HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: HM 1307 Sarbanes-Oxley Act
SPONSOR(S): Brandes
TIED BILLS: **IDEN./SIM. BILLS:** SM 1822

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR or BUDGET/POLICY CHIEF
1) Federal Affairs Subcommittee	8 Y, 3 N	Bennett	Camechis
2) State Affairs Committee	10 Y, 4 N	Camechis	Hamby

SUMMARY ANALYSIS

This memorial urges Congress "to repeal the Sarbanes-Oxley Act of 2002 to remove the damaging obstacles that the act has created for American public companies and replace it with reasonable non-intrusive measures to protect investors." The memorial does not specify or suggest protective measures that should replace the Act.

The Sarbanes-Oxley Act was enacted by Congress in 2002 and only applies to publicly-traded companies. The Act was Congress' response to the "illegal, unethical, or, at best, highly questionable behavior" undertaken by managers of Enron, WorldCom, and several other companies. Generally, the asserted purposes of the Act are to re-instill investor confidence in the financial market by enhancing institutional accountability and improve the reliably and accuracy of corporate disclosures. To achieve these goals, Section 404 of the Act mandates that all publicly-traded companies establish internal controls and procedures for financial reporting and to document, test, maintain, and report to the SEC the effectiveness of those controls and procedures. Additionally, companies with a market cap (or value) greater than $75 million are required to hire a registered public accounting firm to audit the company and attest to, and report on, the company's internal controls.

It has been asserted that the Sarbanes-Oxley Act also increases directors' and officers' risk in connection with a host of possible claims or violations, either by increasing the odds they will be implicated in such claims or by increasing the resulting penalties. However, it has also been asserted that, while Sarbanes-Oxley imposes greater fines and longer prison terms for corporate wrongdoing, it does not criminalize behavior that was previously considered lawful.

Subsequent to enactment of the Sarbanes Oxley Act, concerns have been raised regarding high compliance costs for businesses and a perceived weakening in the competitiveness of U.S. capital markets.

This memorial has no fiscal impact.

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. EFFECT OF PROPOSED CHANGES:

Effect of Proposed Changes

This memorial urges Congress "to repeal the Sarbanes-Oxley Act of 2002 to remove the damaging obstacles that the act has created for American public companies and replace it with reasonable non-intrusive measures to protect investors." The memorial does not specify or suggest protective measures that should replace the Act.

Present Situation

Background

On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002. (Act or SOX) [1] The Act, which legally affects only publicly-traded companies, was Congress' response to the "illegal, unethical, or, at best, highly questionable behavior, undertaken-in alarmingly bold fashion, over long-periods of time-by managers of Enron, WorldCom, and several other companies."[2] Generally, the purpose of the Act is to re-instill investor confidence in the financial market by enhancing institutional accountability and improving the reliably and accuracy of corporate disclosures. In part, the Act:[3]

- Establishes a new Public Company Accounting Oversight Board, which is supervised by the Securities and Exchange Commission (SEC);
- Restricts accounting firms from performing other services for companies they audit;
- Requires new financial disclosures for public companies, and their officers and directors;
- Requires adoption of regulations regarding securities analyst conflicts of interest; and
- Strengthens criminal and civil penalties for violating securities laws and other laws.

The Act has been the subject of widespread debate and criticism since its enactment. The most controversial aspect of the Act, Section 404[4], requires all publicly-traded companies to establish internal controls and procedures for financial reporting and to document, test, maintain, and report the effectiveness of those controls and procedures the SEC. Additionally, companies with a market cap[5] greater than $75 million are required to hire a registered public accounting firm to audit the company and attest to, and report on, the company's internal controls.[6]

Cost of Compliance

Most of the costs placed on companies are associated with Section 404 and include costs related to increased accounting staff, external consulting and technology expenses, and increased audit fees. The

[1] P.L. 107-204 (July 30, 2002).
[2] Manuel A. Utset, *Time-Inconsistent Management & the Sarbanes-Oxley Act*, 31 Ohio N.U. L. Rev. 417 (2005).
[3] U.S. Congressional Research Service, *Securities Law: Sarbanes-Oxley Act of 2002 and Selected 108th Congress Bills Concerning Corporate Accountability"*, (RL31879; April 23, 2003) by Michael V. Seitzinger and Elizabeth Bazan. (CRS Report).
[4] Section 404 of the Sarbanes–Oxley Act of 2002 (Public Law 107-204, July 30, 2002), as amended by Section 989G(a) of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Public Law 111-203, July 21, 2010) (15 U.S.C. 7262).
[5] "Market cap" is short for "market capitalization." It represents the value of a company, including all of its assets, capital, revenues, etc. Basically, if the company were to be sold for a fair price, it would be close to the market cap. Of course people may have different opinions of what a company's value is, but there is a certain way to calculate the market cap. The market cap is calculated as follows: (Number of Shares Outstanding) (Market Cap of a share). This formula is easy to understand because the shares represent ownership of the company. All of the shares together represent the entire company, so we can find the value of the company by finding the total value of all of the shares. http://www.stanford.edu/~mikefan/metrics/marketcap.html.
[6] Originally, all publicly traded companies with a market cap under $75 million were also required to comply with Section 404(b); however, the high compliance cost of Section 404 led the SEC to delay compliance deadlines, and in 2010 the Act was amended. Section 989G (b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, exempted small companies (generally defined as companies with market cap under $75 million) from the requirements of section 404(b).[6]

SEC originally estimated that the average annual cost of compliance with section 404 would be $91,000 annually.[7] A report by the 2006 SEC Advisory Board admitted that "actual average costs of Section 404 compliance have in fact been far in excess of what was originally anticipated . . . because the estimate of the costs for Section 404 implementation was underestimated so dramatically (millions of dollars per year, versus $91,000), the pain and loss of value has been significantly greater for a small company."[8] The SEC Advisory Board estimated that a company with a market value between $75 and $700 million would pay $900,000 in actual compliance costs.[9] Independent studies report annual compliance cost to be between $1.7 and $2.3 million.[10] Non-monetary cost of compliance include monitoring and opportunity costs throughout the corporate structure, which redirect management from its primary task of generating earnings to the secondary task of overseeing accounting practices.[11]

Capital-Market Trends

Comprehensive studies have suggested that the Act's compliance costs have negatively impacted domestic and foreign companies and encouraged them to delist from U.S. capital markets and go private (restructure to become a private company rather than publicly traded company)[12] or seek foreign market listings, usually in London or Hong Kong. A study which reviewed the required SEC filings to delist, deregister, or go private found a "significant" number of companies exiting the U.S. markets. The following percentages represent companies exiting the U.S. markets that cited Sarbanes-Oxley Act (or U.S. regulatory burdens) as a principal reason for doing so:[13]

- 18% of companies withdrawing from national exchanges, i.e. NYSE, Nasdaq (0.6% in 2003).
- 17% of companies deregistering with the SEC.
- 31.5% of foreign companies deregistering with the SEC.
- 54% of companies going private (19% in 2002).

While there is no conclusive evidence, studies by the Yale Journal on Regulation reported that "a fair reading of the empirical literature investigating U.S. capital-market competitiveness post-SOX indicates, at a minimum, that the statute has negatively impacted the stock exchanges' competitiveness due to losses of small-firm listings."[14] The SEC, which oversees compliance with Sarbanes-Oxley, performed an analysis and did not find that medium sized U.S. companies ($75-$250 million market cap) were leaving U.S. markets for foreign markets. However, their analysis "[did] show that the U.S. markets share of world-wide IPOs raising less than $250 million has declined over the past five years and further shows a dramatic decline in the number of smaller IPOs since 1999."[15]

---

[7] Sections IV and V of Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release No. 33-8238 (June 5, 2003).

[8] SEC Advisory Comm. on Smaller Pub. Cos., Final Report 10 (2006). Note: This report was issued before the Dodd-Frank Act exempted small companies; however, the advisory committee notes that mid-sized companies, between $75 and $700 million market cap, would also face drastically increased cost form the original estimate.

[9] *Id.*

[10] The Economic Effects of SOX Section 404 Compliance: A Corporate Insider Perspective, by Cindy R. Alexander, Scott W. Bauguess, Gennaro Bernile, Yoon-Ho Alex Lee, and Jennifer Marietta-Westbergy, at 18 (March 2010).

[11] Paul P. Arnold, *Give Smaller Companies A Choice: Solving Sarbanes-Oxley Section 404 Inefficiency*, 42 U. Mich. J.L. Reform 931, 935 (2009).

[12] 21% of companies surveyed in one study considered going private or selling the company as a result of the Act. See Foley Lardner Study, at 10. Foley Lardner LLP, The Cost of Being Public in the Era of Sarbanes-Oxley (May 19, 2004) (presentation at 2004 National Directors Institute) available at http://www.foley.com.

[13] *See* Clarence D. Long IV & Samuel Wolff, *"Post-SOX Trends in Delisting and Deregistration,"* 9 Rich. J. Global L. & Bus. 53 (2010) (percentages are averages of 2007-2008 data; deregistration filings were not adopted until 2007).

[14] Roberta Romano, *Does the Sarbanes-Oxley Act Have A Future?*, 26 Yale J. on Reg. 229, 255 (2009) (Yale Journal).

[15] U.S. Securities and Exchange Commission, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between $75 and $250 Million, at 44, April 2011.

Officer and Director Liability

It has been asserted that the Sarbanes-Oxley Act also increases directors' and officers' risk in connection with a host of possible claims or violations, either by increasing the odds they will be implicated in such claims or by increasing the resulting penalties. [16]

A Senior Fellow of the Cato Institute has described the law as follows:

> Perhaps the most visible symbolic change is that Sarbanes-Oxley required the CEO and CFO to certify that their financial statements "fairly" represent "financial conditions and results," and face prison sentences if they are wrong. The SEC always had the power to require such a certification ceremony, and in fact did so before Sarbanes-Oxley was enacted. But Section 302(a) is more extreme. It threatens prison sentences of up to 20 years for executives who "willfully" certify incorrectly that reports have "fairly" presented "financial conditions and results," or years for doing so "knowingly." Executives can be banned from serving as an officer or director because of undefined "misconduct." They can be required to forfeit one year of back pay if earnings have to be restated due to "material noncompliance." Nobody can know in advance what "willfully" or "fairly" or "misconduct" or "material noncompliance" means, so all these potentially capricious punitive measures fail to live up to the rule of law. Certification puts the CEO in the position of a nervous auditor – a job few CEOs are qualified to do -- rather than a general manager who properly delegates such specialized chores to experts.[17]

Another legal analysis of the Act indicates that, "It is important to recognize that, while Sarbanes-Oxley imposes greater fines and longer prison terms for corporate wrongdoing, it does not criminalize behavior that was previously considered lawful. Committing securities fraud, obstructing justice, intentionally destroying evidence, and filing false financial statements were all illegal before Sarbanes-Oxley was adopted. Similarly, Sarbanes-Oxley does not create new bases for civil lawsuits." [18] The analysis further indicates that, "[d]irectors and officers have always been at risk for claims that they violated either their duty of care in taking appropriate steps to make informed business decisions, or their duty of loyalty by failing to put the interests of the company and its shareholders before their own. Sarbanes-Oxley sets forth new "required" activities for directors and officers. Failure to perform those activities may be viewed as evidence of a de facto breach of the duty of care."[19]

Recent Federal Legislation

During the current 112th Congress, at least eight legislative proposals have been filed seeking to alter the Sarbanes-Oxley Act of 2002, all of which remain in committee.[20]

---

[16] Dan A. Bailey, J. David Washburn & Quentin Collin Faust, Now It's Personal: The Real Impact of Sarbanes-Oxley on Directors and Officers, WALL ST. LAWYER, Sept. 2002. Available at http://securities.stanford.edu/news-archive/2002/20020900_Headline11_BWF.htm.

[17] *Sarbanes-Oxley in Retrospect,* Alan Reynolds, Senior Fellow, The Cato Institute. Available at: https://www.cato.org/events/sarbanes-oxley.pdf

[18] Dan A. Bailey, J. David Washburn & Quentin Collin Faust, Now It's Personal: The Real Impact of Sarbanes-Oxley on Directors and Officers, WALL ST. LAWYER, Sept. 2002. Available at http://securities.stanford.edu/news-archive/2002/20020900_Headline11_BWF.htm.

[19] *Id.*

[20] H.R. 2941, referred to the Subcommittee on Capital Markets and Government Sponsored Enterprises; H.R. 1697, House Financial Services, subcommittee hearings held; H. R. 3213, referred to the House Committee on Financial Services; H.R. 3655, referred to the Subcommittee on Capital Markets and Government Sponsored Enterprises; S. 1600, referred to the Committee on Finance; S.1866, referred to the Committee on Finance, S. 1965, referred to the Committee on Finance.

B. SECTION DIRECTORY: Not applicable.

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues: None.

2. Expenditures: None.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues: None.

2. Expenditures: None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR: None.

D. FISCAL COMMENTS: None.

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision: Not applicable.

2. Other: None.

B. RULE-MAKING AUTHORITY: None.

C. DRAFTING ISSUES OR OTHER COMMENTS: None.

IV. AMENDMENTS/ COMMITTEE SUBSTITUTE CHANGES

None.