

## Sarbanes-Oxley Five Years Later: Will Criticism of SOX Undermine Its Benefits?

*Cheryl L. Wade\**

### I. INTRODUCTION

In 2002, the Sarbanes-Oxley Act<sup>1</sup> (“SOX” or the “Act”) not only changed the details relating to financial reporting, internal controls, and corporate governance in general, but also changed the discussion about corporate climates and cultures, at least temporarily. The political discourse leading up to SOX’s enactment in the aftermath of the accounting debacles of 2001 and 2002 was replete with discussions about more ethical and responsible corporate governance. The Act’s passage, accompanied by the get-tough-on-Corporate-America speeches made by President George W. Bush and others<sup>2</sup> changed the way corporate actors discuss their ethical obligations. The Act’s strict requirements regarding financial disclosure and accounting inspired a climate in which discussions about corporate ethics moved from the periphery of corporate discourse to the center of corporate discourse.<sup>3</sup>

Five years after its enactment, however, the business community’s criticism of SOX is almost virulent. An examination of some of the post-2002 discourse about SOX within the business community reveals that most of the business community has deemed SOX illegitimate. According to a survey described in CFO magazine, ninety-four percent of executives from 217 companies surveyed in 2005 felt that the cost of

---

\* Dean Harold F. McNiece Professor of Law, St. John’s University School of Law.

1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified as scattered sections of 11, 15, 18, 28, & 29 U.S.C.) (Supp. 2006).

2. John D. McKinnon & Christopher Conkey, *Politics & Economics: Bush Gives Hope to Foes of Sarbanes-Oxley Law; President Offers Political Cover for Easing Burden on Business, But Joins Executive-Pay Critics*, WALL ST. J., Feb. 1, 2007, at A4.

3. For example, the Act requires disclosure about a code of conduct for senior officers, and the “internal controls requirements . . . force both lawyers and auditors to investigate the firm’s ethical climate along with legal compliance.” Donald C. Langevoort, *Someplace Between Philosophy and Economics: Legitimacy and Good Corporate Lawyering*, 75 *FORDHAM L. REV.* 1615, 1621 (2006).

compliance outweighed the benefits of SOX.<sup>4</sup> Another study revealed that more than half of directors in the Americas want SOX repealed or “overhauled.”<sup>5</sup> Seventy-two percent of directors surveyed in the Americas said SOX made them too cautious, and consequently they are “not taking the necessary risks to drive growth.”<sup>6</sup> Fifty-nine percent of directors surveyed in the Americas have declined a board position due to the risk associated with failure to adequately comply with SOX.<sup>7</sup> Academics and business people assert that some of the Act’s most significant provisions provide little or no protection for investors.<sup>8</sup> Commentators lament the high costs imposed on businesses to comply with SOX.<sup>9</sup>

Five years after its enactment, regulators acknowledged that the value of SOX is found in the principles on which it is based.<sup>10</sup> Recognizing that the underlying principles of the Act are as important as the details relating to specific corporate governance changes, regulators, attempting to reduce unnecessary costs, provided guidance in 2007 intended to change the interpretation and implementation of SOX’s most controversial provision, Section 404.<sup>11</sup> Section 404 requires managers to install and assess internal controls designed to lower the risk that financial statements will contain material misstatements or omissions.<sup>12</sup> The Securities and Exchange Commission (“SEC” or “Commission”) and the Public Company Accounting Oversight Board

---

4. Chris Morrison, *Challenging the Validity of Sarbanes-Oxley Pt. 1*, FINANCIALWIRE (Feb. 2, 2007), <http://www.investrend.com/articles/article.asp?analystId=0&id=44365&topicId=160&level=160>.

5. Press Release, Korn/Ferry Int’l, Majority of Board of Directors Feel Sarbanes-Oxley Regulations Should be Repealed or Overhauled (Feb. 23, 2006) [hereinafter Press Release, Korn/Ferry], [http://www.kornferry.com/Library/Process.asp?P=PR\\_Detail&CID=1419&LID=1](http://www.kornferry.com/Library/Process.asp?P=PR_Detail&CID=1419&LID=1). The study found that fifty-eight percent of board directors surveyed felt regulations served only to make boards overly cautious and the laws should be repealed or overhauled. *Id.* The study is “[t]he most comprehensive, longest-running survey of its kind in the world . . . . [It] examines opinions and practices found in boardrooms of major corporations throughout the world.” *Id.*

6. Chris Evans, *Directors Call for Sarbanes-Oxley Repeal*, Accountancy Age (Feb. 23, 2006), <http://www.accountancyage.com/accountancyage/news/2150885/sarbanes-story>.

7. Press Release, Korn/Ferry, *supra* note 5; Evans, *supra* note 6.

8. *See infra* Part IV (exploring the changing discourse surrounding SOX, which is becoming overwhelmingly critical).

9. *See Morrison, supra* note 4 (discussing the argument that dollar amounts involved in compliance outweigh its benefits).

10. *Sarbanes-Oxley Act Fifth Anniversary* (C-Span television broadcast July 30, 2007), available at [http://www.c-spanarchives.org/library/index.php?main\\_page=product\\_video\\_info&products\\_id=200222-1&highlight=sarbanes](http://www.c-spanarchives.org/library/index.php?main_page=product_video_info&products_id=200222-1&highlight=sarbanes).

11. *See infra* Part III (discussing the SEC’s revised interpretation of SOX compliance as more principle-based as opposed to a check-the-box type of compliance).

12. Sarbanes-Oxley Act § 404 (codified at 15 U.S.C. § 7262 (Supp. 2006)).

("PCAOB") advised managers and auditors to undertake an approach that focuses on the principle of risk assessment.<sup>13</sup> This principles-based approach should replace the detail oriented "compliance-by-checklist" approach that some managers have taken when complying with SOX.<sup>14</sup>

This Article addresses four basic questions. First, what is the impact of the business community's attack on the legitimacy of SOX? Second, what will be the nature of corporate compliance with a law that is deemed illegitimate by so many to whom the law applies? Third, will the business community's disdain for the Act erode the substance of the Act? Finally, will business people who conclude that SOX is illegitimate ignore the principles on which the Act is based and continue to place form over substance when they comply?

SOX changed some of the details of corporate governance, but it also took aim at unprincipled, unethical conduct. The focus of this essay is not on the details of the critiques of the Act, but on the way the discourse is unfolding today. The tone of that discourse may undermine one of the Act's fundamental principles: ethical and diligent compliance. Managers and auditors have become mired in the minutiae of SOX compliance. Because most members of the business community question the efficacy and legitimacy of SOX, they seem to engage in "compliance-by-checklist," checking off the details related to complying with SOX while ignoring the broad principles of ethical compliance and diligent monitoring. These fundamental principles get lost in the compliance-by-checklist approach that results from the business community's criticism of SOX and conclusions about its value and the legitimacy of compliance. The Act's most salient goal is to increase investor confidence,<sup>15</sup> but the "compliance by checklist" mode with respect to disclosure and corporate governance . . . may provide assurance that a company is following the rules, [even though] it is debatable whether investors are better off for it."<sup>16</sup>

---

13. See *infra* Part VI (exploring the principles-based approach to section 404).

14. Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411 (2007) (arguing that the term "principles-based" is misleading and is used in an attempt to inspire ethical compliance with corporate law, and securities and accounting regulations).

15. Louis M. Thompson, Jr., *Sarbanes-Oxley Means Opportunities and Challenges for Companies and IROs*, CPA J. (Sept. 2005), <http://www.nysscpa.org/cpajournal/2005/905/perspectives/p14.htm>; see also Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 ST. JOHN'S L. REV. 671 (2002) (observing that SOX duplicates existing law, regulation, and standards).

16. Thompson, *supra* note 15.

## II. DOES GOOD CORPORATE GOVERNANCE REQUIRE REGULATING UNETHICAL BEHAVIOR?

Recently, the *New York Times* printed an editorial featuring the following statement in bold print: “Being against insider trading is like being against sin . . . . Like most sins, it principally offends those who don’t or can’t indulge. . . . And like most sins, it shouldn’t be a crime.”<sup>17</sup> The author of the editorial discussed recent allegations that insiders at various companies made millions from trading on material nonpublic information.<sup>18</sup> He argued that:

[I]nsider trading is so common that the only way the Securities and Exchange Commission can enforce laws against it is selectively, much as a patrolman tickets only the red sports car when everyone on the road is speeding . . . . [S]topping the sports car slows traffic only for a mile or two. It gives the false impression that the policeman is on the beat, making the financial markets safe for the rest of us.<sup>19</sup>

At one point in the editorial, the author boldly proclaimed, “I’m an expert on this issue.”<sup>20</sup> Although this may seem immodest, the next line read, “I was convicted of using advance knowledge of the content of my columns for *The Wall Street Journal* to make money in the stock market.”<sup>21</sup> The author was R. Foster Winans, the defendant in an important and infamous insider trading case.<sup>22</sup>

The editorial relates to three important points about corporate governance in general and SOX in particular. First, it is very difficult for academics, policymakers, lawyers, politicians, legislators, and regulators to agree about what constitutes good corporate regulation and governance. For example, Winans and many commentators before him have convincingly argued that legislators and regulators should “[t]hrow out the current insider trading laws . . . .”<sup>23</sup> There are, however, equally convincing arguments that support the ban on insider trading. Similarly, with respect to many corporate governance practices, there are convincing arguments that a particular practice is good, and there

---

17. R. Foster Winans, Editorial, *Let Everyone Use What Wall Street Knows*, N.Y. TIMES, Mar. 13, 2007, at A19.

18. *Id.* (“Earlier . . . we heard that a band of Wall Streeters pocketed \$14 million in allegedly illegal profits based on inside information, and that unnamed traders have made more than \$5 million knowing ahead of time about a buyout offer for Texas Utilities.”).

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.* See *Carpenter v. U.S.*, 484 U.S. 19, 29 (1987) (finding that “Winans continued in the employ of the Journal, appropriating its confidential business information for his own use, all the while pretending to perform his duty of safeguarding it”).

23. Winans, *supra* note 17, at A19.

are equally convincing arguments that the same practice fails to enhance firm performance or governance. This is vividly illustrated by disagreements relating to some of SOX's key provisions.<sup>24</sup>

Secondly, Winans pointed out that the public will not know when laws fail to do what they claim to do.<sup>25</sup> Investors are likely to believe that even ineffective laws will protect them when, in actuality, they do not. This creates a false sense of safety among investors and the general public. At the time of its enactment, SOX embodied a national sentiment that was a political and practical reaction to the public's discontent with the Enron, WorldCom, and other governance and accounting scandals of 2001 and 2002.<sup>26</sup> To say that the public's reaction to SOX in 2002 was favorable would be an understatement. According to one report, "investors cheered the law during its early days . . . [S]tock market values increased significantly as a result of the reforms imposed by the Sarbanes-Oxley Act . . . . [I]t has restored confidence in a market that was battered by a six-month long string of corporate scandals from Enron to WorldCom."<sup>27</sup>

Paradoxically, the companies that were most aggressive in manipulating earnings were the companies that benefited the most from SOX.<sup>28</sup> The stock of those companies rebounded because the enactment of SOX made investors believe that firms would no longer fraudulently manipulate financial information.<sup>29</sup> Because of SOX, investors believed the information they received was more reliable.<sup>30</sup>

---

24. See *infra* Part III (discussing the debate over whether SOX's prohibitions against insider trading are warranted or desirable).

25. Winans, *supra* note 17, at A19 (arguing that arbitrary enforcement, such as stopping only red sports cars for speeding violations when everyone is speeding, gives the false impression of safety).

26. See, e.g., Chris Morrison, *Challenging the Validity of Sarbanes-Oxley Pt. 3*, FINANCIALWIRE (Feb. 13, 2007), <http://www.investrend.com/articles/article.asp?analystId=0&id=45723&topicId=160&level=160> (observing that politicians enacted SOX in response to public resentment after the Enron, WorldCom, and Tyco scandals); Chris Morrison, *Challenging the Validity of Sarbanes-Oxley Pt. 2*, FINANCIALWIRE (Feb. 7, 2007), <http://www.investrend.com/articles/article.asp?analystId=0&id=44965&topicId=160&level=160> (stating that SOX came "into effect during a period of high anti-corporate sentiment in the public").

27. University of Iowa News Release, *UI Researchers Find Positive Reaction to Sarbanes-Oxley Act* (Feb. 20, 2007) <http://news-releases.uiowa.edu/2007/february/022007sox-reaction.html> [hereinafter University of Iowa News Release].

28. *Id.* Researchers studied "a sub-set of 425 companies that were seen as using aggressive accounting tactics prior to SOX and their value increased by an additional 5 percent during the study period." *Id.* The news release acknowledges that the rise could likely be explained by the fact that their stock prices had been driven low by post-Enron consumer doubts. *Id.*

29. *Id.*

30. *Id.* (examining how the stock market drops amidst the revelation of fraudulent accounting behavior, but rises and rebounds with news of government action and enforcement).

Though SOX seems to have restored investor confidence, some research suggests that this confidence may not be warranted.<sup>31</sup> For example, SOX requires that each member of an audit committee be independent.<sup>32</sup> Empirical studies, however, fail to establish conclusively that an audit committee comprised entirely of independent directors actually enhances a company's performance.<sup>33</sup> It is unclear whether an audit committee composed of only independent directors will reduce accounting irregularities; thus, post-SOX audit committees may not deserve increased investor confidence.<sup>34</sup>

The third point the Winans editorial makes is the focus of this essay. Winans claims that insider trading is a sin, but not a crime. How does this notion play out under SOX? There is considerable disagreement about whether SOX enhances firm performance, improves the quality of financial disclosures, or provides investor protection.<sup>35</sup> Will the debate about SOX's usefulness lead some corporate agents to conclude that mere cosmetic compliance with SOX is a sin rather than a crime? What about civil liability under SOX? Will business people who have concluded that SOX should be repealed or rolled back deem cosmetic compliance, or compliance-by-checklist, with SOX's civil provisions a legitimate approach? Will business leaders consider such an approach ethical because they have concluded that SOX should not have been enacted?

---

31. See *infra* notes 33–34 and accompanying text (discussing empirical studies which suggest that independent audit committees have no effect on the reduction of accounting irregularities).

32. Sarbanes-Oxley Act §301 (codified at 15 U.S.C. § 78j–1 (Supp. 2006))

33. Peter J. Wallison, *Will Independent Directors Produce Good Corporate Governance*, in AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH (January 6, 2006), available at [http://www.aei.org/publications/pubID.23648,filter.all/pub\\_detail.asp](http://www.aei.org/publications/pubID.23648,filter.all/pub_detail.asp); P. Krishna Prasanna, *Corporate Governance—Independent Directors and Financial Performance: An Empirical Analysis*, INDIAN INST. OF CAP. MARKETS 9TH CAPITAL MARKETS CONFERENCE PAPER, available at <http://ssrn.com/abstract=877807>.

34. Wallison, *supra* note 33, at 2 (noting that the benefits to a supermajority of independent directors are theoretical because the empirical evidence at best is ambiguous). Yet another level of ambiguity is added when there is disagreement about how to define independence. Cf. Eric M. Fogel & Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 47–48 (2007) (illustrating the difficulty of defining independence by showing that the definitions articulated by stock exchanges and other regulatory agencies have been both over inclusive and under inclusive).

35. See *supra* notes 28–34 and accompanying text (examining the debate surrounding the empirical support for SOX).

### III. THE DEBATE ABOUT SOX AND THE MEANING OF GOOD CORPORATE GOVERNANCE

This Section will focus on the debate and disagreement over what makes for good corporate governance in general, and more specifically, whether the corporate governance changes enacted under SOX are worthwhile.

Some commentators complain that SOX's corporate governance provisions fail to address the problems that caused the spectacular accounting debacles in 2001 and 2002.<sup>36</sup> They claim that the Act focuses "on minor issues such as who has access to office keys, while placing insufficient emphasis on who has access to financial records."<sup>37</sup> Some of these commentators conclude that SOX will not protect investors from corporate fraud in the future, relying on empirical studies which suggest that some of the corporate governance changes under the Act will not deter fraudulent financial reporting.<sup>38</sup>

Professor Roberta Romano explains that the corporate governance provisions of the Act were enacted without congressional consideration of empirical studies claiming that the changes would not improve firm performance or enhance the quality of audits.<sup>39</sup> Romano advocates for the rescission of SOX's corporate governance changes, "either by transforming them into statutory defaults that apply to firms at their option or by removing them completely and redirecting jurisdictional authority to the states."<sup>40</sup>

According to much of the relevant empirical evidence, Romano argues, there is no meaningful connection between some of the Act's most significant sections and improved firm performance or reduced accounting impropriety.<sup>41</sup> For example, SOX's Section 301 requires that all members of public company audit committees be independent.<sup>42</sup> At least intuitively, it would seem that audit committee members with no financial ties beyond director fees with the companies they

---

36. See, e.g., Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005) ("SOX was enacted in a flurry of congressional activity . . . after the spectacular failures of the once highly regarded firms Enron and WorldCom. . . . But many of the substantive corporate governance provisions of SOX are not in fact regulatory innovations devised by Congress to cope with deficiencies in the business environment in which Enron and WorldCom failed."); McKinnon & Conkey, *supra* note 2, at A4 (describing President Bush's statements that SOX has been a success but excesses should be rolled back).

37. McKinnon & Conkey, *supra* note 2, at A4.

38. Romano, *supra* note 36, at 1529.

39. *Id.* at 1523.

40. *Id.* at 1602.

41. *Id.* at 1529.

42. Sarbanes-Oxley Act § 301 (codified at 15 U.S.C. § 78j-1 (Supp. 2006)).

investigate would be the most effective monitors of that company's managers. However, Romano states that "[t]he literature on the composition of audit committees does not support the proposition that requiring audit committees to consist solely of independent directors will reduce the probability of financial statement wrongdoing or otherwise improve corporate performance."<sup>43</sup>

The results of empirical studies relating to several of SOX's other provisions yield similar results.<sup>44</sup> SOX's Section 201 prohibits auditors from providing non-auditing services to the firms for which they serve as accountants.<sup>45</sup> Romano states that:

The rationale for the ban was that the receipt of high fees for nonaudit services compromises auditor independence by providing auditors with a financial incentive to permit managers to engage in questionable transactions. . . . The overwhelming majority of the studies (nineteen out of twenty-five) suggest that SOX's prohibition of the purchase of nonaudit services from an auditor is an exercise in legislating away a [sic] audit quality.<sup>46</sup>

Furthermore, fifteen of the twenty-five studies conclude that there is no connection between the provision of nonaudit services and audit quality.<sup>47</sup>

A similar argument can be made with respect to Section 402(a) and Section 302. Section 402(a) prohibits public companies that are not financial institutions from making loans to executives.<sup>48</sup> This Section of SOX was enacted to avoid obvious conflicts between the interests of executives and the interests of the firms for which they work.<sup>49</sup> However, empirical research suggests that executives increase their equity investment in their firm after obtaining firm loans.<sup>50</sup> These equity purchases help to align the executives' interests with those of the firm and its shareholders.<sup>51</sup> Therefore, observers disagree about the efficacy of 402(a) as a measure that protects investors.<sup>52</sup> Additionally, under Section 302, chief executives and chief financial officers must

---

43. Romano, *supra* note 36, at 1533.

44. *See infra* notes 46–47 and accompanying text (discussing studies which concluded that SOX has had no effect on audit quality).

45. Sarbanes-Oxley Act § 201 (codified at 15 U.S.C. § 78j–1(g) (Supp. 2006)).

46. Romano, *supra* note 36, at 1533–36.

47. *Id.* at 1536.

48. Sarbanes-Oxley Act § 402(a) (codified at 15 U.S.C. § 78m(k) (Supp. 2006)) (prohibiting personal loans to executives).

49. *See* Sarbanes-Oxley Act § 402 (entitled “Enhanced conflict of interest provisions”).

50. Romano, *supra* note 36, at 1539.

51. *Id.*

52. *Id.* at 1540 (calling the SOX legislation a “blunderbuss” approach).

attest to the accuracy of their firm's financial statements, but empirical research results conflict about whether executive certification provides investors with any tangible information or benefit.<sup>53</sup>

SOX does not require that a majority of the directors who serve on a public company's board be independent, but the New York Stock Exchange and NASDAQ do impose this requirement.<sup>54</sup> There is disagreement over the idea that a "supermajority independent board of directors is the ideal corporate governance structure."<sup>55</sup> It seems like a good idea for a board, which monitors management, to be comprised of independent directors with no ties to the company or its management. Others, however, worry that the costs of increased independence will be inefficiently exorbitant when independent directors who are not intimately familiar with the company must gather information.<sup>56</sup> In any event, empirical research conducted by several scholars has failed to establish a connection between boards with a large number of independent directors and increased shareholder wealth.<sup>57</sup>

Because there is extensive debate about the utility of the corporate governance changes required under SOX, the details of the Act's provisions seem less important. The Act's underlying principles, rather than specific corporate governance changes, provide business leaders with the guidance they need. Yet the debate about the utility of SOX's corporate governance changes is likely to eclipse the importance of the Act's underlying principles. Business leaders comply with the details and minutiae, and the letter of the law, in order to avoid liability while ignoring the Act's principles. Moreover, because of the fervor of the debate about SOX, business leaders who fail to seriously consider the Act's principles do not assess their own attitudes as sinful, unlawful or problematic.

#### IV. THE CHANGING DISCOURSE ABOUT SOX

Because of the emerging empirical evidence involving SOX's effectiveness, today's discourse regarding SOX is dramatically different

---

53. *Id.* at 1540–41.

54. See Fogel & Geier, *supra* note 34, at 35 (describing the New York Stock Exchange and NASDAQ's rule requiring a majority of directors to be independent).

55. Usha Rodrigues, *The Fetishization of Independence* 1 (U.G.A. Legal Stud. Res., Working Paper No. 07–007, 2007), available at <http://ssrn.com/abstract=968513>.

56. See generally Cheryl L. Wade, *What Independent Directors Should Expect from Inside Directors: Smith v. Van Gorkom as a Guide to Intra-Firm Governance*, 45 WASHBURN L.J. 367, 374–76 (2006) (discussing the process of information gathering and the process of sharing information between independent and inside directors).

57. Fogel & Geier, *supra* note 34, at 52–56.

than it was in 2002.<sup>58</sup> As noted earlier, the Act was met with little hostility when it was passed due to the 2001 and 2002 scandals.<sup>59</sup> Today, some regulators, institutional investors and academics continue to focus on the Act's benefits.<sup>60</sup> There are commentators who argue that the Act has the potential to prevent corporate fraud, and caution against rolling back the legislation because of "the steady stream of corporate fraud revelations" that continue to arise years after SOX's enactment.<sup>61</sup> Other commentators chronicle the improvements in internal controls, corporate governance, and financial audits as companies comply with SOX.<sup>62</sup>

However, five years after its enactment, most of the discussion regarding SOX is critical. Many argue that the Act should be repealed because it is an unconstitutional federalization of corporate law.<sup>63</sup> Others complain that compliance with SOX has made companies that are listed on U.S. stock exchanges less competitive than companies listed elsewhere.<sup>64</sup> Some commentators lament the high costs of

---

58. Compare Scott Harshbarger & Gourtam U. Jois, *Looking Back and Looking Forward: Sarbanes-Oxley and the Future of Corporate Governance*, 40 AKRON L. REV. 1, 7 (2007) ("Indeed, SOX exists and is appropriate for this situation precisely because it imposes baseline obligations with which corporations are required to comply.") with Romano, *supra* note 36, at 1594 ("Financial turmoil thus appears to be a necessary but not sufficient condition for the enactment of market regulation, and the quality of federal legislative decisionmaking . . . has consistently left much to be desired.").

59. See *supra* Part III (discussing the atmosphere surrounding creation and passage of the legislation).

60. Harshbarger & Jois, *supra* note 58, at 6. Harshbarger and Jois note that institutional investors' and regulators' continued support of SOX suggests that the Act will not be abolished. *Id.*

61. *Id.* (citing to the "accounting issues at Fannie Mae and options backdating at Apple").

62. See generally Daniel L. Goelzer, *Auditing under Sarbanes-Oxley: An Interim Report*, 7 J. BUS. & SEC. L. 1 (2007); Milton Ezrati, *Taking a Second Look at SOX*, ON WALL STREET, Apr. 1, 2007, available at <http://www.onwallstreet.com/asset/article/529371/taking-second-look-sox.html?pg=> (discussing how companies improved compliance with SOX).

63. See Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Spring 2003 (arguing that SOX disrupted the traditional regulation of corporation law by the states).

64. See, e.g., Emma Trincal, *Chamber Pushes Regulatory Reform*, HEDGEWORLD NEWS, Mar. 12, 2007; Robert Schroeder, *Regulations, Litigation Criticized at Conference: Sarbanes-Oxley said to weigh on U.S. Public Companies*, MARKETWATCH, Mar. 13, 2007 (reporting on warnings of New York City Mayor Michael Bloomberg and New York Senator Charles Schumer of the decline of New York as a prominent financial center as companies move offshore to avoid compliance with SOX). Some observe, however, that there are other reasons why the number of initial public offerings has decreased in U.S. markets and that they are not less competitive because of SOX. See Goelzer, *supra* note 62, at 6-7 (arguing that assertions "that [SOX] is undermining the competitiveness of our markets [are], at best, overstated").

compliance with certain SOX provisions,<sup>65</sup> despite evidence that these costs are declining.<sup>66</sup> In any event, whether the complaints are valid or not, most business people today are acutely critical of the Act.

In the years since its passage, academics and members of the business community have argued convincingly that the substantive corporate governance changes required by the Act fail to benefit the investing public because they do not improve corporate performance or the quality of an audit committee's work.<sup>67</sup> In other words, the corporate governance provisions do not operate in a way that will prevent the type of corporate misconduct and oversight failure that precipitated the 2001 and 2002 accounting scandals. Even if the details of the corporate governance changes are wrongheaded, however, the principles underlying the legislation should be upheld. Unfortunately, the widespread discussion about the failure of the detailed governance changes may preclude the changes in corporate culture and climate that the Act's underlying principles were intended to inspire.

#### V. WILL CRITICISMS OF SOX UNDERMINE ITS BENEFITS?

Notwithstanding the increasing criticism of SOX from members of the business community and academics, regulators and institutional investors continue to extol its virtues.<sup>68</sup> The Act, including the much maligned Section 404, has produced some tangible benefits. One scholar notes, "the number of companies that disclosed serious chinks in their internal accounting controls jumped to 586 in the first four months of 2005, compared with 313 for all of 2004."<sup>69</sup> Some chief executives acknowledge that because Section 404 required them to examine the adequacy of internal controls, they discovered accounting inaccuracies, acquired a better understanding of how their companies operate, and

---

65. See *infra* Part VI (discussing Section 404 of the Act and the arguments surrounding the high cost of compliance).

66. See Goelzer, *supra* note 62, at 6 (discussing how SOX costs have declined); Aaron Siegel, *Research shows compliance costs rev up*, INVESTMENT NEWS, Mar. 12, 2007, available at <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070312/FREE/70309018/1017/TOC&ht=> (asserting that SOX compliance costs have dropped over the past two years).

67. Romano, *supra* note 36, at 1530–31.

The existence of a literature that addresses the efficacy of some of the SOX mandates highlights an even more troubling feature of the legislative process. . . . The gist of the literature, that the proposed mandates would not be effective, was available to legislators while they were formulating SOX. Yet it went unnoticed or was ignored.

*Id.* at 1526.

68. Harshbarger & Jois, *supra* note 58, at 5–6.

69. Amy Borrus, *Learning to Love Sarbanes-Oxley*, BUS. WK., Nov. 21, 2005, at 126–28.

were able to cut costs and be more productive in other aspects of their businesses.<sup>70</sup>

It is possible, however, that the current discourse about SOX will reverse or undermine any beneficial impact of the Act. The business community's criticism of SOX leads many business people to question its legitimacy. Such organizational challenges to the Act's legitimacy may result in marginal compliance at best, and perhaps noncompliance in some instances. In other words, if firms perceive the Act to be "poorly crafted [and] unduly burdensome," they will not be compelled to comply fully.<sup>71</sup>

If, however, it is true that the Act's corporate governance requirements do not improve firm performance or audit quality, marginal compliance or even noncompliance is largely irrelevant. The failure to comply with rules that will not benefit investors cannot harm those investors. For example, if the empirical evidence establishes that having an independent audit committee will not benefit investors by improving firm performance or audit quality, a company's failure to comply with this mandate should not harm investors.

It is clear, however, that SOX is not solely concerned with the details of corporate governance and financial reporting. Responding to the Act's critics, Representative Oxley emphasized that "the core principles of Sarbanes-Oxley are paramount, and if changes need to be made in the way the law is enforced, the regulators have the power to make those adjustments."<sup>72</sup> The value of SOX lies in the principles underlying the Act rather than in the Act's corporate governance details. It is at this point that the discourse questioning the Act's legitimacy becomes most relevant. Corporate actors who challenge the Act's legitimacy may or may not comply with the details of the corporate governance mandates. Furthermore, business leaders who challenge the legitimacy of SOX may fail to adhere to the underlying principles that inspired the legislation. This is the real danger of the manner in which the discourse unfolds among the Act's detractors. Because most business leaders deem the Act illegitimate, firms may comply only with the details of the Act's corporate governance rules while ignoring the Act's underlying

---

70. *Id.* Some companies were inspired to upgrade their computer systems. Others used "the paperwork generated [in complying with 404] to describe their internal controls as job-training manuals." *Id.* However, Pitney Bowes CFO Bruce Nolop noted that "[t]here's no doubt that 404 goes too far . . . . You end up documenting things for the sake of documenting them[.]" *Id.*

71. Paul S. Atkins, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks Before the Financial Services Roundtable Lawyers Council 2007 Spring Meeting (May 10, 2007).

72. John Cranford, *Taking Stock of Accounting Law*, CQ WKLY, Mar. 19, 2007, at 790.

principles, including its goal to inspire a more ethical way of disclosing financial information to investors.

#### VI. THE SEC'S NEW PRINCIPLES-BASED APPROACH TO SECTION 404

Much of the criticism of SOX has focused on Section 404, the most contentious of the Act's provisions.<sup>73</sup> Section 404 requires managers to create, maintain, and test processes that monitor internal controls over financial reporting, thereby decreasing the likelihood that financial statements will contain material inaccuracies.<sup>74</sup> Even though the costs of complying with Section 404 have decreased in each of the three years after the provision became effective, the business community complains vociferously that compliance costs outweigh the benefits provided under Section 404.<sup>75</sup> Business leaders lament that they have far too little time to spend attending to core business issues because so much time, money, and effort is spent complying with Section 404.<sup>76</sup> They express concern that the time and effort invested in complying with the internal control and reporting requirements reduce the type of innovation that makes businesses profitable. This has been especially problematic for smaller companies, who may be deterred from taking entrepreneurial risks.<sup>77</sup> Moreover, the enhanced auditing requirements of Section 404 have strained relationships between clients and their auditors.<sup>78</sup> Firms complain that overzealous auditors focus on irrelevant minutiae, further wasting manager's time and the shareholders' money.<sup>79</sup>

In a speech made before the U.S. Chamber of Commerce, Representative Barney Frank spoke of making legislative changes to the

---

73. Goelzer, *supra* note 62, at 5–6.

74. Sarbanes-Oxley Act § 404 (codified at 15 U.S.C. §7262(a)(Supp. 2006)).

75. Kara Scannell, *Moving the Market: Costs Fall Again for Firms To Comply With Sarbanes*, WALL ST. J., May 16, 2007, at C.3. "Total compliance costs in 2006, the third year companies have had to follow the new rules, fell 23% . . . from the prior year. That is 35% lower than the first year . . ." *Id.*; see also Borrus, *supra* note 68, at 126–28 (noting many of the technical and administrative advances triggered by compliance with section 404).

76. Joe DosSantos, *Master Data Management as a Compliance Solution*, SEC INDUS. NEWS, June 18, 2007 ("Corporations appear to be spending more time and money on regulatory compliance now than at any time in recent history.").

77. Peter Ferola, *The Role of Audit Committees in the Wake of Corporate Federalism: Sarbanes-Oxley's Creep Into State Corporate Law*, 7 J. BUS. & SEC. L. 143, 160 (2007).

78. *Id.* ("The new rules with respect to audit committees may have created an adversarial model of corporate governance where the committee is placed in the position of second-guessing the CEO and CFO as well as the company's auditors.").

79. *Id.*

Act if necessary.<sup>80</sup> However, SEC chairman Christopher Cox concluded that no legislative changes are necessary.<sup>81</sup> For now, it seems that the only changes will be in the way the Act is implemented or interpreted.<sup>82</sup>

In the years immediately after SOX's enactment, the SEC provided no guidance for managers with respect to complying with Section 404.<sup>83</sup> On June 20, 2007, however, the SEC responded to the business community's concerns about the costs of 404 by issuing interpretive guidance<sup>84</sup> that the SEC's deputy chief accountant says is not a retrenchment of Section 404.<sup>85</sup> The SEC's deputy chief accountant described the principles on which the SEC's interpretive guidance is based, stating:

The first principle is that management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner. The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk.<sup>86</sup>

In other words, the SEC advises managers to focus on the risk that financial statements will contain material inaccuracies in order to comply with Section 404.<sup>87</sup>

The SEC declined to provide more specific guidance, rules, or examples because it wanted management to focus on the principle of

---

80. Robert Schroeder, *Sarbanes-Oxley Fix Debated at Competition Summit*, MARKET WATCH, Mar. 14, 2007, available at <http://www.marketwatch.com> (search "Sarbanes-Oxley Fix Debated").

81. *Id.* (covering the debates of SOX at a summit on American competitiveness).

82. Romano, *supra* note 36, at 1602. "Congressional repeal of SOX's corporate governance mandates is not on the near-term political horizon. Officeholders would not want to be perceived as revising rules that are supposed to diminish the likelihood of corporate accounting scandals." *Id.*

83. See John W. White, Dir., Div. of Corp. Fin. U.S. Sec. and Exch. Comm'n, Statement by SEC Staff: SEC's Proposed Interpretive Guidance to Management for Section 404 of Sarbanes-Oxley Act (May 23, 2007), available at <http://www.sec.gov/news/speech/2007/spch052307jww.htm> (providing interpretive guidance regarding SOX).

84. *Rules and Related Matters*, SEC NEWS DIG., June 21, 2007, available at <http://www.sec.gov/news/digest/2007/dig062107.txt>.

85. Zoe -Vonna Palmrose, Deputy Chief Accountant, U.S. Sec. and Exch. Comm'n, Statement by SEC Staff: SEC's Proposed Interpretive Guidance to Management for Section 404 of Sarbanes-Oxley Act, (May 23, 2007), available at <http://www.sec.gov/news/speech/2007/spch052307zvp.htm> [hereinafter Palmrose SEC Statement].

86. *Id.*

87. *Commission Announcements*, SEC NEWS DIG., May 24, 2007.

risk and how it operates at a manager's particular company.<sup>88</sup> A list of specific rules, standards, or examples would inspire managers to take an approach under Section 404 that would have them simply checking off items on an articulated checklist.<sup>89</sup> Under this approach, managers focus on form rather than substance or principles, which may require managers to consider items on a checklist that are not relevant to their firms and the risk that their firms' financial statements may be materially misleading.<sup>90</sup> The SEC's principles-based implementation of Section 404 is aimed at avoiding this type of inefficiency. SEC Chairman Christopher Cox predicted that principles-based compliance, focusing on the risk of material financial misstatements, will be particularly beneficial for smaller companies.<sup>91</sup>

Compliance costs should decrease because the new SEC guidance developed specifically for management will allow each small business to exercise significant judgment in designing an evaluation method that is tailored to its individual circumstances. Unlike external auditors, management in a smaller company tends to work with its internal controls on a daily basis. They have significant knowledge about how their firm operates. The new SEC guidance allows management to make use of that knowledge, which should lead to a much more efficient assessment process.<sup>92</sup>

The changing focus on Section 404 takes aim at the check-the-box approach that managers have previously taken:

We're re-orienting 404 to focus on what truly matters to investors—and away from expensive and unproductive make-work procedures that waste investors' money and distract attention from what's genuinely material. No longer will the 404 process tolerate procedures performed solely so someone can claim he considered every conceivable possibility.<sup>93</sup>

---

88. *Id.* "In adopting the revisions [to 404's interpretation] . . . regulators said small companies, in particular, should benefit by being able to focus audits on financial records that appeared to present the greatest risks of fraud." Robert Schroeder, *Regulators asked for Sarbanes-Oxley costs*, MARKETWATCH, June 12, 2007, available at <http://www.marketwatch.com> (search "Regulators asked for Sarbanes").

89. See *supra* notes 10–15 and accompanying text (describing the "check-the-box" approach to SOX and the drawbacks of such an approach).

90. Palmrose SEC Statement, *supra* note 85.

91. Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Testimony Concerning Section 404 of the Sarbanes-Oxley Act and Small Business (June 5, 2007), available at <http://www.sec.gov/news/testimony/2007/ts060507cc.htm>.

92. *Id.*

93. *Id.* Under the new guidelines corporate managers have more flexibility in preparing financial reports because the new guidance does not require "every financial control to be checked." Robert Schroeder, *Further Tweaks Urged for Sarbanes-Oxley*, MARKETWATCH, Feb.

The PCAOB coordinated with the SEC to make changes to the way auditors comply with Section 404 that are similar to the changes made under the Commission's 404 interpretive guidance for corporate management.<sup>94</sup> Auditing Standard No. 5 has replaced the original internal control auditing standard articulated in Auditing Standard No. 2.<sup>95</sup> The new standard for auditors, similar to the interpretive guidance given to management, incorporates a principles-based approach that focuses on the risk that a particular company's financial statement would contain material misinformation.<sup>96</sup> This approach, like the approach to be taken by management, allows auditors to customize their audits according to the significant risks of a particular company.<sup>97</sup> Consequently, auditing costs for smaller, less complex companies will not be unreasonably high because auditors will not spend time investigating details that are not related to the risk of disclosure inaccuracies for that company. Auditors are now encouraged to use "professional judgment in the 404 process, particularly in using risk-assessment" and in "determining when and to what extent the auditor can use the work of others."<sup>98</sup>

## VII. CONCLUSION

Will the newly articulated principles-based approach that focuses on risk assessment lower the costs of section 404 compliance while protecting investors? With respect to lowering costs, some observers argue that little will change because auditors and managers will continue to focus on details and minutiae in order to avoid liability for

---

26, 2007, available at <http://www.marketwatch.com> (search "Further Tweaks Urged for Sarbanes-Oxley").

94. Press Release, Public Company Accounting Oversight Board, Board Approves New Audit Standard For Internal Control Over Financial Reporting and, Separately, Recommendations on Inspection Frequency Rule (May 24, 2007), available at [http://www.pcaobus.org/News\\_and\\_Events/News/2007/05-24.aspx](http://www.pcaobus.org/News_and_Events/News/2007/05-24.aspx).

95. *Id.* Auditing Standard No. 5 is entitled "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements" while Auditing Standard No. 2 was the previous, more rules-based internal control standard. *Id.*

96. *Id.*

97. Robert Schroeder, *Accounting Board OKs Streamlined Sarbanes-Oxley Checks*, MARKETWATCH, May 24, 2007, available at <http://www.marketwatch.com> (search "Accounting Board OKs Streamlined"). Interestingly, "[t]he new standard is a third the length of the old one." *Id.*

98. *Commission Announcements: SEC Commissioners Endorse Improved Sarbanes-Oxley Implementation to Ease Smaller Company Burdens, Focusing Effort on 'What Truly Matters.'* SEC NEWS DIG., April 4, 2007; see also Robert Schroeder, *SEC agrees to coordinate auditing proposals*, MARKETWATCH, Apr. 4, 2007, available at <http://www.marketwatch.com> (search "SEC Agrees to Coordinate Auditing Proposals") (further discussing the restructuring of the auditing standards).

noncompliance.<sup>99</sup> As one commentator notes, “Simply proclaiming that audits should be risk-based won’t make them so. . . . Auditors and companies will still face potential liability for not looking at every last process that could be deemed an internal control.”<sup>100</sup> In addition, as far as investor protection is concerned, standards and principles are meaningless unless auditors and managers apply them faithfully.<sup>101</sup>

One member of Britain’s Financial Services Authority offered an interesting perspective on principles-based regulation. He stated, “There are . . . rules. But you can afford to be less intrusive because as a regulator, you have principles you can fall back on.”<sup>102</sup> This, however, is easier than it sounds. Britain’s Financial Services Authority announced a “simple principle saying financial firms must segregate their clients’ money from their own money. Lawyers representing the financial firms [asked]: “What do you mean by clients? What do you mean by money? What do you mean by segregated?”

One commentator worried that focusing on principles rather than hard and fast rules would make the proponents of principles-based regulation seem “soft” on corporate malfeasance.<sup>103</sup> This is a problem, however, only if corporate management is permitted to ignore one of the most fundamental principles that inspired the enactment of SOX. The principle is that ethical business, accounting, and disclosure practices, and diligent oversight aimed at achieving these goals, will inspire an ethical corporate culture in which corporate malfeasance is infrequent. Emphasis on the admittedly broad principles of ethical compliance and monitoring, and the clearly articulated demand and expectation that managers behave ethically, will reduce risks and protect investors.

---

99. Harshbarger & Jois, *supra* note 58, at 8–9.

100. Carol E. Curtis, *No Rest for the Weary Regulator or Compliance Officer: Hedge Funds Face Likely Scrutiny, But Small Companies, At Least, Get Relief*, SEC. INDUS. NEWS, Jan. 8, 2007, at 16 (quoting John Berlau, director of the Center for Entrepreneurship at the Competitive Enterprise Institute).

101. A member of PCAOB acknowledged that principles-based standards must be faithfully applied. Schroeder, *supra* note 97.

102. Crawford Panel on a Single Canadian Securities Regulator, *Issue Analysis: Growing Support for Principles-Based Securities Regulation*, [http://www.crawfordpanel.ca/3\\_Issues\\_Analysis-Principles\\_Based\\_Regulation.doc](http://www.crawfordpanel.ca/3_Issues_Analysis-Principles_Based_Regulation.doc).

103. Alan Murray, *Paulson Walks Fine Line Amid Calls for a Less-Intrusive Regulatory Scene*, WALL ST. J., Nov. 29, 2006, at A2.