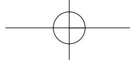

On My Mind

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Where Was SOX?

Believers in democracy should let shareholders opt out of expensive regulation.

PRESIDENT-ELECT OBAMA is promising to re-regulate Wall Street. But before we do that, let's think about the regulatory burden that firms already bear. A good place to start is the Sarbanes-Oxley Act, or SOX.

Congress hastily passed SOX in the summer of 2002, following the implosions of Enron and WorldCom. The idea was to force firms and their auditors to clean up their books and to disclose their "internal controls" and procedures for ensuring the accuracy of their financial reporting.

Sarbanes-Oxley didn't stop Wall Street from taking bad risks with investors' money.

It's been well documented that SOX's costs have been huge. Large firms' financial officers, surveyed in 2007, said their companies spent an average of $1.7 million each to comply with SOX (compared with an initial SEC estimate of five hours per report!). This doesn't include such indirect costs as diverting executive attention from managing the business.

Fans of red tape would argue that SOX's costs have been worth it and that the financial crisis signals how much we needed, and still need, SOX's disclosures.

On the contrary. The crisis shows that SOX did not have the advertised payoff of flushing Enronesque risk out of the market. Firms now collapsing from risks hidden in their walls and foundations were subject to SOX. What, exactly, did SOX accomplish other than imposing huge costs and giving us a false sense of security for six years?

Despite these failings, Congress does not necessarily have to scrap SOX. We suggest a way to make it work. SOX would remain, but firms could have their shareholders vote to opt out of some or all of its provisions. Or firms going public could opt out of SOX and let potential investors decide whether to buy their shares.

Our idea fits nicely with the talk we've heard about shareholder power. Corporate governance reformers argue in particular that shareholders should have a say in executive pay. Indeed, the House voted 2-to-1 last April for "say on pay," requiring firms to let shareholders take nonbinding votes on compensation. The idea is not going away; it was sponsored in the Senate by a certain Senator Obama. If shareholders should vote on pay, then why not on something that can have even more effect on profits. How about "Say on SOX"?

Our proposal would let firms decide whether SOX is a luxury they can afford. We suspect that larger firms will usually stay with SOX despite its costs. But many of the smaller and newer firms may decide that SOX's costs outweigh its benefits. Allowing them to opt out would be like giving a tax break to entrepreneurs to help restart the economy. Unlike firms that decided after SOX to go private, firms opting out of SOX would still be subject to the rest of the securities laws.

Some might say that shareholders won't understand the implications of opting out of SOX. But experts abound who could warn of the risks. Surely given SOX's notoriety, opting out couldn't fly under the public radar. The market can price the risk of going without SOX, and shareholders' portfolios will reveal their preferences for SOX's expensive protections.

SOX fans and critics should agree that going SOX-free is more consequential than a nonbinding vote on executive compensation. Say on SOX therefore takes a bigger step toward corporate democracy than Say on Pay. By the same token, our proposal clearly tests the whole idea of shareholder democracy. If we can't trust shareholders to decide wisely on SOX, should they have Say on Pay? If shareholders cannot evaluate SOX's benefits and burdens, can they calibrate executive compensation to attract competent talent and provide the right incentives? Surely shareholders' mistakes about compensation can cost as much as mistakes about SOX compliance.

Giving shareholders a say on SOX means taking a stand for shareholder power. It's time for the corporate governance reformers to decide what they really believe. F

LEFT: KLAUS SCHOENWIESE; JIM ZIV