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Robert E. Freer Jr.

Raymond W. Burroughs

UNINTENDED CONSEQUENCES: SARBANES-OXLEY AND ITS PROGENY

Robert E. Freer, Jr.[*]
Raymond W. Burroughs[**]

INTRODUCTION

The magnitude of the market dollar impact, along with the number of investors and employees affected by the corporate accounting malfeasance of Enron, WorldCom, and other corporations, announced in late 2001 and early 2002, drove the Sarbanes-Oxley Act of 2002 (SOX) to swift implementation.[1] Experts deemed the apparent concurrence in accounting issues and lack of detection by the auditors to have contributed to the accounting malfeasance problems at Enron.[2] The resulting congressional hearings and investigation led to the passage of SOX and the demise of Arthur Andersen LLP, the largest of the "Big 5" accounting firms at the beginning of 2002.[3] This swift enactment of SOX failed to anticipate the impact it would have on the

[*] Princeton University AB, 1963, University of Virginia, J.D. 1966, BB&T Visiting Professor in Ethics & Free Enterprise Leadership, School of Business Administration, The Citadel, 2009- adjunct professor, The Charleston School of Law, 2006- Member Bars of Virginia and The District of Columbia; Associate Member Bar of South Carolina. Former Vice President and Counsel for Kimberly-Clark Corporation.

[**] Ray Burroughs, JD, LLM works in the Tax, Estate Planning and Probate and Commercial Transactions Practice Groups at Young Clement Rivers LLP law firm in Charleston, South Carolina, and is a graduate of the University of South Carolina School of Law and New York University School of Law. He may be reached at rburroughs@ycrlaw.com. The authors would like to recognize and thank Andrew Scott Raynal, a former Baker Free Enterprise Foundation Fellow and Halsey Shreier of Clawson and Staubes, for their research assistance with this article.

[1] *See* Paul Lowengrub, *The Impact of Sarbanes-Oxley on Companies, Investors & Financial Markets*, SARBANES-OXLEY COMPLIANCE J. (Dec. 6, 2005, 12:00 PM), http://www.s-ox.com/dsp_getFeaturesDetails.cfm?CID=1141.

[2] Louis Lavelle, *Commentary: How Governance Rules Failed at Enron*, BLOOMBERG BUS. WK. (Jan. 21, 2002), http://www.businessweek.com/magazine/content/02_03/b3766045.htm.

[3] *See, i.e., Corporate Accountability: Hearing Before the House of Rep.*, 107th Cong. 1470-72 (2002) (statement of Eliot Spitzer, N.Y. State Att'y Gen.).

day-to-day practices of American businesses, including accounting firms, as well as how it would impact foreign businesses trading, or contemplating trading, in the U.S.[4]

Congress, the SEC, and the President created the Sarbanes-Oxley Act as a quick fix to help stimulate the economy by attempting to rebuild consumer confidence.[5] Overall, Sarbanes-Oxley promoted diligence, integrity, and honesty, which was needed to restore consumer confidence in the cynical business climate caused by the Enron and WorldCom scandals. If Congress had stopped with Title I and Title II, on auditor independence and oversight, it would have been sufficient to create the level of discipline and accountability within the financial reporting system to correct the abuses. Regrettably, in Titles III and IV, where SOX addresses "Corporate Responsibility" and "Enhanced Financial Disclosure," the legislature has gone too far. Titles III and IV enhance the powers of the audit committee, increase disclosure requirements, and impose criminal liability on board members who report inaccurately.[6] Ultimately, this legislative stew has undermined protection for faithful actions of board members.[7]

More specifically, Section 302 requires the principal executive officers and the principal financial officers of public companies to attest that the periodic reports filed by the company do not contain misleading statements or omissions of material fact.[8] Furthermore, the officers must certify that they are responsible for establishing and maintaining internal controls, which are designed to ensure the reports accurately present the financial condition of the company; evaluating the effectiveness of these internal controls; and presenting their conclusions regarding these internal controls or any changes made

[4] *The Impact of the Sarbanes-Oxley Act: Hearing Before the Comm. on Fin. Services*, 109th Cong. 2 (2005) (statement of Hon. Michael G. Oxley, Chairman, Comm. on Fin. Services), *available at* http://financialservices.house.gov/media/pdf/109-21.pdf ("[t]he costs of Section 404 are much higher than expected. That is a cause for concern, and I am particularly sensitive to any undue burden on small and mid-size companies whose compliance costs are a higher percentage of total revenues.").

[5] Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 Cardozo L. Rev. 703, 705 (2007).

[6] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 101, 116 Stat. 745, 775-791 (2002) (codified at 15 U.S.C. §7201 (2002)).

[7] Christopher Whalen, *Revisiting Sarbanes-Oxley*, INT'L ECON., Fall 2003, at 40-43, *available at* http://www.international-economy.com/ TIE_F03_Whalen.pdf#search=%22Sarbanes-Oxley%2C%20Prudent%20Man%20Rule%22.

[8] Sarbanes-Oxley Act § 302, 116 Stat. at 777-78.

thereto.[9] Section 906 encourages officers to take seriously the certification of the periodic reports by imposing criminal penalties of up to $1 million and ten years imprisonment on officers who certify misleading financial statements.[10] If such officers knowingly certify a non-conforming statement, the penalties are expanded to up to $5 million and twenty years in prison.[11]

The third and most controversial of the provisions is Section 404, Management Assessment of Internal Controls.[12] Since its passage, the additional administrative costs of compliance have strained valuable resources of American businesses and resulted in a corporate culture of red tape and suspicion that has placed U.S. businesses at a significant competitive disadvantage.[13] SOX has adversely impacted America's competitive position by substantially increasing non-productive overhead while discouraging foreign firms and fast-growing firms in the United States from listing on U.S. exchanges.[14]

Evidence shows that the Sarbanes-Oxley Act of 2002 has created more burdens than aid. Although it has instilled consumer confidence, the Act has caused publicly-traded companies and the U.S. market to become substantially more unattractive. Publicly-registered companies subject to the regulations of the SEC are too restricted to expand, grow, and compete with companies listed in foreign markets. Corporate officers cannot perform their duties properly, and consumers cannot expect to receive full performance from companies. Foreign companies who once dreamed of registering on the U.S. exchanges have suddenly opted for more attractive and less-restrictive markets.

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[9] *Id.*

[10] Sarbanes-Oxley Act §906, 116 Stat. at 806.

[11] *Id.*

[12] *See* Prentice, *supra* note 5, at 705.

[13] *See* Tamara Loomis, *Sarbanes-Oxley Burdens Small Companies*, 228(117) N.Y. L.J. 1 (Dec. 19, 2002).

[14] *SarbOx Has Foreign Companies Decamping*, CIOINSIGHT (Mar. 5, 2005), http://www.cioinsight.com/c/a/Past-News/SarbOx-Has-Foreign-Companies-Decamping/ (quoting Rhian Chilcott, Confederation of British Industry, who explained that the real problem for the U.S. economy is not just the number of companies delisting, but "the companies that would have listed, but now won't. Across the board, people are reconsidering.").

I. STATUTORY HISTORY

Corporate fraud has played a material role in the industrial history of the United States.[15] For example, "financial genius Jay Cooke, who masterminded a new strategy for selling government debt during the Civil War, and Samuel Insull, who built a vast utilities empire only to be ruined by the Depression."[16] There are only a few differences from past and present corporate scandals: higher stakes and the sums of money have become increasingly more difficult to hide from more informed regulatory officials as well as stockholders. Unfortunately, two of the most notorious corporations, Enron and MCI WorldCom, embraced illegality and scandal with open arms in the 21st century, ruining the lives of employees, investors, and directors. While Enron and WorldCom are not alone in their fraudulent endeavors, the public attention created by the magnitude of fraud forced stricter accounting regulations, more corporate fraud legislation, and a more vigilant and intrusive Securities and Exchange Commission (SEC).[17]

In August of 2001, former Vice President for Corporate Development at Enron, Sherron Watkins, warned Enron's CEO, Ken Lay, of impending financial problems based on "a wave of accounting scandals."[18] Subsequently, the company announced that it was worth $1.2 billion less than it had reported to the SEC and its shareholders, due to inflated estimates of income and failure to include all debts in investor reports. [19] By the end of 2001, Enron's accounting issues forced the company into bankruptcy, and its accountant, Arthur Andersen, LLP, has since gone bankrupt and ceased to do business.[20]

As the Enron nightmare was unfolding, at MCI WorldCom, another publicly-traded corporate behemoth, "several former

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[15] *See Corporate Fraud on Trial: What Have We Learned?*, KNOWLEDGE@WHARTON (Mar. 30, 2005), http://knowledge.wharton.upenn.edu/createpdf.cfm?articleid=1131.

[16] *Id.* at 1 (citing David Skeel, ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM (2005)).

[17] *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

[18] *Enron Whistleblower Tells of 'Crooked Company,'* MSNBC (Mar. 15, 2006, 7:46 PM), http://www.msnbc.msn.com/id/11839694.

[19] *Enron Fraud*, LAWYERSHOP.COM, http://www.lawyershop.com/practice-areas/criminal-law/white-collar-crimes/securities-fraud/lawsuits/enron (last visited Aug. 22, 2010).

[20] *Id.*

employees gave statements alleging instances of hiding bad debt, understating costs, and backdating contracts."[21] WorldCom failed to investigate the claims of the former employees, and as a result, its shareholders sued.[22] The lawsuit was dismissed for "lack of evidence."[23] However, upon an investigation beginning in March 2002, the SEC found that the past employer claims were true, and "the SEC filed a civil fraud lawsuit against WorldCom," which resulted in several executives being found liable.[24] WorldCom revealed that it had overstated its earnings by more than $9 billion during the period between 1999 and the first quarter of 2002, primarily by improperly accounting for its operating costs.[25]

As a result of the corporations' grave malfeasance, all publicly-registered companies were treated as if they had Enron or WorldCom potential. Spurred on by countless numbers of other corporate scandals including the likes of Adelphia, Tyco, and ImClone, reform was inevitable.[26] Investor confidence in major companies and the stock market was at an all-time low, thanks in part to these large corporations' scams.[27] Not to mention, the tragedies of 9/11 added to the calamity and financial woes of the country as 2001 came to a close.[28] Congress and the SEC had to efficiently and rapidly restore integrity and honesty into the market. In the spring of 2002, the House of Representatives passed H.R. 3763 entitled "Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002"

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[21] *WorldCom Securities Fraud Scandal*, LAWYERSHOP.COM, http://www.lawyershop.com/practice-areas/criminal-law/white-collar-crimes/securities-fraud/lawsuits/worldcom (last visited Aug. 22, 2010).

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] First Amended Complaint, SEC v. WorldCom, Inc., 273 F. Supp. 2d. 431 (2003) (No. 02-CV-4963).

[26] *See WorldCom*, *supra* note 21.

[27] William H. Donaldson, Chairman, Sec. & Exch. Comm'n, Remarks to the National Press Club (Jul. 30, 2003), http://www.sec.gov/news/speech/spch073003whd.htm (noting that corporate malfeasance resulted in a "widespread collapse of investor confidence.").

[28] Patrick McGeehan, *After the 'Darkest Year,' a Change Wall St.*, N.Y. TIMES, Sep. 8, 2002, http://www.nytimes.com/2002/09/08/business/after-the-darkest-year-a-changed-wall-st.html (noting that "aiming at the World Trade Center, the terrorists struck . . . a complex that not only was just a few blocks from the stock exchange, the heart of the financial system, but also was the communication and transportation hub connecting Wall Street to the rest of the world" and that the attack "shut down American financial markets for several days.").

proposed by Representative Michael Oxley (R-Ohio).[29] Oxley introduced his bill in a much different format than that of the current law—a much less stringent and exhaustive proposal that was only partially comparable to current legislation.[30] More specifically, the proposal did not contain any provisions stipulating that corporate officers sign off on all financial reports.[31] The House passed the bill by a vote of 334–90.[32] The House then referred the bill to the Senate Banking Committee with the support of President Bush and the Securities and Exchange Commission.[33] On June 25, 2002, the Chairman of that Committee, Senator Paul Sarbanes (D-MD), proposed his own bill, Senate Bill 2673, to the Senate Banking Committee.[34] Structurally, Sarbanes's bill shows more similarities to the current Act establishing titles within the bill, which included Section 404 of Title IV and Section 302 of Title III—two of the most troublesome sections that remain part of the current law.[35]

Congress then formed a committee to reconcile the differences between Representative Oxley's bill and Senator Sarbanes's bill.[36] While Congress evaluated the proposals, the media in the United States swarmed around the Enron and WorldCom indictments and scandals.[37]

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[29] Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, H.R. 3763, 107th Cong. (2002).

[30] *Compare Id., with* Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745.

[31] H.R. 3763

[32] *Final Vote Results for Roll Call 110*, CLERK.HOUSE.GOV (April 24, 2002), http://clerk.house.gov/evs/2002/roll110.xml (counting ballots for H.R. 3763).

[33] Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1004 (2005) ("The [House bill], with the support of President Bush and the SEC, was then referred to the Senate Banking Committee").

[34] Public Company Accounting Reform and Investor Protection Act of 2002, S. 2673, 107th Cong.

[35] *Compare Id., with* H.R. 3763; *see also*, Sarbanes-Oxley Act of 2002 § 101.

[36] *See* Nagy, *supra* note 33, at 1005-06 ("After the Senate's unanimous vote on July 15, 2002, the House and the Senate formed a Conference Committee to reconcile the stark differences between Senator Sarbanes's bill (S. 2673) and Representative Oxley's bill (H.R. 3763).").

[37] Richard W. Stevenson & Richard A. Oppel Jr., *Corporate Conduct: The Overview; Fed Chief Blames Corporate Greed; House Revises* Bill, N.Y. TIMES, Jul. 17, 2002, http://www.nytimes.com/2002/07/17/business/corporate-conduct-overview-fed-chief-blames-corporate-greed-house-revises-bill.html ("With political pressure growing and the stock market falling, the House hurriedly passed a measure that

Congress, influenced by the pressure of the media and the consumers in the midst of the corporate scandal frenzy, relied heavily on Senator Sarbanes's bill, and the Committee finalized the conference bill on July 24, 2002, naming it "the Sarbanes-Oxley Act of 2002."[38] When both houses of Congress voted on the newly revised bill, it was passed with confidence in an overwhelming fashion: 423–3 in the House and 99–0 in the Senate.[39] On July 30, 2002, President George W. Bush hurriedly signed it into law just before the August congressional recess.[40] What resulted is a law containing eleven titles (each divided into sections) which vary in context from additional corporate responsibilities to implementation of more severe criminal penalties.[41]

Congress's approach mandated that companies adopt many unreasonable requirements, which gave little consideration to a company's size or financial records, into their accounting practices.[42]

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would . . . curb corporate wrongdoing." Furthermore, "[Senator] Oxley said a number of senators . . . voted for [the bill despite reservations] because 'nobody wanted to get in front of that train.'"); Richard A. Oppel Jr., *Worldcom's Collapse: Congressional Action; Little Progress On Corporate Governance Bill*, N.Y. TIMES, Jul. 22, 2002, http://www.nytimes.com/2002/07/22/us/worldcom-s-collapse-congressional-action-little-progress-corporate-governance.html?scp=6&sq=sarbanes+oxley&st=nyt ("President Bush and Democratic leaders increased the pressure on Congress to complete its work within days" on reconciling the House and Senate versions of the future Sarbanes-Oxley Act.); Richard A. Oppel Jr., *Corporate Conduct: The Overview; Negotiators Agree On Broad Changes In Business Laws*, N.Y. TIMES, Jul. 25, 2002, http://www.nytimes.com/2002/07/25/business/corporate-conduct-overview-negotiators-agree-broad-changes-business-laws.html?scp=1&sq=sarbanes+oxley&st=nyt ("The [bill] moved along quickly in the wake of the daily disclosures of corporate scandal.").

[38] *Bill Summary & Status*, THOMAS.LOC.GOV, http://thomas.loc.gov/cgi-bin/bdquery/z?d107:HR03763:@@@S|TOM:/bss/d107query.html (last visited Feb. 1, 2011).

[39] *Final Vote Results for Roll Call 348*, CLERK.HOUSE.GOV (July 25, 2002), http://clerk.house.gov/evs/2002/roll348.xml_(counting ballots for H.R. 3763); *U.S. Senate Roll Call Votes 107th Congress-2nd Session*, SENATE.GOV (July 25, 2002), http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=107&session=2&vote=00192.

[40] Elisabeth Bumiller, *Corporate Conduct: The President; Bush Signs Bill Aimed At Fraud In Corporations*, N.Y. TIMES, Jul. 30, 2002, http://www.nytimes.com/2002/07/31/business/corporate-conduct-the-president-bush-signs-bill-aimed-at-fraud-in-corporations.html ("President Bush signed a sweeping corporate-fraud bill today. . . .").

[41] Sarbanes-Oxley Act of 2002 § 1.

[42] *See e.g*,. Ehud Kamar et. al., *Going-Private Decisions And The Sarbanes-Oxley Act Of 2002: A Cross-Country Analysis*, 25 J.L. ECON. & ORG. 107, 129 (2009) (finding based on empirical analysis that Sarbanes-Oxley

SOX has also created difficulty in timing the announcement of corporate actions, raised director exposure to litigation despite their best attempts to get it right, and has disadvantaged American corporations by raising compliance costs into the stratosphere. Years later, it is apparent that Sarbanes-Oxley has created more trouble than it has been worth.[43] Conceptually, the Act's approach for reforming corporate accounting practices is simultaneously revolutionary and indefensible. The corporate world indisputably needed some sort of regulatory interference. However, the substance of SOX lacks the foresight and specificity required and has created dissatisfaction and hurdles for corporate officials, foreign companies, and many lawmakers that not only hinder corporate action, but also place unnecessary financial strain upon companies.[44]

"disproportionately burdens small firms"); Nathan Wilda, *David Pays for Goliath's Mistakes: The Costly Effect Sarbanes-Oxley Has on Small Companies*, 38 J. MARSHALL L. REV. 671, 680 (2004) (stating that "[b]ecause the Act does not distinguish between large and small companies, the burden of compliance is weighing very heavily on smaller firms").

[43] *See e.g.*, Romano, *supra* note 17, at 1524 (finding that "extensive empirical literature suggests that [corporate governance] mandates [in Sabanes-Oxley] were seriously misconceived, because they are not likely to improve audit quality or otherwise enhance firm performance and thereby benefit investors as Congress intended" and that "the mandates should be rescinded").

[44] *See* Kenneth B. Davis Jr., *The SEC and Foreign Companies – A Balance Of Competing* Interests, 71 U. PITT. L. REV. 457, 462 (2010) (citing that compliance with Sarbanes-Oxley is a "serious concern for foreign companies" and has reportedly contributed to the "sharp downward trend in foreign registered offerings"); Cheryl L. Wade, *The Sarbanes-Oxley Act And Ethical Corporate Climates: What The Media Reports; What The General Public Knows*, 2 BROOK. J. CORP. FIN. & COM. L. 421, 440 (2008) ("Business leaders complain that SOX was hastily enacted and that its benefits are severely outweighed by its costs, thereby reducing the competitiveness of U.S. companies in the global economy."); Kara Scannell, *Sarbanes Oxley Critics Declare a Victory – At Least for Now*, WALL ST. J.: WASH. WIRE (Nov. 03, 2009, 11:56 AM), http://blogs.wsj.com/washwire/2009/11/03/sarbanes-oxley-critics-declare-a-victory-at-least-for-now/ (discussing lawmaker concerns with regard to the negative impact Sarbanes-Oxley has on small, publicly-traded companies and the need to exempt them from the Act's financial controls).

II. SECTION 404

Section 404 is not only the crux of the Sarbanes-Oxley Act of 2002 but also the root of many problems associated with the Act.[45] Section 404 requires that each publicly-held company prepare and include reports issued by corporate managers in the company's quarterly and yearly filings to outline the state of the company's internal accounting controls; additionally, Section 404 requires that the effectiveness of such internal controls be attested to by an independent outside auditor.[46] Section 404 imposes penalties upon both the company and the external auditors if the auditor is not totally independent of the company.[47] This liability creates confusion, as well as a chilling effect, between companies and auditors alike because some communication between the two is necessary but too much is illegal.[48] Moreover, the company must bear the costs for the measures to inspect their internal controls, for the outside auditor's survey of those controls, and for the solutions to the problems detected by either party.[49]

A. "THE CHILLING EFFECT"

Section 404 and its various interpretations have created a "chilling effect" amongst companies, their internal audit committees,

[45] *See e.g.*, Renee M. Jones, *Will the SEC Survive Financial Regulatory Reform?*, 71 U. PITT. L. REV. 609, 620 (2010) (calling Section 404 the "most controversial provision" in Sarbanes-Oxley); Charles W. Murdock, *Sarbanes-Oxley Five Years Later: Hero or Villain*, 39 LOY. U. CHI. L.J. 525, 550-51 (2008) (detailing some of the significant problems with section 404 and noting that the "[compliance] cost has been so much larger than anticipated").

[46] Sarbanes-Oxley Act of 2002 § 404 ("The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.").

[47] *See id.*

[48] Lynn Stephens & Robert G. Schwartz, *The Chilling Effect of Sarbanes-Oxley: Myth or Reality?*, CPA J. (June 2006), http://www.nysscpa.org/cpajournal/2006/606/infocus/p14.htm.

[49] Prentice, *supra* note 5, at 728-29 (discussing costs of section 404 including "internal control expenditures" and "audit fees").

and their independent auditors.[50] The "chilling effect" stems from a disinclination of independent auditors to advise their clients on internal control issues, and many independent auditors take the position that the provision of any services outside of the audit could be perceived as a violation of their independence.[51] Accountants, auditors, and corporate officials fear risking their livelihoods by crossing the fine line that divides a permissible amount of communication with the company and an excessive amount, which has been deemed illegal.[52] The confusion exists because it is necessary that accountants and internal auditors communicate and cooperate in order to produce beneficial results for the companies and themselves, but too much communication could lead to the imposition of fines and other penalties on the company or accountants.[53] The rules relating to auditor independence that give rise to this communication breakdown are found in Title II of the Act.[54] Specifically, the Act draws a line between audit services and non-audit services, with the latter being generally prohibited if the auditor is to be qualified an independent.[55]

However, the Act has many features that should be helpful in providing fair reporting of financial results. The creation of the federally mandated Public Company Accounting Oversight Board in Title I should do much to clean up the cozy relationship that has existed between some auditors and some registrants.[56] In Free Enterprise Fund v. Public Company Accounting Oversight Board, the Supreme Court found the Act to be constitutional; nevertheless, the Court declared that the absence of meaningful oversight by the executive branch appointment process made exercise of the Board's authority

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[50] Stephens & Schwartz, *supra* note 48.
[51] *Id.*
[52] *Id.*
[53] Sarbanes-Oxley Act of 2002 § 3.
[54] Sarbanes-Oxley Act of 2002 §§ 201-09.
[55] Sarbanes-Oxley Act of 2002, § 201 (Non-audit service is defined to include 1) bookkeeping or other services related to the accounting records or financial statements of the audit client; 2) financial information systems design and implementation; 3) appraisal or valuation services, fairness opinions; 4) actuarial services; 5) internal audit outsourcing services; 6) management functions or human resources; 7) broker or dealer, investment adviser, or investment banking services; 8) legal services and expert services unrelated to the audit; and 9) any other service that the Board determines, by regulation, is impermissible.).
[56] Sarbanes-Oxley Act of 2002 § 101.

unconstitutional.[57] Prior to the decision, Board members were only removable for "good cause shown."[58] The decision of the Court declared the removal restriction invalid, leaving the Board members removable "at will" going forward.[59] Because there is no savings clause in the statute, the Court's "split" decision is somewhat troubling, as the opinion in no uncertain terms relates that, except as Board tenure is modified, "the Sarbanes-Oxley Act remains fully operative as a law."[60] The case can be taken as a strengthening of auditor independence. Going forward, the financial community and the public will benefit from a higher level of confidence that reported financial results reflect the application of an understood standard consistently applied. This will greatly help the public and all segments of commerce.

B. SO EXPENSIVE

The main concern with SOX for publicly-traded companies registered in the United States is the cost of compliance, not only in terms of what companies have to directly pay external parties but also in terms of ancillary costs such as time.[61] As they contend with budget issues, smaller public companies are particularly struggling to comply.[62] Midsize firms, which are currently spending the smallest

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[57] Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 130 S.Ct. 3138 (2010).

[58] *Id.* at 3142.

[59] *Id.* at 3145.

[60] *Id.* at 3161.

[61] OFFICE OF ECON. ANALYSIS, U.S. SEC. & EXCH. COMM'N, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements*, 2 (2009) [hereinafter *Study of Section 404 Internal Control*], available at http:// www.sec.gov/news/studies/2009/sox-404_study.pdf.

[62] U. S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-361, REPORT TO THE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP, U.S. SENATE, SARBANES-OXLEY ACT: CONSIDERATION OF KEY PRINCIPLES NEEDED IN ADDRESSING IMPLEMENTATION FOR SMALLER PUBLIC COMPANIES, at 5 (2006) [hereinafter SENATE REPORT ON IMPLEMENTATION FOR SMALLER PUBLIC COMPANIES] ("While smaller companies historically have paid disproportionately higher audit fees than larger companies as a percent of revenues, the percentage difference between median audit fees paid by smaller versus larger public companies grew in 2004, particularly for companies that implemented the act's internal control provisions (section 404). Smaller public companies also cited other costs of compliance with section 404 and other provisions of the act, such as the use of resources for compliance rather than for

percentage of their budgets on compliance, have seen their costs go through the roof; however, these midsize firms are the most likely to invest in financial reporting software and may be able to best control their costs.[63] Large firms have also taken a hit. For example, an officer of Pfizer reported that their measured annualized compliance costs have increased to $125 million.[64] On any scale, this level of compliance costs is out of hand. Regardless of the firm size, the cost of compliance has squeezed profit margins for all, discouraging initial public offerings and forcing smaller companies to delist, thereby decreasing the competition on which the U.S. economy was founded and that today spurs improvements in products and services for consumers.[65]

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other business activities. Moreover, the characteristics of smaller companies, including resource and expertise limitations and lack of familiarity with formal internal control frameworks, contributed to the difficulties and costs they experienced in implementing the act's requirements. . . . Smaller public companies and accounting firms noted that the complexity of the internal control framework and the scope and complexity of the audit standard and related guidance for auditors on section 404 issued during rather than prior to the initial year of implementation contributed to the costs and challenges experienced in the first year of implementation. It is generally expected that compliance costs for section 404 will decrease in subsequent years, given the first-year investment in documenting internal controls. The act, along with other market forces, appeared to have been a factor in the increase in public companies deregistering with SEC (going private)—from 143 in 2001 to 245 in 2004. However, these companies were small by any measure (market capitalization, revenue, or assets) and represented 2 percent of public companies in 2004. Based on our survey responses and discussions with smaller public companies that implemented section 404, it appears that the act has not adversely affected the ability of those smaller public companies to raise capital. However, it is too soon to assess fully the impact of the act on access to capital, particularly because of the large number of smaller public companies—the more than 5,900 small public companies considered by SEC to be non-accelerated filers—that have been given an extension by SEC to implement section 404.").

[63] Paula L. Green, *Costly Compliance*, GLOBAL FIN., Apr. 2005, available at http://www.gfmag.com/archives/65-65-april-2005/1667-features-costly-compliance.html#axzz1MdpeIIS6 ("The cost of complying with the controversial section, which forces companies to monitor the internal controls they have in place to ensure their financial reporting is accurate and requires outside auditors to vouch for those controls, can tally several million dollars for a mid-size company.").

[64] Pfizer Officer, Florida Directors' Institute Program, Univ. of Tampa, 2006.

[65] *See* Thomas Selling, *Sarbanes-Oxley: Unintended Consequences*, GLOBAL VISTA, THUNDERBIRD (2004), http://www.enewsbuilder.net/

An analysis released by the SEC in September of 2009 discovered that "the largest cost component is internal labor costs—which can comprise more than 50 percent of the total compliance costs."[66] As may be expected, "[l]arger companies tend to incur higher compliance costs in dollar terms ('absolute cost'), while smaller companies report higher costs as a fraction of asset value ('scaled cost')."[67] "The Section 404(a) cost is borne through increased internal labor and outside vendor expenses, while the Section 404(b) cost is experienced primarily through increased independent-auditor fees. . . ."[68] According to the Government Accountability Office (GAO), which undertook a study to analyze the costs for public companies to comply with SOX, "In 2002, 64 companies that went private cited cost as one of the reasons for the decision; however, that number increased to 143 and 130 companies in 2003 and 2004, respectively."[69] Of the

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thunderbird/e_article000246430.cfm; *see also*, Matt Quinn, *Sarbanes-Oxley Has Some Publics Thinking Private*, INC.COM (May 20, 2004), http://www.inc.com/news/articles/200405/sarbanes.html (citing a survey published by Chicago law firm of Foley and Lardner, LLP, which found that of 115 companies surveyed, most of which consisted of small to mid-size firms, there was a 50% increase in respondents contemplating delisting as a result of the Act from 2002 to 2003).

[66] *Study of Section 404 Internal Control*, *supra* note 61, at 5.

[67] *Id.* at 2.

[68] *Id.* at 2.

[69] SENATE REPORT ON IMPLEMENTATION FOR SMALLER PUBLIC COMPANIES, *supra* note 62, at 23. In this report, GAO (1) analyzes the impact of the Sarbanes-Oxley Act on smaller public companies, particularly in terms of compliance costs; (2) describes responses of the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) to concerns raised by smaller public companies; and (3) analyzes smaller public companies' access to auditing services and the extent to which the share of public companies audited by mid-sized and small accounting firms has changed since the act was passed. To address these objectives, Dr. Liz Arnold, a colleague of Professor Freer at The Citadel, reviewed information from a variety of sources, including the legislative history of the Act, relevant regulatory pronouncements and public comments, research studies and papers, and other stakeholders (such as trade groups and market participants). To analyze the impact of the Act on smaller public companies, in connection with her Ph.D. thesis at Rutgers University, she obtained data from SEC filings provided through a licensing agreement with Audit Analytics, and analyzed data elements including auditing fees and auditor changes to determine costs of compliance. Similarly, she constructed a database of public companies that went private using SEC filings and press releases retrieved from Lexis-Nexis, an online periodical database. To obtain information on smaller public companies' experiences with Sarbanes-Oxley Act compliance, Dr. Arnold also

companies that cited cost as a reason for going private, "roughly 58 percent in 2004 and 2005 and 41 percent in 2003 . . . mentioned the Sarbanes-Oxley Act specifically."[70] Companies, large and small, are required to bear the burden of financing the implementation of SOX by paying for external auditors and accountants to attest that the companies' internal accounts are effective and efficient.[71] SOX has proved onerous for small companies by forcing them from public ownership.[72] Average compliance costs increased from and average of

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conducted a survey of companies with market capitalization of $700 million or less and annual revenues of $100 million or less that, as of August 11, 2005, reported to SEC that they had complied with the Act's internal control-related requirements. One hundred fifty-eight of 591 companies completed the survey, for an overall response rate of 27%. Additionally, she held discussions with representatives of SEC, the Small Business Administration (SBA), PCAOB, smaller public companies, the Committee of Sponsoring Organizations of the Treadway Commission (COSO), financial service providers, rating agencies, institutional investors, trade groups, accounting firms, and other market participants. Because the SEC has extended the date by which registered public companies with less than $75 million in public float (known as non-accelerated filers) had to comply with the Act's internal control-related provisions (Section 404) to their first fiscal year ending on or after July 15, 2007, Dr. Arnold could not analyze the impact of the internal control provisions of the act for a significant number of smaller public companies (SEC estimates that non-accelerated filers represent about 60% of all registered public companies). Thus, to gain some insight into the potential impact these provisions may have on smaller public companies, Dr. Arnold analyzed public data and other information related to the experiences of public companies that have fully implemented the Act's provisions. To determine the Act's impact on smaller privately held companies, Dr. Arnold interviewed officials about state requirements comparable to key Sarbanes-Oxley provisions and representatives of smaller private companies and financial institutions about capital access requirements. Dr. Arnold also analyzed data on companies' initial public offering (IPO) and secondary public offering (SPO) from SEC filings. To assess changes in the domestic public company audit market, Dr. Arnold used public data—for 2002 and 2004—on public companies and their external accounting firms to determine how the number and mix of domestic public company audit clients had changed for firms other than the large accounting firms.

[70] *Id.*

[71] Sarbanes-Oxley Act of 2002 § 404.

[72] *See e.g.,* D. Skylar Rosenbloom, *Take It Slow: A Novel Concept In The Life Of Sarbanes-Oxley*, 63 WASH. & LEE L. REV. 1185, 1201 (2006) (noting that "[a]dvocates for small business believe these increased costs are the impetus behind the increase in companies opting to delist their shares instead of accepting the burdens and costs of Sarbanes-Oxley"); Kamar et. al., *supra* note 42, at 107 (2009) (finding based on empirical evidence that "SOX induced

$1.2 million when SOX was enacted to an average of $2.8 million in 2005, an increase of 130%.[73]

Some relief was recently granted to certain small companies, specifically those not defined as large accelerated filers or larger filers[74] under Rule 12b-2, by H.R. 4173, also known as the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[75] The Dodd-Frank Act amended SOX such that public companies with less than $75 million public float are exempted from the provisions of 404(b) that require an external audit of internal control.[76] The Dodd-Frank Act left unchanged the compliance requirements of 404(a) relating to management's report on internal control.[77] Similarly, the requirement that all public companies, no matter the size, submit to an external audit of their financial statements remains intact.[78] In a slight of hand and an acknowledgement of trend, subsection (b) of 989G called for a study of the possible benefits of extending the exemption of 989G(a) to public companies with floats between $75 million and $250 million, and whether or not such reductions in compliance costs would

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small firms to exit the public capital market during the year following its enactment").

[73] John Gibeaut, *Small Companies Eye Going Private To Avoid Sarbanes-Oxley*, Bowne SecuritiesConnect, http://www.bowne.com/securitiesconnect/details.asp?storyID=1073 (abstracted from ABA Journal, Jan. 2005, 20-21). Gibeaut also notes that this figure is particularly troubling because it does not reflect the cost of compliance with Section 404, which was phased in for small filers in July of 2005.

[74] 17 C.F.R. § 240.12b-2 (2009). ("(1) Accelerated filer. The term accelerated filer means an issuer after it first meets the following conditions as of the end of its fiscal year: (i) The issuer had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $75 million or more, but less than $700 million, as of the last business day of the issuer's most recently completed second fiscal quarter; (ii) The issuer has been subject to the requirements of section 13(a) or 15(d) of the Act (15 U.S.C. 78m or 78o(d)) for a period of at least twelve calendar months; (iii) The issuer has filed at least one annual report pursuant to section 13(a) or 15(d) of the Act; and (iv) The issuer is not eligible to use Forms 10KSB and 10QSB (249.310b and 249.308b of this chapter) for its annual and quarterly reports. (2) Large accelerated filer. The term large accelerated filer means an issuer after it first meets the following conditions as of the end of its fiscal year: (i) The is

[75] Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 989G, 103 Stat. 440 (2009).

[76] *See id.*

[77] *See id.*

[78] *See id.*

encourage companies to list on U.S. exchanges in their initial public offerings.[79]

Lawmakers drafted and passed SOX with expectations that initial costs would decrease after several years. However, the costs continue to remain higher than anticipated, reaping fear in some companies that causes them to stay private or even delist.[80] "[T]he number of public companies that went private has increased significantly from 143 in 2001 to 245 in 2004, with the greatest increase occurring during 2003."[81] Based on a Foley & Lardner study, SOX caused the average cost of being public in fiscal year 2006 for a company with annual revenue under $1 billion to increase 171% from fiscal year 2001.[82] The average cost of being a public company with annual revenue over $1 billion increased 54% from fiscal years 2001 to 2006.[83] The most drastic cost increases for all public companies were found in the fees paid to auditors.[84] Those companies found on the S&P Small-Cap had audit costs increase 311% from fiscal years 2001 to 2006, while companies on the S&P Mid-Cap and S&P 500 saw audit costs increase 251% and 189%, respectively, in that same time frame.[85]

In November 2004, the GAO study determined that costs for smaller companies were disproportionately higher due to the requirement that companies file reports on the strength of their internal financial controls and fix any problems that were found.[86] Total costs of compliance had jumped 90% by 2003.[87] According to one study performed by Charles River Associates that surveyed ninety companies from the Fortune 1000, costs associated with Section 404 compliance in

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[79] *See id.*

[80] *Anti-Fraud Laws Cost More Than Expected,* MSNBC.COM, http://www.msnbc.msn.com/id/12691559/ (last updated 5/8/2006 8:54:02 PM).

[81] SENATE REPORT ON IMPLEMENTATION FOR SMALLER PUBLIC COMPANIES, *supra* note 62, at 21.

[82] Foley & Lardner LLP, *The Cost of Being Public in the Era of Sarbanes-Oxley,* FOLEY, 15-16 (Aug. 2, 2007), http://www.foley.com/files/tbl_s31Publications/FileUpload137/3736/Foley2007SOXStudy.pdf.

[83] *Id.*

[84] *Id.* at 6-9.

[85] *Id.* at 1, fig. 1.

[86] SENATE REPORT ON IMPLEMENTATION FOR SMALLER PUBLIC COMPANIES, *supra* note 62, at 5.

[87] Bloomberg, *Sarbanes-Oxley Law Raises Audit, Legal, Board Costs (Update 1),* BLOOMBERG (May 5, 2003), http://www.bloomberg.com/apps/news?pid=71000001&refer=&sid=azllqgt9rNGM.

2004 were approximately $7.8 million.[88] The report also stated that compliance costs with Section 404 represented about 0.1% of total company revenue for these companies.[89] Financial Executives International (FEI) conducted a survey in March of 2005, consisting of 217 companies, and found that each company spent an average of $4.36 million in *added* internal control, auditor, and consultant costs during the first year of compliance with Section 404.[90] FEI also found that companies with revenues over $25 billion spent, on average, $14.7 million in compliance, auditor, and consultant costs.[91] "Another survey of corporate board members conducted by executive-search firm Korn/Ferry International estimate[d] that complying would cost the U.S. companies surveyed an average of $5.1 million."[92] "More than half the companies surveyed by [FEI] . . . agree[d] Section 404 has given investors more faith in their financial statements . . . [b]ut 94% said the new rules have cost more than they are worth."[93] While some costs associated with Section 404 compliance have declined due to increased efficiency in the number of internal and external staff hours needed for compliance, other costs have increased.[94] Auditing

[88] Charles River Associates, *Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates from a Sample of Fortune 1000 Companies* (Apr. 2005), http://www.sec.gov/spotlight/soxcomp/soxcomp-all-attach.pdf.

[89] *Id.*

[90] Scott Sunshine & Chris Allen, Financial Executives International, *Sarbanes-Oxley Compliance Costs Exceed Estimates*, PRNEWSWIRE (Mar. 21, 2005), http://www.prnewswire.com/news-releases/sarbanes-oxley-compliance-costs-exceed-estimates-54305407.html.

[91] *Id.*

[92] Beth Carney, *Foreign Outfits Rue Sarbanes-Oxley*, BLOOMBERG BUSINESSWEEK (Dec. 15, 2004), http://www.businessweek.com/bwdaily/dnflash/dec2004/nf20041215_9306_db016.htm; *see also* Press Release, Korn/Ferry International, Price of Regulatory Compliance Skyrockets, According to Board Directors Worldwide (Nov. 22, 2004), http://www.kornferry.com/PressRelease/840.

[93] Barbara Hagenbaugh & Matt Krantz, *New Accounting Rules Raise Price of Audits*, USA TODAY: MONEY (Apr. 12, 2005 10:56 PM), http://www.usatoday.com/money/companies/regulation/2005-04-12-audits_x.htm.

[94] Financial Executives International, *FEI Survey: Sarbanes-Oxley Compliance Costs are Dropping; Average Compliance Costs are $3.8 Million, Down 16% from Prior Year; Reductions About Half of What Were Anticipated*, PRNEWSWIRE (Apr. 6, 2006) [hereinafter *FEI Survey*], http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/04-06-2006/0004335523&EDATE= ("FEI polled 274 public companies, of which 238 are 'accelerated filers' according to SEC definitions and have average revenues of $6 billion, to gauge experiences in complying with

and accounting firms have increased their fees as more work and time are demanded of them due to responsibility imposed as a result of SOX.[95] A Manufacturers Alliance/MAPI member survey indicated that "[b]efore SOX was enacted, the SEC estimated compliance costs at around $91,000 per company . . . but average costs [in 2005] for 40 MAPI companies was $1.613 million for external audit fees for Section 404 compliance, plus $1.894 million for internal work for compliance."[96] "A USA Today analysis of data from AuditAnalytics.com show[ed] audit and related fees . . . jumped 40% to $3.5 billion among Standard & Poor's 500 companies [in 2004] . . . on top of a 17% increase in fees they had to absorb in 2003."[97] "According to a study by . . . law firm Foley & Lardner LLP of 708 large and small companies, average audit fees for 2004 were up 61 percent over 2003 . . . [and] for Standard & Poor's 500 companies, the average tab was $7.4 million in audit fees in 2004, up from $4.8 million a year earlier."[98]

Monetary costs have not only increased because of many direct sources such as external auditors, accountants, and lawyers, but they have also increased also because of time, which could be more beneficially spent on other matters instead of complying with SOX regulations. Each company must take time to ensure that all internal controls fall within regulations and that all employees comply with the stricter internal regulations. In the first year that SOX was fully instituted, Alliance companies, from the Manufacturers Alliance/MAPI survey, "devoted an average of 38,252 hours to Section 404 implementation."[99] Similarly, the FEI survey presented the statistic that businesses with over $5 billion in revenues measured an average of

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Sarbanes-Oxley's Section 404. This is the fourth SOX compliance survey FEI has conducted since 2004.").

[95] *See* Colleen Cunningham, *Weighing the Worth of an External Audit*, COMPLIANCE WK. (Apr. 27, 2010), http://www.complianceweek.com/article/5904; *FEI Survey*, *supra* note 94.

[96] Thomas J. Duesterberg, *Rethinking Sarbanes-Oxley*, WASH. TIMES (May 23, 2006, 10:53 PM), http://www.washtimes.com/commentary/20060523-105305-8693r.htm.

[97] Hagenbaugh & Krantz, *supra* note 93.

[98] Leon Lazaroff, *Debate Rages on Costs, Value of Sarbanes-Oxley*, CHI. TRIB. (Apr. 23, 2006), http://www.chicagotribune.com/business/yourmoney/sns-yourmoney-0423watch,1,6402236.story?coll=chi-navrailbusiness-nav.

[99] Duesterberg, *supra* note 96; *see also* Donald A. Norman, *The Cost of SOX and the Compliance Process: Year Two*, Manufacturers Alliance/MAPI, 2006, at 8, *available at* http://www.sec.gov/news/press/4-511/tjduesterberg9949.pdf.

35,000 hours each in 2004 to comply with the new regulations.[100] Consequently, the large amount of hours relinquished by companies to maintain compliance has decreased productivity.[101] Costs associated with lost productivity increased by nearly $900,000 in 2004 for respondents with annual revenue under $1 billion and approximately $4,235,000 in 2004 for respondents with annual revenue of $1 billion and over.[102]

C. FROM THE OUTSIDE

SOX Section 404 implemented many expensive encumbrances that foreign companies do not want to tolerate. Foreign companies that were once traded in the United States or that were looking forward to opening to the U.S. markets no longer want to be placed under the microscope of the SEC.[103] In a report issued by the SEC in September of 2009, of all foreign firms responding, 26.1% reported that Section 404 had "very seriously" motivated considerations of delisting, and 25.5% reported that 404 "somewhat" motivated such considerations.[104] As a result, fewer foreign companies have listed within the United States to avoid the high costs associated with SOX compliance.[105] "Financial-management consultancy Parson Consulting estimate[d] that complying with Sarbanes-Oxley would cost the 70 British-headquartered businesses included in their survey a total of $860 million."[106] Thomas Selling's article described the impact on new listings:

> New listings by foreign companies in United States markets have dropped sharply since the passage in 2002 of the Sarbanes-Oxley Act. And among foreign

[100] Hagenbaugh & Krantz, *supra* note 93; Stuart Michelson & Jud Stryker, *A Comprehensive Survey of the Impact of the Sarbanes-Oxley Act of 2002* 8 (Stetson Univ. Sch. of Bus. Admin. Working Paper Series, Working Paper No. 80308, 2008), *available at* http://www.stetson.edu/business/fdc/media/Papers/SOX_ResearchPaper_Michelson_Stryker.pdf; Financial Executives International, *Special Survey on Sarbanes-Oxley Section 404 Implementation Executive Summary* (July 2004), *available at* http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/FEI%20SOX%20404%20Survey%20August%202004%20-%20 Executive%20Summary.pdf.

[101] *See* Hagenbaugh & Krantz, *supra* note 93.

[102] Foley & Lardner, *supra* note 82, at 15-16.

[103] *See* Selling, *supra* note 65.

[104] *Study of Section 404 Internal Control*, *supra* note 61, at 67, fig. 3.

[105] *Study of Section 404 Internal Control*, *supra* note 61, at 67.

[106] Carney, *supra* note 92.

> companies already listed on United States markets, many would like to escape the burdens imposed by the act's requirements, which have roughly doubled the cost of a U.S. listing.[107]

These foreign companies are choosing to expand to other markets, specifically European markets. "The real problem for the U.S. economy is not just the number of companies delisting, but 'the companies that would have listed, but now won't. Across the board, people are reconsidering.'"[108] Money that was once generated or could be potentially generated in the United States under either the New York Stock Exchange (NYSE) or the National Associated Securities Dealers Automated Quotations (NASDAQ) is now moving overseas, creating an adverse effect for which SOX is to blame.

Going forward, the companies that leave or fail to register within the United States are opting for markets where they face less regulation and lower costs. In 2000, "nine out of every 10 dollars raised by foreign companies through new stock offerings were done in New York rather than London or Luxembourg. . . . But by 2005, the reverse was true: Nine of every 10 dollars were raised through new company listings in London or Luxembourg. . . ."[109] Although the United States market is attractive for growth, the costs and burdens of SOX compliance outweigh the potential long-term benefit, and the London Stock Exchange (LSE) is an attractive alternative. The LSE is now one of the most popular havens for SOX escapees. Thomas J. Duesterberg, in his article *Rethinking Sarbanes-Oxley*, compared the LSE to U.S. markets:

> In 2005, the London Stock Exchange saw 129 new listings, while the New York Stock Exchange gained only 6 net new listings and the NASDAQ only 14. Not one of the 10 largest new global listings was registered in the United States, and 22 of the top 25 were registered outside the U.S. . . . Of those

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[107] Selling, *supra* note 65.

[108] *SarbOx Has Foreign Companies Decamping*, *supra* note 14 (quoting Rhian Chilcott, head of the Washington, D.C. office of the Confederation of British Industry).

[109] Tom Feeney, *COMPETE Act Reduces SOX's Costs*, SMALL BUS. & ENTREPRENEURSHIP COUNCIL (May 26, 2006), http://www.sbecouncil.org/news/display.cfm?ID=1670 (quoting Craig Karmin & Aaron Lucchetti, *New York Loses Edge in Snagging Foreign Listings*, WALL ST. J., Jan. 26, 2006, at C_1); *see also* Duesterberg, *supra* note 96.

> choosing new issues in London, 38 percent considered the United States, but 90 percent of those cited the onerous demands of SOX as tipping the balance in favor of London.[110]

"In 2000, foreign companies raised $16.9 billion in new listings in New York and London, with the U.S. claiming 89% of that total. . . . [In 2005], London grabbed 88% of that business."[111]

Russian companies provide another example of foreign companies choosing SEC alternatives. Russia has been recovering from its socialistic past with fervor, and its companies have been looking to expand into the world market, but not the U.S. markets. Russian companies registered on the LSE in droves in 2005.[112] According to the LSE's head of international business development, Tracy Pierce, "the [LSE] is in discussions with a number of companies from China and Russia seeking refuge from U.S. regulation."[113]

The United States has recognized the reluctance of foreign companies to register because of SOX, and the SEC is maneuvering to regain and maintain the absconded companies.[114] In September 2005, the European Union and SEC worked out a proposal to "eliminate the requirement that European companies using International Financial Reporting Standards (IFRS) reconcile their financial reports to United States Generally Accepted Accounting Principles (U.S. GAAP)."[115] Despite this agreement, many foreign companies have shown no signs

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110 Duesterberg, *supra* note 96.

111 Elfenbein, Posting *WSJ: Foreign Firms Bailing Out*, CROSSING WALL ST. (Dec. 23, 2005, 6:08 AM), http://www.crossingwallstreet.com/archives/2005/12/wsj-foreign-firms-bailing-out.html; *see also* Karmin & Lucchetti, *supra* note 109.

112 Conal Walsh, *Fear of the FTSE foreigners*, GUARDIAN.CO.UK: THE OBSERVER, (Jan. 22, 2006), http://observer.guardian.co.uk/business/story/0,,1691868,00.html.

113 Carney, *supra* note 92.

114 Jo Lynne Koehn & Stephen C. DelVecchio, *Revisiting the Ripple Effects of the Sarbanes-Oxley Act*, CPA J., (May 2006), http://www.nysscpa.org/cpajournal/2006/506/essentials/p32.htm.

115 *Id.*; *see also*, KPMG LLP, *SEC Proposes to Eliminate U.S. GAAP Reconciliations by IFRS Filers*, DEFINING ISSUES, No. 07-19 (June 2007), http://www.kpmg.com.cn/en/virtual_library/Audit/defining_issues/Defining Issues0719.pdf.

of returning to United States markets and bearing the costs associated with SOX.[116]

Compliance with the Sarbanes-Oxley Act of 2002 has also indirectly impeded the harmonizing of accounting standards between the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). International standards are principle-based and U.S. standards are more rule-based.[117] Prior to Sarbanes-Oxley, the FASB and IASB were working toward harmonizing accounting standards so that companies would only have to prepare financial statements under one set of standards. Until September 2005, overseas companies complying with IASB standards had to restate or reconcile financial statements to U.S. GAAP for filing with the SEC.[118] The procedure that the group worked out leaves potential inconsistencies for the plaintiff's Bar to exploit in the future. Perhaps in response, European regulators have expressed an interest in requiring American companies trading in Europe to restate or reconcile to IASB standards.[119]

Principle-based accounting does have rule frameworks, and they are general enough to allow the judgment of the preparers to determine how a transaction at hand should be represented in the financial records.[120] However, there is concern about how these "judgments" would hold up under Sarbanes-Oxley.[121] That was the biggest concern posed by the 10% of CFOs who opposed principle-based accounting, according to a CFO magazine survey.[122] The larger issue now in harmonizing U.S. and International accounting is harmonizing the IASB standards to Sarbanes-Oxley.[123]

D. THE PRUDENT MAN

An equally abhorrent consequence of SOX that has reared its head is the evisceration of the age-old Prudent Man Rule.[124] The

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[116] Eve Novakova-Cornejo, *Harmonization of Accounting Standards*, FREE ENTERPRISE FOUND. NEWS, Summer 2005, at 3-5.

[117] *See id.* at 5; *see also* Koehn & DelVecchio, *supra* note 114.

[118] Novakova-Cornejo, *supra* note 116, at 3.

[119] *See id.*

[120] Alix Stuart, *Standing on Principles*, CFO MAG., Sept. 2006, at 45-50, available at http://www.cfo.com/article.cfm/7852613/1/c_7850066.

[121] *Id.*

[122] *Id.*

[123] Novakova-Cornejo, *supra* note 116.

[124] *See* Whalen, *supra* note 7.

Prudent Man Rule has been the sum of essential director responsibility and limit of liability for almost 200 years.[125] "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.'"[126] Title III and IV of the Sarbanes-Oxley Act of 2002 greatly damaged that normality and with it the bedrock of director responsibility.

In the post-SOX world, those with responsibility to invest money for others cannot act according to the Rule with confidence; these officers and directors are now forced to primarily consider the rules and regulations of SOX, instead of making the appropriate or most auspicious business decision.[127] These directors and officers must make decisions to protect themselves and their companies not only from the omnipresent SEC but also from the potential for crippling litigation by aggressive plaintiff's counsel intent on scoring big recoveries.[128] Neither of whom appear to have more than the barest regard for existing investors.[129] Through SOX regulations, a plaintiff's counsel can depict corporate decisions, which were previously protected and reserved for the corporate board, as ill-considered or worse, allegedly decided based upon a desire to bolster or forestall an impact on the public share price of corporate securities, and thus, actionable. At the very least, the temptation for such litigation previously forestalled by acceptance of the Prudent Man Rule will be harmful not only in its costs both in dollars and the distraction of key corporate officers but also harmful, even if unwarranted, to share price.

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[125] *See id.* at 41 ("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.").

[126] *Id.*

[127] Peter J. Wallison, *Blame Sarbanes-Oxley*, AM. ENTERPRISE INST. FOR PUB. POL'Y RES. (Sept. 1, 2003), http://www.aei.org/publications/pubID.19123/pub_detail.asp.

[128] *See* Whalen, *supra* note 7, at 41.

[129] *See* Wallison, *supra* note 127.

Furthermore, it is also falsely suggestive that share price manipulation is a common practice.

Also, lawyers, accountants, and others who once enjoyed a privileged and confidential relationship with officers of a corporation, now have a duty to report any malfeasance they detect within the corporation to protect themselves from the even stricter criminal penalties.[130] Lawyers and accountants are now police used to enforce corporate laws and regulations, instead of serving the corporations in their normal capacity.[131]

III. SECTIONS 302 AND 906

SOX has also crippled corporate creativity and expansion through Sections 302 and 906, which create provisions that hold chief executive officers and chief financial officers personally liable and impose strict penalties.[132] Section 302 requires that corporate officers sign off on all financial reports and that they maintain proper financial controls.[133] Failure to do so gives rise to civil liability and criminal liability as set forth in Section 906, which imposes up to $1 million in fines and/or up to ten years imprisonment.[134] The increased punishments have consequently made management reluctant "to take the risks and make the investments that had previously brought the economy roaring back from periods of stagnation or recession."[135]

Sections 302 and 906, on corporate liability, instill consumer confidence at the expense of corporate officers and directors, which may lead to more conservative business decisions,[136] therefore, hindering companies from developing and implementing productive strategies within local and global markets. Corporate officers are less likely to take risk, putting them at a disadvantage compared to companies without restraints or consequences for aggressive business strategy.[137] They have to devote much more time to defensive actions rather than offensive actions.[138]

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[130] *See* Whalen, *supra* note 7, at 41.
[131] *Id.*
[132] Hagenbaugh & Krantz, *supra* note 93.
[133] Sarbanes-Oxley Act of 2002 § 302.
[134] § 906.
[135] Wallison, *supra* note 127.
[136] *See id.*
[137] Debra D'agostino, *A Rock and a Hard Place; Sarbanes-Oxley Compliance Costs Spiraled Out of Control in the First Year – Can Technology*

IV. LEGISLATIVE RESPONSE

Members of Congress recognized the problems associated with the hastily written Sarbanes-Oxley Act and are attempting to amend the Act or completely repeal the Act. Several proposals in Congress are aimed at diminishing the burdens associated with SOX:

Republican Representative Tom Feeney of Florida and Republican Senator Jim DeMint of South Carolina proposed the Competitive and Open Markets that Protect and Enhance the Treatment of Entrepreneurs Act (COMPETE Act) to their respective houses in Congress.[139] The COMPETE Act, if passed, would have reduced the burdens of the implementation of Section 404 of the Sarbanes-Oxley Act of 2002 by granting exemptions to smaller companies with a market value of less than $700 million or annual revenue of less that $125 million and fewer than 1,500 shareholders.[140] This Act aimed to create incentives for registered small businesses, which could not afford to stay public because of the burdens of Section 404.[141] Although the COMPETE Act died in Congress, some of the concessions granted to smaller companies under Section 989(G) of the Dodd-Frank Act are similar in spirit.[142]

Congressman Ron Paul (Texas-R) proposed his own bill to the House of Representatives, the Due Process and Economic Competitiveness Restoration Act (the Paul Act), which would have repealed Section 404 entirely.[143] The Paul Act was written with the intent to ensure financial regulations do not harm economic competitiveness, nor deprive Americans of due process of law. The Paul Act aimed to accomplish these goals by repealing SOX provisions that hold corporate chief executive officers criminally liable for the content and quality of their companies' financial reports, even when the

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Help?, ALL BUS. (Aug. 1, 2005), http://www.allbusiness.com/legal/antitrust-trade-law-sarbanes-oxley-act/13437920-1.html.

[138] *Id.*

[139] Competitive and Open Markets that Protect and Enhance the Treatment of Entrepreneurs Act, S. 2824, 109th Cong. (2006).

[140] *Id.*

[141] *Id.*

[142] *Compare* S. 2824, *with* H.R. 4173, 111th Cong. § 989G (2009).

[143] Due Process and Economic Competitiveness Restoration Act, H.R. 1657, 109th Cong. (2005).

chief executive officers had no intention to engage in criminal behavior and took reasonable steps to assure the accuracy of the statements.[144]

Congressman Jeff Flake (Arizona-R) also proposed his bill, the Competitiveness Enhancement Opportunity Act of 2005, to the House of Representatives in April of 2005.[145] This bill would have made Section 404 of the Sarbanes-Oxley Act of 2002 voluntary.[146] In 2007, two important reforms were made: the issuance of Management Guidance, and an order approving the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard Number Five (AS5).[147] These reforms were implemented with the goal of reducing compliance costs, the former through better understanding, and the latter through direct reduction in the time it takes to complete independent audits, presumably reducing audit fees.[148] The SEC relates that the reforms have in fact reduced compliance costs, although there may be an argument that companies with Section 404 exposure are becoming more efficient in their compliance procedures with the passage of time.[149] Whatever the basis, the study shows a reduction in mean compliance costs from "$2.87 million pre-reform to $2.33 million post-reform."[150] This represents a 19% reduction in total compliance costs since the 2007 reforms.[151]

According to Robert Freer, in his article published in the Charleston Mercury, the SOX Act still requires further amendment:

> The Sarbanes-Oxley Act, although well-intentioned, seems to have been geared more toward public opinion than public company accountability. Lawmakers were under pressure to take action in the wake of million-dollar accounting scandals that shook the confidence of the American public. Legislators took it upon themselves to take punitive measures against an entire industry, and in their haste to please the public, drafted and passed legislation

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[144] *Id.*

[145] Competitiveness Enhancement and Opportunity Act of 2005, H.R. 1641, 109th Cong. (2005).

[146] *Id.*

[147] *See Study of Section 404 Internal Control*, *supra* note 61, at 98, Appendix A.

[148] *See id.* at 72.

[149] *See id.* at 94-95.

[150] *Id.* at 4-5.

[151] *Id.* at 5.

> that now victimizes that same public with its cost for compliance. A seriously thought-out amendment rolling back Titles III and IV would be helpful to restoring some balance to its effect. Much of the enhanced reporting would still occur but the heavy emphasis on Board potential culpability for even an innocent error would be left for civil liability tribunals not the criminal courts. For that corporate manager truly culpable, previously existing remedies are already available and effective.[152]

V. SOLUTIONS

No law is perfect, but the burdens of the Sarbanes-Oxley Act have proven to outweigh the potential benefits. Further reform is needed to revise the Act to stimulate entrepreneurship, economic growth, and creativity within companies who choose to list on the United States markets. Regulations are always unattractive, but when those regulations that are intended to benefit an entity and its investors injure the entity and its investors, they must be reformed. Section 404 has caused too many problems for many public companies. External audits have exhausted many companies' income and time. The extreme costs and time that businesses have lost due to compliance was not the goal of the legislation when enacted.

> When given the opportunity to suggest how the implementation of Section 404 could be made more efficient or effective, companies identified the following top recommendations: Reduce the degree of documentation (67%); [p]ermit greater reliance on internal audit data and resources (66%); [c]larify the definition of 'key controls' (55%); [p]ermit roll-forward procedures (58%); [and, a]llow cumulative reliance on year-one testing and documentation (53%).[153]

In order to reassert the entrepreneurial strategy that is innately required of companies desiring to compete in the present world market, Sections 302 and 906 must be eliminated. Highly qualified individuals

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[152] Robert E. Freer, Jr., *The Law of Unintended Consequences-Thy Name is Sarbanes Oxley*, FREE ENTERPRISE FOUND. (2007), http://www.free-enterprise-foundation.org/sarbanes-oxley.html.

[153] FEI Survey, supra note 94.

should not have to look over their shoulders at every turn fearing reprimand. Liability should only be imposed upon corporate officers when evidence exists of intentional misrepresentation. By allowing this small space for unintentional errors, corporate officers are likely to regain the confidence to take necessary risks in order to grow and attract consumers. Regulations are welcome, but regulations that restrict the freedom of the United States markets should be reformed to promote the best business practices free from unnecessary limitations.