and positioning.

The theories that define the political milieu of the so-called 'Enron era' are few or nonexistent. Essentially we have market failure attributed to fraud and investor deception. I would like to add a theory for debate as to why Sarbanes-Oxley was born, but first I refer to Belkaoui's helpful overview of reactive public policies attributed to the history of accounting, banking, and the financial markets of the United States and their association with the oversight agency for these matters, the Securities and Exchange Commission (SEC). Belkaoui writes,

> The period between 1929 and 1933 saw a dramatic decline in stock prices, creating social upheaval and concern about the viability of the capital market system in the United States. More and better disclosure about corporate affairs was needed to allow for a better evaluation of the soundness of corporate endeavors. Congress intervened and passed the Securities Act of 1933 to require registration of new securities offered for public sales and the Securities Exchange Act of 1934 to require continuous reporting by publicly owned companies and registration of securities, security exchanges, and certain brokers and dealers. Both acts gave the Securities and Exchange Commission (SEC) the authority to protect the public interest by calling for the disclosure of adequate information when securities are exchanged or sold. Other acts were passed later to broaden and strengthen the responsibility of the SEC, namely (a) the Public Utility Holding Act of 1935, which requires registration of interstate holding companies covered by this law; (b) the Trust Indenture Act of 1939, which requires registration of trust indenture documents and supporting data; (c) the Investment Company Act of 1940, which requires registration of investment companies; (d) the Investment Advisors Act of 1940, which requires registration of investment advisers; (e) the Securities Investors Protection Act of 1970, which provides a fund through the Securities Investor Protection Corporation for the protection of investors; and (f) the Foreign Corrupt Practices of 1977, which governs questionable and illegal payments by U.S. corporations to foreign political officials and requires accurate and fair record-keeping and internal-control systems by all public companies (1985, p. 149).

According to my research, there is one element in the list of regulations above that receives very little attention yet has a profound link to the bad behavior, most notably greed, attributed to the 1990s and 2000s problem we have been discussing. A brief case study of The Glass-Steagall Act of 1933 is a probable window into the root of the problem and, ironically, it may be a combination of government failure *and* market failure

4.3 Glass-Steagall: A Brief Case Study and a New Theory for Understanding SOX

The following analysis is based on a personal interview with an anonymous money manager of a client-based stock portfolio of several hundred million dollars in corporate stock. This source is credible because this person is a long-time professional who worked directly with the players in the historical overview that follows. Any element of bias attributed to the case study has been removed to the best of my ability with historical fact checking against the equally biased, though not unavailable, media reporting on the following events. In response to the market crash of 1929, Congress enacted The Banking Act of 1933 (also known as the Glass-Steagall Act), which essentially responded to the notion that commercial banks, investment banks, and brokers should be separate industries to remove any conflict of interest. Moreover, Glass-Steagall required the insurance companies to be separate industries – separated primarily by non-interlocking boards of directors. History confirms that one of the theories behind the Crash of 1929 and the depression that ensued was that these three industries were closely tied. The Glass-Steagall Act, like many of its counterparts named by Belkaoui above, had remained the law of the land since its inception. However, in 1999, Glass-Steagall is repealed, and it is the politics surrounding this repeal that deserves careful examination.

In 1999, the repeal of the Act allowed insurance companies, commercial banks, and the investment banking firms to come back together as conglomerate corporations. Three specific people were instrumental in lobbying for the repeal: Sanford Weill of Citigroup, Chuck Prince (the lawyer for Citigroup and Weill's corporate counsel), and Alan Greenspan, the Chairman of the Federal Reserve Bank of the United States. Greenspan, for example, thought that bringing these entities together would be a benefit to the country because there would be cost savings and a better product for the consumer; the competitive model had proven successful in Japan and Europe, where this togetherness is allowed. Ironically, however, it is also in these foreign markets that rampant fraud is a problem in banking and finance.

Why these men? Weill and Prince wanted to grow their conglomerate consisting of Citibank, Smith Barney (their brokerage firm), and Travelers Insurance Co. (their insurance agency). The repeal of Glass-Steagall allowed these three entities to come under one umbrella again thus providing similar opportunities for potential corruption and fraud up to 1933. My personal interview with my source also attributes bad behavior with another player, Jack Grubman, a renowned research analyst in the telecommunications field and an employee of Smith Barney. Grubman wrote voluminous reports on the positive characteristics attributed to the reconnection of the three industries and, as a market analyst – one whose recommendations money managers and Wall Street brokers rely upon in making decisions for clients – advised the investment world to buy telecommunications stock because they could under the repeal.

Meanwhile, Grubman is attending the board meetings of WorldCom (no longer a conflict of interest under the repeal) and in his attendance he is privy to inside information of the board at WorldCom. Simultaneously, he is also making investment banking recommendations for WorldCom where Smith Barney and Citibank will be the lending institutions to WorldCom. In fact, Citibank personally loans money to WorldCom's CEO Bernard Ebbers and also provides new issues of stock for clients at Smith Barney to buy even though the WorldCom stock is plummeting all the way to becoming the largest bankruptcy in American history. All along, Smith Barney is receiving commission income on stock sales and Citibank and Smith Barney receive fees for investment banking all the while as WorldCom stock falls.

The result of this reunion of companies due to the repeal of Glass-Steagall is a large income stream that accrues to Citigroup and to its subsidiary Smith Barney. Jack Grubman is fired and barred from the securities industry for life and a $2 – 5 billion punitive settlement from Citigroup to the SEC ensues. Additionally, Weill ends his 20-year reign as CEO and Chairman of Citigroup and retires as chairman emeritus. Chuck Prince, then the current CEO is named CEO and Chairman in April of 2006. This case study is meant to provide an alternative, inside perspective of the events that are connected to corporate bad behavior. Are Weill and Prince and Greenspan bad people? Perhaps not. Are they law-abiding? Indeed, they followed the law of the land – that is, the repeal of Glass-Steagall. We must look carefully at the multiple players in the game during this time in history – Ebbers of WorldCom is going to jail for 85 years, Grubman must find an alternative industry to make a living, and millions of shareholders are still recovering from their own financial losses. From the news, it looks like Weill and Prince are doing all right in retirement. But the ride from 1999 to the present has many consequences – some of which inspired the Sarbanes-Oxley Act to protect the investor from aggressive, misguided perhaps, and downright unethical corporate executives.

4.4 Sarbanes-Oxley – A Public Policy Implementation Analysis

Having laid the theoretical public policy framework of market failure and information asymmetry as well as providing an overview of the political sequences leading to the bill, I now look at SOX as a policy tool. To best understand SOX for current and future management implications, we must examine the implementation characteristics of Sarbanes-Oxley. The following analysis examines the legal domain where Sarbanes-Oxley is codified and where it receives its administrative authority. I conclude my analysis with a personal interview with two stakeholders on the receiving end of the bill and discuss their first-hand assessment three years since passage of the Act.

4.5 The Legal Domain of Sarbanes-Oxley

A preface to the legislation is a brief commentary on where the law evolved. The law was formed by a bipartisan effort of the U.S. Senate and House of Representatives. Specifically, the Senate Committee on Banking, Housing, and Urban Affairs, at the time chaired by Senator Paul S. Sarbanes (D-MD), and the House Committee on Financial Services, chaired by Congressman Michael G. Oxley (R-OH), are the two congressional committees by design to manage *market failures*. The combined congressional committees oversee the entire financial services industry, up to and including banking, insurance, and securities. Consequently, it is Sarbanes and Oxley, by their current leadership of their committees, to whom Congress, and the public for that matter, looks to address the financial crises attributed to corporate bad behavior in the early 2000s.

The Sarbanes-Oxley Act became law during the second session of the 107th Congress on January 23, 2002 and was signed into law on July 30, 2002 by President George W. Bush. The law is officially named The Public Company Accounting Reform and Investor Protection Act of 2002 (H.R. 3763, 2002), although it is most recognized in the industry and by the government as The Sarbanes-Oxley Act or SOX. The law is codified in U.S. Code at 15 USC Sec. 7201, Title 15 "Commerce and Trade", Chapter 98 – Public Company Accounting Reform and Corporate Responsibility (http://uscode.house.gov).

SOX has three primary authoritative bodies, beginning first with the Securities and Exchange Commission (SEC), whose primary function is to protect the buying and selling of securities. The laws governing the SEC are described earlier, and after the Investment Advisers Act of 1940, the Sarbanes-Oxley Act of 2002 is the SEC's most recent law it is charged to oversee. In addition to the SEC, SOX has implementation power by way of the U.S. Department of Justice whose primary function is to prosecute the federal crimes associated with the Act such as "attempts or conspiracies to commit fraud, certifying false financial statements, document destruction or tampering, and retaliating against corporate whistleblowers" (Department of Justice). In partnership with the Attorney General, the Federal Bureau of Investigation (FBI) is charged with the authority to investigate crimes associated with corporate fraud and remains the primary detective agency to investigate and arrest corporate bad behavior.

I attribute the theoretical framework that best describes the policy process and implementation of laws such as SOX to the work of Sabatier, who affirms that "the policy process requires looking at an intergovernmental policy community or subsystem composed of bureaucrats, legislative personnel, interest group leaders, researchers, and specialist reporters within a substantive policy area" (1991, p. 148). What the author recognizes is that the prescribed agencies noted above authorized to oversee SOX have enormous governmental scope, and their unique agency cultures combined with their span of control are important variables in the overarching successful and efficient implementation of the law. In addition to Sabatier's framework, Elmore's theory of backward mapping asserts that "the closer one is to the source of the problem, the greater is one's ability to influence it; and the problem-solving ability of complex systems depends not on hierarchical control but on maximizing discretion at the point where the problem is most immediate (1980, p. 605)." Both Sabatier and Elmore help provide the necessary theory behind the successful implementation of public policy from the government's perspective, primarily pointing to the multiple layers of complexity of costs and benefits and politics associated with the entire public policy process. To conclude, the multilayered policy process is best described by Simmons, Davis, Chapman, and Sager as:

> A sequential flow of interaction between governmental and non-governmental participants who discuss, argue about and find common grounds for agreeing on the scope and types of governmental actions appropriate in dealing with a particular problem…The purpose here is to look beyond the decision nexus to the *interaction* involved in the policy process. Thus, attention centers on the psychology of the actors and the sociology of the groups (1974, p. 458).

Noting Simmons', et al. focus on 'psychology of the actors', the public policy process at all levels – design through implementation – involves real people operating in a politically democratic and bureaucratic domain. Consequently, policies are imperfect, are managed by imperfect people, and manage imperfect situations.

4.5 Sarbanes-Oxley: The Law & Comments from the Field

Like many laws, Sarbanes-Oxley must be read as a rule book thanks to the many mandates listed in the bill. The following summary highlights the bill's most strenuous Titles as they apply to the response to the problem of corporate bad behavior. I abridge the content for illustration purposes, but it is taken directly from the language of H.R. 3763. The following are the key components of SOX:

- Title I: Public Company Accounting Oversight Board – reports to SEC
    - Oversees the audit of public companies
    - Establishes audit report rules and standards
    - Inspects, investigates, and enforces all compliance mandates
    - Empowers the Board to impose disciplinary sanctions of neglect
    - Funds the Board through fees collected from issuers
- Title II: Auditor Independence
    - Prohibits auditors from performing alternative services (consulting)
    - Prohibits the auditor from being the lead for more than five years
    - Requires that creditors report to the audit committee
- Title III: Corporate Responsibility
    - Requires each member of the audit committee to me a member of the BOD
    - Instructs the SEC to require CEOs and CFOs to certify financial reports
    - *CEO/CFO must forfeit certain bonuses and compensation received if the company is required to make an accounting restatement due to the material non compliance of an issuer*
    - *Bans the trading by company directors and executive officers in a public company's stock during pension fund blackouts*
- Title IV: Enhanced Financial Disclosures *
    - Requires senior management and principal stockholders to disclose changes in the securities ownership
- Title V: Analysts Conflict of Interest
    - Restricts the ability of investment bankers to pre-approve research reports
- Title VIII: Corporate and Criminal Fraud Accountability
    - Imposes criminal penalties for knowingly destroying, altering, concealing, or falsifying records
    - Makes non-dischargeable in bankruptcy certain debts incurred in violation of securities fraud laws

- Subjects to fine or imprisonment (up to 25 years) any person who knowingly defrauds shareholders of publicly traded companies
- Title IX: White Collar Crime Penalty Enhancements
  - Establishes penalties for mail fraud, violations of the Employee Retirement Income Security Act of 1974, and establishes criminal liability for failure of corporate officers to certify financial reports (these crimes have penalties up to $500,000 and 20 years in prison)
- Title X: Corporate Tax Returns
  - Expresses the sense of the Senate that the Federal income tax return of a corporation should be signed by the CEO
- Title XI: Corporate Fraud Accountability
  - Authorizes SEC to seek injunction to freeze extraordinary payments earmarked for designated persons or corporate staff under investigation for possible violations of Federal securities law
  - Increases penalties for violations of the Securities Act of 1934 to $25 million and up to 20 years in prison (H.R. 3763, 2002)

* It is in Title IV that the notorious Section 404 is located. Titled 'Management Assessment of Internal Controls, Section 404 is what the end user of SOX, that is, the corporation itself and its CPA firm, has the most difficulty due to the compliance standards that essentially add the marginal costs to the firm. It is also 404 that has given rise to compliance consulting firms to assist corporations prepare and manage the regulations mandated in 404 and all of SOX as well.

4.6 Comments from the Field – An Interview with the Big Four and a CFO

In conjunction with the research program for this paper, I arranged a confidential personal interview with a partner at one of the Big Four accounting firms (these include Deloitte, Touche, & Tohmatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers). Additionally, I arranged a confidential interview with a CFO of a Fortune 15 company. My goal was to ask the first-hand implementers in the field and to learn what type of impact SOX has had on the management of their organization. The following are the questions and summary of the responses of my interviews.

4.7 Interview with a CFO of Fortune 15 Company (Transcribed Word-For-Word)

1. **How has Sarbanes-Oxley impacted your company?**

   - Biggest impact is a greater awareness and ownership of business process owners [managers of functional departments]
   - Appreciation for processes and controls – indeed a catalyst for positive change
   - SOX is good for business for understanding how the business operates and for the consumer

2. **What has been the most challenging issue to overcome pertaining to SOX?**

   - Organizations all have different starting points in compliance
   - Also, some firms may be on different starting points with regards to all processes across the board.
   - The more innovative and cutting edge a company is, the easier the company is able to adapt to large-scale regulations, mandates, etc.

3. **What have been the most rewarding impacts regarding SOX compliance policies?**

   - A talent pool with better business judgment, more informed decisions to handle broader aspects of complexity

4. **How would you rate (excellent, good, fair, none) the current corporate culture with regards to ethics across the many stakeholders of the company?**

   - Good. Transparency is key…frequent and candid communication…good process of [expediting] issues and problems through both the business and financial stream

5. **Do you have a corporate code of ethics**?

   - Indeed…we are a very regulated industry and codes are essential
   - They are part of the culture – they are known and owned and held accountable
   - Execs 'walk the walk'

6. **What is your opinion about recent reports that say the costs of SOX outweigh the benefits? Do you agree with this?**

- If efficient management processes are in place, then a firm should be able to handle such costs
- Indeed, the benefits outweigh the costs
- However, there are some firms in our industry that are not as innovative and ‘ready’ – hence, the costs are significantly higher
- Costs will eventually tale off and if processes are in place, control aspects will remain and the firm will be better for it

7. What does your company do to restore and build customer, employee, and investor confidence in your firm?

- We rely on transparency and predictability elements in performance – we meet commitments with Wall St. – we share strategy – we communicate
- As for buyers and sellers – commitments on both sides of the supply chain and we are held accountable by way of getting or losing contracts based on ‘compliance’ commitments

8. How do you avoid an Enron?

- Our culture eliminates bad apples – no one can stray from the pack
- Notes on Enron – moral compass broken – short-term focus – confidence and courage element – team environment had a flawed level of integrity throughout the executive suite – all were bad apples

9. What is the future of SOX?

- There could be a SOX II in the light of globalization - we’re dealing with high risk countries such as India, China, Russia, etc., all having entirely different cultures of ethics. Hence, SOX II for global U.S. countries should be on the researcher’s list to investigate

Following this interview was an additional personal communication with a Big Four CPA Firm.

4.8 Interview with a CPA of a Big Four Accounting Firm (transcribed word-for-word)

1. How has Sarbanes-Oxley impacted your company?

- Dramatically…the reality is that the accountants have become a regulated industry. Meaning the public accounting profession. Before, we were self- regulated, like banks.
- From a resourcing standpoint, it has been a public demand on the accounting profession – example, now ‘date certain’ is a tremendous impact on the Big Four to hire additional resources, foreign countries if necessary, train them and meet our responsibilities…resulted in walking away from high risk customers for Section 404
- In the audit side, there is a tremendous increase in demand in the ‘attest’ business and in the tax side has created a situation where management – a market shift from your audit firm in specialty practice from audit business and some of the work has gone to non Big Four
- It has raised the bar for quality on audits – documentation has improved noticeably – what gets measured gets done when you become regulated

2. What has been the most challenging issue to overcome pertaining to SOX?

- Resourcing and training has been the most challenging to meet the demand in a changing market place – highly technical people – experienced auditors not just staff auditors
- How this is accomplished – longer and harder hours – transfer of experienced people from international to domestic demand – firing of clients

3. What have been the most rewarding impacts regarding SOX compliance policies?

- Most rewarding impact – auditing committees are more interested in your ‘voice’ – taking the audit more seriously today – audit committees are much more engaged and a more diligent to their fiduciary requirements – partners and staff are more engaged and the clients are more interested … hence, good for confidence to be restored

4. How would you rate (excellent, good, fair, none) the current corporate culture with regards to 'ethics' across the many stakeholders of the company?

- Regarding the Big Four…the cost of failure has never been higher and clients are taking the tone at the top – did you 'message' ethics and communicate it enough
- Companies had ethics policies…now, the emphasis has become more front and center and is it positive
- Internally, with regards to 'independence' as an auditor the Big Four has become much more focused as issues have been identified as standards met around the world – the controls in place that SOX asserts are more intensely monitored and more focused

5. Do you have a corporate 'code of ethics'?

- Code of ethics – common sense – every quarter and attached to the independence confirmation is the code of ethics…example of independence…if a family friend of mine is on a board – I couldn't receive a gift to mitigate a perception of confidence or appearance of impropriety

6. What is your opinion about recent reports that say the costs of SOX outweigh the benefits? Do you agree with this?

- From the perspective of the Big Four…yes. It has been very costly – regarding 404 – but most of the dialogue is dealing with 404. I think for smaller companies it's harder – such as new IPOs with 0 to millions [in revenues] – SOX is a good thing, but when government makes it a law, the intentions are good, but the ramifications are not always cost effective – there are talks of exceptions on the horizon

5. CONCLUSION

5.1 Final Assessment of SOX and the *New Corporation*

This paper set out to address the following questions: *how does the concept of market failure apply to ethical corporate governance? Are corporate ethics authentic in the modern corporation or just lip service? Will Sarbanes-Oxley achieve results?* The methodological approaches to these questions have varied from a traditional public policy analysis where I examined the theoretical framework associated with the need for SOX, to modeling the implementation stream, to personal interviews with the end-user. Nagel provided helpful groundwork for my own questions as he offers a list of standard methodological perspectives public policy analysts must ask. He specifically pushes the analyst to "draw a conclusion as to which policy to adopt from information on goals, policies, and relations; to establish the relations between policies and goals; and to determine what policies are available for adoption and what goals are appropriate to consider" (1988, p. 8). I refer to Nagel here primarily because he helps shape the overarching objective in any policy analysis by centering the study on goals – the goals of the government (remove market failure); the goals of business (maximize profitability); the goals of society (look to the market for solutions).

The paper is centered on early and contemporary theories of commerce followed by a comprehensive discussion of market failure and information asymmetry – the theoretical roots leading to the government's response to the failure of the corporation. I then provided an analysis from the broker's perspective asserting that the repeal of the Glass-Steagall Act was a catalyst for the ensuing bad behavior among the returning industries under one corporate domain. My objective was to also categorize the authoritative and agency-power from which SOX obtains its legal and implementation direction. The multi-level implementation stream requires several years of future data to more fully analyze the results – results that will measure the efficient output by government as well as its presumed ability to impact corporate behavior. In these early years of the law, I found the final impact at the implementation level is most notable by the personal interviews of the practitioners in the field, the CFO and CPA. The goal was to determine if SOX will work and if it is good legislation. The final verdict from the field suggests that the law has indeed brought accountability, service, and compliance to the front of the line in the corporation. Moreover, it appears to have forced companies to innovate their systems to become more ethically inclined, but also to reduce the costs of compliance.

Based on my findings, I affirm that SOX is good legislation as a reactive policy responding to bad corporate behavior. I predict that the future of SOX will be debated for several years to come, but that the recovery from the Enron-era will need these years to distance the memories of the era of fraud. Additionally, I predict that SOX will evolve to stay relevant to the demands of investors and to the realities of American and global commerce. Finally, SOX will provide the balance necessary, even initially by force, to find the mean – to find the intermediate of good corporate behavior. In forthcoming essays, I look beyond Sarbanes-Oxley by first leaping back to one of the centerpieces of ethics in the philosophical context of Aristotle and then leaping forward to examine the results of the future manager's outlook on the ethical frontier of what I call the *New Corporation* – that is, the corporation where Sarbanes-Oxley is no longer new, but part of the long-term corporate culture.

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