Was the well-intentioned landmark legislation slapped together too quickly?

Revisiting Sarbanes-Oxley

By Christopher Whalen

The financial scandals involving Enron, Global Crossing, and Arthur Anderson were front-page news a year ago. Members of both political parties, fearing the wrath of voters with approaching mid-term elections, were scrambling for cover. The Senate unanimously passed a piece of draconian legislation sponsored by Maryland Democrat Paul Sarbanes, a man never particularly friendly to free markets or private property. The bill was expected to die quietly in the House.

But early last June the scandal involving WorldCom broke into the news and, as one Republican operative puts it, "Suddenly the Sarbanes legislation took on a life of its own." Members of both parties, facing a midterm election and enraged constituents, clamored for action, pressing House Financial Services Committee Chairman Michael Oxley (R-OH) to move the legislation. The Bush White House let it be known that no delay would be accepted. Notes one insider: "Mike Oxley put his name on the legislation, managed to make some minor changes, and sent it to the floor where it passed almost unanimously."

The Sarbanes-Oxley legislation made it through conference with the Senate in three days and was signed into law on July 30, 2002, by President George W. Bush, who even lauded the event by correctly characterizing the bill as "the most far-reaching reforms of American business prac-

Christopher Whalen is a writer and investment banker who lives in Croton-on-Hudson, New York.

THE INTERNATIONAL ECONOMY

THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY

888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Under Sarbanes-Oxley the accused is presumed guilty until proven innocent.

tices since the time of Franklin Delano Roosevelt." Thanks to President Bush and the Republican Congress, Americans must live with a law that greatly expands government regulation of the financial markets, but probably does nothing to protect investors from future acts of fraud.

More than a year since Congress passed the legislation known as Sarbanes-Oxley, inhabitants of Wall Street and Main Street are still trying to figure out how to comply with the law. As Washington's latest foray into market intervention, the law attempts to make lawyers, directors, and accountants police corporate behavior. The legislation mandates specific rules for officials of public companies and the professionals who work for them, and sets tough criminal penalties for violations. But like all attempts to regulate market behavior, Sarbanes-Oxley is very long on promises but short on practical implementation.

The Sarbanes-Oxley legislation sweeps away decades of jurisprudence based on Delaware law and standards for corporate responsibility such as the Prudent Man rule. In 1830, Judge Samuel Putnam set down a general canon for corporate behavior: "Those with responsibility to invest money for others should act with prudence, discretion, intelligence, and regard for the safety of capital as well as income." Sarbanes-Oxley replaces the Prudent Man rule with strictures that violate our Constitutional freedoms and do little to actually prevent future scandals. One thing is not in doubt: Sarbanes-Oxley makes the job of running a company more difficult and much more expensive.

First and foremost, the law reminds lawyers that they work for a company and not its corporate officers, effectively voiding legal privilege between corporate lawyers—in-house or external—and other corporate officers. Under proposed regulations, lawyers "practicing before the Securities and Exchange Commission" are now required to report possible misdeeds by company officers to the chief legal officer or to the board of directors. If a resolution is not forthcoming, the lawyer must contact the SEC directly—that is, turn in his own client! No proof is required to trigger the "upward reporting" responsibility—under Sarbanes-Oxley the accused is presumed guilty until proven innocent.

This unprecedented expansion of the federal surveillance of attorney conduct eviscerates state law in the area of corporate governance. One CEO likens this provision of Sarbanes-Oxley to the ring of the dinner bell for the trial lawyers. Several CEOs interviewed by *TIE* say the legislation forces corporate officers to exclude counsel from internal debates and limit information provided to lawyers.

Like the lawyers, accountants are now reminded that they work for the companies they audit and not the officers who manage the company. Sarbanes-Oxley establishes strict guidelines for how auditors must gather, report, and preserve information used to prepare public disclosure documents. The law also prohibits auditing firms from providing other services to their accounting clients, forcing companies to hire several accounting firms to perform the tasks once accomplished by one.

This European legal regime places an enormous onus on independent directors of public companies, making them responsible for compliance with SEC requirements, according to Bob Messino of Weil, Got-

Thanks to President Bush and the Republican Congress, Americans must live with a law that greatly expands government regulation of the financial markets, but probably does nothing to protect investors from future acts of fraud.

One CEO likens this provision of Sarbanes-Oxley to the ring of the dinner bell for the trial lawyers.

shal & Manges. The audit committee of a public company, which must be comprised entirely of independent directors, is now responsible for all corporate accounting duties, including direct supervision of the company's chief financial officer, says Peter M. Drexler, a CPA who specializes in Sarbanes-Oxley compliance.

Because of the new responsibilities placed on lawyers and auditors, Sarbanes-Oxley is spawning cottage industries specializing in compliance with the law and documentation of all aspects of a company's financial reporting. Many experts anticipate that legal expenses for most public companies will double due to Sarbanes-Oxley. One lawyer guesses that between the increase in direct cost and the time required for outside directors to do their job, companies are going to be forced to treat directors as full-time, senior executive positions. Another attorney suggests 250 hours per year as a reasonable estimate of the minimum time required for independent directors to do their jobs. A third observes that the cost of directors' liability insurance is doubling every six months.

When asked by *TIE* how many board seats an individual can prudently hold down under Sarbanes-Oxley, a spokesman for House Commerce Committee Chairman Billy Tauzin (R-LA) replies: "One." The official elaborates: "You can only do a good job on one board position. People still have not thought through the legal ramifications of Sarbanes-Oxley. Even if you as a director do everything right, a misstep by a company officer or lawyer can land you in a lawsuit or in jail."

Legal expenses for most public companies will double due to Sarbanes-Oxley.

Yet a Senate aide with responsibility for Sarbanes-Oxley compliance issues differs and says that public companies want directors, especially professional directors who do nothing else, to serve on more than one board so that they are economically independent. "If you only focus on directorships and don't have a full-time job, you can probably handle three or four director positions without problems," says the veteran corporate attorney.

Between the increase in direct cost and the time required for outside directors to do their job, companies are going to be forced to treat directors as full-time, senior executive positions.

Despite signs of contrition from Wall Street, few believe that anything has really changed in corporate America. Former Banking Committee staffer Robert Feinberg says that by focusing on the accountants and lawyers, Sarbanes-Oxley serves to distract attention from what's really happening on Wall Street. "Most people should not invest in stocks, but Sarbanes-Oxley pretends to make it safe to do so," complains Feinberg, who likens Wall Street's marketing machine to an ongoing criminal enterprise. A Republican operative points to the June 5, 2002, speech at the National Press Club by Goldman Sachs CEO Hank Paulson, where the powerful banker made a public "mea culpa" for the Internet bubble and every financial scandal before or since, as "one of the most disingenuous performances I've ever seen."

For Washington's political elite, the once popular and profitable opportunity to serve as an outside director may be losing its appeal. Consider some examples.

General John M. Shalikashvili, 66, former head of the Joint Chiefs of Staff, sits on the boards of Boeing, United Defense, L-3 Communications, Plug Power, and the Frank Russell Trust Co. He chairs the audit committees of Boeing and L-3, and sits on the audit committees of United Defense and Plug Power. Under Sarbanes-Oxley, members of audit committees are required to closely supervise auditors and chief financial officers—complex areas of responsibility.

Given Shalikashvili's additional responsibilities as a consultant and visiting professor at Stanford University, it seems reasonable to ask whether the retired U.S. Army general can possibly put in the 100 hours plus per month that many lawyers and CPAs believe is required for an independent director to meet the minimum requirements of the law for five board positions. Not surprisingly, Shalikashvili's spokesman said that he was too busy to speak with *TIE*.

Another example: Kenneth M. Duberstein, 58, became one of Washington's most influential lobbyists after serving as White House chief of staff from 1988 to 1989. He serves as a director of Fannie Mae, the Boeing Company, ConocoPhillips, Fleming Companies, Inc., and St. Paul Companies, Inc., and also serves as a member of the board of governors of the National Association of Securities Dealers and the American Stock Exchange. Both Boeing and Fannie Mae are currently targets of SEC inquiries. Duberstein did not return calls by *TIE* seeking comment for this article.

Indeed, because of the rising risk of civil and criminal liability, many experts believe that outside directors will become a very rare breed. For example, the New York Stock Exchange rules approved on August 1, 2003, say that for outside directors to be considered "independent" the board of a company must "affirmatively determine that the director has no material relationship with the listed company." Look through the ranks of the Fortune 500 and it is hard to find a company that does not currently violate the NYSE rule.

Lawyers and accountants are not cops and most corporate boards are simply not up to the huge task required by Sarbanes-Oxley.

Past experience suggests that federal regulation of financial markets has provided, at best, an after-the-fact remedy to punish the guilty rather than any preventative protection for investors.

Many of the parts of the legislation make sense in financial and common sense terms, but their successful implementation is far from assured. Lawyers and accountants are not cops and most corporate boards are simply not up to the huge task required by Sarbanes-Oxley. Past experience suggests that federal regulation of financial markets has provided, at best, an after-the-fact remedy to punish the guilty rather than any preventative protection for investors. Once again, American consumers are promised a functioning market, but get only more bureaucratic rules and regulation.

The Honorable E. Norman Veasey, chief justice of the Delaware Supreme Court, told a conference in New York in July that "whether we like it or not, we are in a 'brave new world' and we'll all have to muddle through and make the best of it." One Bush Administration official belatedly frets that the explosion of WorldCom and other scandals last year made Sarbanes-Oxley more draconian than originally intended. He warns that it is unlikely that Congress will revisit the Sarbanes-Oxley legislation until after the next election—if at all. The one lesson of this sad episode is that Washington seems to produce its most socialist laws under Republican administrations, perhaps suggesting that as with the purchase of assault rifles, both Congress and the White House should be compelled to go through a waiting period before legislation takes effect. ◆