Sarbanes-Oxley: Was It Worth It?

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MR. LEUZ: I was pointed out to get us started here. The panel is supposed to discuss whether Sarbanes-Oxley was worth it and, in particular, talk about the consequences of Sarbanes-Oxley, including some potentially unintended consequences.

I thought I would begin with the claim frequently voiced in the press that Sarbanes-Oxley has actually caused a lot of firms to go private. I would like to share some data with you based on research I have done on this matter, as I thought it would set the stage for the discussion.

What we have here in the graph is an increasing going-private trend—this is basically the number of deregistrations from the SEC. The way “going private” is defined here is in the same way the SEC defines going private, i.e., as filing Form Fifteen with the SEC in order to deregister. Once firms have less than three hundred holders of record, they can terminate their obligation to file with the SEC by filing this form.

So when you look at that graph, it looks like there is a huge spike in 2003, indicating a significant number of firms deregistering. However, you have to take into account one thing, which is that firms can actually deregister from the SEC but continue to trade in public equity markets. They can trade in the over-the-counter markets, mainly shedding their reporting obligation, but they are not recapitalizing, nor ceasing to trade. So what are these firms doing? They are going dark. They are really shutting down their disclosure, but they are not “real” going-private transactions in the sense of a recapitalization or change in the ownership.

* This is an edited version of the transcript from the first panel at the DePaul Business and Commercial Law Journal Symposium, Corporate Governance: The Ins and Outs for Ds and Os, held on April 19, 2007.

2. Id.
3. Id.
Looking at the trends broken down into these two categories, you see that the spike in 2003 and 2004 is really coming from the firms that are going dark, not from firms that are indeed going private. Going-dark firms, when you look at their characteristics, tend to be very different from going-private firms. They are typically smaller and many of them are distressed. Thus, shedding their reporting obligations and saving their reporting costs is potentially a very sensible strategy for them.

Now you may look at these numbers and say, the chart goes only to 2004; how does this evidence comport with anecdotal evidence that we read in the press every day? We hear and read that there are more and more going-private deals.

So let us look at more recent trends in going private; this time I give you the total going-private volume in dollars. You clearly see—there are huge increases in 2004 and 2005, and then another increase in 2006. That is what we read about in the press.

But to get at the question of whether SOX\(^5\) is behind this trend, you want to take a closer look and ask, "Where is the volume coming from?" It turns out that the volume spike is really coming from the recent mega deals. It is coming from very large going-private transactions. It is not coming from smaller deals.

The number of going-private transactions has not gone up very much in recent years, which is inconsistent with a Sarbanes-Oxley\(^6\) explanation. If the cost of Sarbanes-Oxley\(^7\) is driving firms to go private, you would think that the smaller firms are the ones that are more likely to be hit by the cost of Sarbanes-Oxley\(^8\) and, hence, respond by going private.

But when you look at the average-deal sizes, you see the average-deal size has increased, rather than declined, which, in my mind, is inconsistent with Sarbanes-Oxley\(^9\) being behind the trend.

With that said, you might have noticed that there still is a little spike in 2003 and that the average deal size takes a dip in 2003. So you might say, "Could this blip be coming from Sarbanes-Oxley?"\(^10\)

6. Id.
7. Id.
8. Id.
9. Id.
Well, let's look at recent trends in going private worldwide. What you see is that the trend worldwide pretty much tracks the trend that we see in the U.S. It looks very similar in terms of the time-series pattern. So, to me, when I look at this, it does not seem to be the case that the going-private trend is really much related to Sarbanes-Oxley,

per se. That is at least something that I would like to put out there for further discussion.

Finally, to give you a brief summary of the evidence that I have seen in academic research, it is very difficult to assess the economy-wide effects of Sarbanes-Oxley.

There are a few studies where people look at stock price reactions around the key legislative events to get a sense for how the market is pricing the new legislation.

But it turns out that the key legislative events are contaminated with many other political and economic news that took place right around the same time. It was a very volatile time period when Sarbanes-Oxley was passed; and, hence, it is very difficult to parse out those effects.

For that reason, it is interesting to look at avoidance strategies where firms are responding to the regulation. If the new regulation was very costly, we would expect to see firms engage in activities that avoid these costs and you would expect these activities to be associated with the Act. But as I showed you, there is very little evidence that going private increased after SOX,

which would be one of the avoidance strategies.

What people have not yet looked at as much in research is the issue of foreign listings. We hear that foreign listings are going elsewhere. We can discuss this issue further, if that is of interest to the audience. I am also not aware of studies that have looked at going public, i.e., whether going public has taken a hit as a consequence of Sarbanes-Oxley making it more costly to be a public firm.

There is, however, some evidence that Sarbanes-Oxley has increased the scrutiny firms face. For instance, we see significant market reactions to the disclosure of internal-control deficiencies. There are very significant reactions to those deficiencies, and there are quite a few significant reactions to the disclosure of internal-control deficiencies. There are very significant reactions to those deficiencies, and there are quite a
number of firms that have disclosed that they have found those weaknesses through Section 404.18

Whether all this, however, means that, on balance, the costs outweigh the benefits or the other way around, I think that is up for debate and that is something that we can address in this panel.

I also would say having looked at this evidence that there is very little doubt that the smaller firms have been hit fairly significantly by this regulation given that it was kind of constructed as a one-size-fits-all regulation. But the SEC is currently looking at this issue and the question of whether smaller firms deserve a break or should be treated differently from a multi-billion-dollar corporation.

That is all I had to say to get us started.

MR. JOE MARINO: I have a question. Sarbanes-Oxley19 really applies towards companies that are filed, but it is not applicable to the hedge funds. And right now, it looks like there is a lot of talk about the hedge funds have been regulating themselves by absorbing certain failures, but that seems to be a careening truck going for a brick wall.

I mean, when—and I believe there is some suspicion that within the next eighteen months we might see a failure of a major hedge fund. And all of this is going to—does not apply to that. Do you think that there should be more regulation with regards to hedge funds in the United States and whether or not it is a loophole that avoids SOX?20

MR. NASHARR: I do not know if I will answer that question directly, but maybe indirectly in the focus that I—

A PARTICIPANT: Can you speak into the microphone, please? We cannot hear you.

MR. NASHARR: We have each somewhat defined a little bit of our own focus here, each carrying a little different angle to the discussion here.

I believe that Professor Leuz could certainly answer your question, but what I am getting into may give us a background to do that.

MR. JOE MARINO: Okay.

MR. NASHARR: Tony Nasharr. I am an attorney here. I specialize in financial institutions. I represent a couple of public companies, but largely my clientele is private companies. And your question was regarding hedge funds, which are private companies essentially. But a lot of these hedge funds have investors and—where they have lending

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20. Id.
relationships with third parties. And that is where the impact, the un-
intended impact, of Sarbanes-Oxley\textsuperscript{21} comes into play.

Certainly the regulation is clear. This is intended for publicly traded
companies, and it is intended to reinforce the public trust in our public
companies as investments and business environment in general. How-
ever, the unintended impact—and you could argue whether it is posi-
tive or negative—the unintended impact is that Sarbanes's\textsuperscript{22}
provisions, the regulations that have come out of it, and then just the
general scope of what the focus is with public companies—what it has
done is it has caused private companies to think what do we have to
do? It has also caused—and somewhat importantly for a lot of us who
may contribute to private foundations who are public charities—it has
imposed certain things on not-for-profit organizations as well.

The reason for that is that the provisions of Sarbanes-Oxley\textsuperscript{23} needs
to be best practices; and best practices are just things that companies
should want to do to be compliant with either third-party require-
ments, whether those be imposed by a lender or a significant vendor
that you have, or even a customer. Those customers could be govern-
ments, government agencies, federal agencies, or state agencies who,
in their contract with you as a private company, they impose certain
restrictions, which are really arising out of the Sarbanes-Oxley\textsuperscript{24} net of
requirements. Those are auditing requirements. They are board of di-
rectors's independence requirements. They are whistle-blower re-
quirements. So you get these unintended impacts of Sarbanes-Oxley\textsuperscript{25}
on private companies and not-for-profit organizations.

In the particular question regarding hedge funds, as I said, you are
going to get the imposition of these whether the regulation exists di-
rectly related to hedge funds or not, and that is going to come from,
like I said, lenders who are going to loan you five hundred million or a
billion dollars. They are going to want certain audit requirements, au-
dit reports on a periodic basis. When you call your auditor in to say,
hey, we need to get this audit done to comply with our lenders' re-
quirements or our customers' requirements, the auditor is going to
say, well, where is your audit policy? Where is your conflict of interest
policy? Where is your committee appointment policy? Where is your
compensation policy?

\textsuperscript{21} Id.
\textsuperscript{22} Id.
\textsuperscript{23} Id.
\textsuperscript{25} Id.
And those are all things that have come out of Sarbanes-Oxley as things that are imposed on publicly traded companies, and now into the private sector as well. I do not know if that specifically answers your question. Another answer to that question is that as people see the word "hedge fund" in the paper, they ask questions. They ask questions to their legislators. And when the legislators start thinking about it, there is no stopping that truck. And if something happens, if one of these hedge funds buys a company that later goes under and other people are hurt by that, I can guarantee you that the legislators will find a way to expand Sarbanes-Oxley to those organizations.

So that is not a clear answer, but it is around what your question is.

MR. JOE MARINO: That is closing the door after the horse left the barn.

MR. NASHARR: But isn't all regulation? I mean, maybe I am—

MR. JOE MARINO: Reactive, yes. It is not proactive.

MR. NASHARR: —overstating it, but, substantially, regulation is imposed to deal with a perceived wrong, whether it is a traffic issue or a financial reporting issue. So you are always going to have that, and there is no fix for that fact in my opinion. But that is me.

I will defer to Kris here. If there are any questions, I think we are going to pick it up later. But that is where we are at.

MR. SWANSON: I am going to try doing my remarks from here because I think I am too tall for the microphone and you guys will probably not hear me as well.

First, I appreciate the opportunity to be here with you today. I applaud the students at the DePaul Business and Commercial Law Journal for organizing this Symposium and contributing so significantly to the debate on this important topic.

At the time it was passed, many of Congressman Oxley's constituents in the fair State of Ohio had the general attitude towards CEOs of, "Give them a fair trial and hang them!" And it is not surprising, since SOX was emergency legislation, that it represented an opportunity for many special interests to pad the enacted legislation with many pet provisions. And even Congressman Oxley concedes that the implementation has not been perfect.

However, although many criticisms have been leveled against SOX generally, I thought that today I would share observations with

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26. Id.
27. Id.
28. Id.
you about some of the benefits that I have seen based on my experience working with a wide variety of corporate clients and boards.

Let me start by giving you some background on who I am and what I do since this impacts my perspective. First, my observations are influenced by what I have observed firsthand in the context of my current job as a consultant and forensic accountant, where I am often retained to serve as an advisory to boards and executive management teams who are trying to quickly, discreetly, and thoroughly investigate various allegations. As we like to say, fraud is a recession-proof business.

Second, I am a former auditor with Arthur Andersen, a former chief financial officer of a Chicago-based futures firm, a certified public accountant, and certified fraud examiner. I am an alum of the University of Chicago’s MBA program. And I am also an alum of DePaul University’s Graduate School of Business where I earned an MS and accounting degree; and I used to eat at Demon Dogs under the “L” tracks at Fullerton before I got married and it got bulldozed.

So, what are some of the benefits that I have seen from SOX?\textsuperscript{30} I am going to share six with you today.

First, SOX\textsuperscript{31} has generated significant business for law firms. (I think this is what they mean when they say, “Know your audience.”) Some of the factors contributing to this include the rise of independent investigations led by outside counsel, the migration of significant tax talent from the public accounting firms to law firms, and the increasing need by executives to hire their own attorneys to advise them in certain situations where, in the past, they may have tried to get the general counsel to give them personal legal advice on the side.

So how is this good for shareholders or society as a whole? Well, let’s take the rise of independent investigations. In the past, and I know you will be shocked, but if something hinky was suspected, it would not be uncommon for various members of management to try to investigate it internally, quietly, and sometimes halfheartedly. And, not surprisingly, if the person running the investigation was involved in the hinky activities, had no training in how to conduct an investigation, or was somehow beholden to the person or persons of interest, it would not be uncommon for the investigation to wrap up quickly with the conclusion that nothing inappropriate or material had been found. We call this the traditional whitewash investigation.

\textsuperscript{30} Id.
\textsuperscript{31} Id.
Today, if serious and credible allegations arise—and you see this, for example, with stock option back-dating investigations that are going on. So, if allegations arise which implicate senior members of management, it is really *de rigueur* for the board to establish a special committee—sometimes it is the audit committee, but often it is a special committee—for the special committee to retain separate, competent, independent counsel and to ensure that a thorough investigation occurs.

Second, in my opinion—and I am not an attorney—but second, in my opinion, SOX has been very empowering for general counsels. I think it is helped to underscore the fact that lawyers in public companies represent the company as a whole, not its officers and directors.

It is a lot more demanding I think to be a G.C. today. At one time, in-house positions were often perceived as being less demanding than in private practice. And it was not uncommon for the management team to tag the general counsel as the "Chicken Little" of the management team, or sometimes the "Department of No."

Today, members of management fully recognize that they ignore their general counsel’s advice at their own peril; and the job I think is—at least the generals counsel that I have talked to say—it is significantly more exciting and challenging, and, of course, the compensation and benefits get better every year.

Third, SOX has made boards and board committees more relevant. I think that it has made board committees acutely aware that they may be held personally liable for corporate decision-making. This is universally considered very bad by some; but, on the other hand, they tell me it is much more exciting to be on boards today than in the old days when it was not uncommon for CEOs to appoint you and expect you to be simply docile and adoring.

So if a typical audit committee met two to three times pre-SOX, it is not uncommon for a typical audit committee to meet eight or nine times a year post-SOX. Now I am not big on meetings for the sake of meetings, but we see boards really grappling with critical and strategic issues these days, replacing CEOs instead of being replaced by CEOs, and meeting more often in executive session.

Director and officer liability insurance premiums have increased, and not nearly as much golf is being played; but before feeling too

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32. *Id.*
33. *Id.*
35. *Id.*
sorry for these men and women, note that their average compensation has increased from approximately sixty thousand to over ninety-three thousand per year, which is not a bad paycheck for a part-time job.

Four, SOX\textsuperscript{36} in my opinion, has dramatically clarified the independent auditor's responsibility. SOX\textsuperscript{37} requires, for example, that the auditor report to an independent audit committee instead of management. And as a former auditor, I can report firsthand that this single provision significantly righted a relationship that had too often been exploited when management demanded that the auditors treat management as the client.

And, if audit firms are required to be independent, doesn't it make sense that the group they report to should also be independent? Otherwise, I think you kind of defeat the purpose of requiring independence. It is like having a doctor sterilize her surgical tools but not wash her hands.

Fifth, I think SOX\textsuperscript{38} has put management on notice. With the new Section 404\textsuperscript{39} certification process, it is a lot harder for management to simultaneously expect to get paid to manage while later relying on an ignorance defense if misleading or fraudulent financial statements were issued on their watch.

In addition, SOX\textsuperscript{40} makes it unlawful for officers, directors, and their agents to fraudulently influence, coerce, manipulate, or mislead the audit firm. In other words, it is finally illegal to lie to your auditors. We have seen in a number of the recent stock option back-dating investigations that those companies that intentionally hid facts from their auditors were first in line for criminal prosecution.

Finally, SOX\textsuperscript{41} has strengthened a culture of compliance in corporate America, reducing both errors and fraud. By implementing the Section 404\textsuperscript{42} certification process, setting up whistle-blower hot lines, developing codes of ethics, and so forth, the culture and control environments within many companies has been strengthened. Many companies in the process of implementing SOX\textsuperscript{43} discovered that they had been running their business with significant gaps in their internal con-

\textsuperscript{36} Id.
\textsuperscript{37} Id.
\textsuperscript{38} Id.
\textsuperscript{41} Id.
trols. PepsiCo, for example, in the complex area of pension accounting, reportedly discovered that many basic steps that it had thought were being performed, such as accounting reconciliations and interest calculations, were not being done.

It is not surprising that things had fallen through the cracks when you recognize that businesses merge and grow, employees come and go, managers get rotated into different areas of responsibility, and so forth. When people invest in companies where the financial statements have errors, they are not really getting what they think they are buying; and when companies experience or commit fraud, Americans lose billions.

In conclusion, SOX has clearly been one of the most significant laws implemented in my lifetime. However, in terms of the question raised in this session's title, "Was it Worth it," I am going to punt. I am assuming that George Stigler was right when he earned the Nobel Prize in economics for his work proving that there is a market for government regulation, a supply and demand for government regulation, often with unintended and far-reaching consequences. In other words, we got the law that we demanded at the time and thought that we wanted.

With the passage of time and the kinds of critical analysis that the DePaul Business and Commercial Law Journal has been known for fostering, I suspect that the best parts of SOX will be preserved and that other parts will be improved. Barry?

MR. CHATZ: Wow! I wish I was an accountant. I am too short to stand at the podium.

SOX was intended to increase regulation and oversight of the accounting profession because more stringent auditor and audit committee independence creates greater corporate responsibility and accountability, more professional responsibility for lawyers, increased issuer disclosures, increased regulation of security analysts, and increased criminal penalties.

This statute attempts to impose ethics and morality on corporate governance. In a democratic world, that is a fiction.

If we look to what has happened, notwithstanding what good-natured, virtuous directors, audit committee members seek to do in reinforcing corporate trust and corporate morality, the fact is we continue to have expansive failures in the marketplace. And my view is the only

44. Id.
45. Id.
46. Id.
reason this happened is that it related to Enron and it is an energy concern.

If we take a look at recent events, nobody really seems to care about what is happening with New Century and the other small—or the types of lenders that deal with poor people, high interest loans. And those companies just fail; and, yes, maybe there will be criminal charges or otherwise, but Sarbanes-Oxley did nothing to protect the borrowers or the investors in those types of companies. We now have an indictment of some guy named David Stockman, a Reagan beneficiary in the Collins and Aikman case. That is great. That does not mean that Collins and Aikman did not fail.

So that the protocol here in the discussion is "What has this done?". It has enriched accountants, lawyers, in certain circumstances requiring corporate people and corporate, whether it is law firms, accounting firms to act more responsible, for people to take responsibility; but, as a bankruptcy trustee and a bankruptcy lawyer, it will do nothing to prevent the criminals, the bad guys from taking advantage of circumstances.

It is terrific that accountant gets information, but if it is wrong, if that person wishes it to be wrong, it will still be wrong and so they may be subject to criminal penalties. Big whoop! It does not really matter.

So instead of having corporate governance in public companies, what is happening is exactly the protocol and the conundrum that the member of the audience raised. What is happening is that the private hedge funds invested in by multiple international governments, companies, and otherwise who have no reporting requirements are beginning to control corporate America.

And that, from an investor standpoint, whether you are an investor or just interested in understanding what happens in public markets, reflects that we will have less information. There will be failures. There already has been failures in corporate circumstance in hedge funds. And what is interesting, however, is that our market is just another commodity; and those companies seem to be failing and nobody cares. Whether it is, as I said, New Century, hedge funds, or otherwise, I do not think that those markets are in any way, shape, or form in our government's interest sector. And, until they are, there will not be any

47. Id.

additional changes because, in essence, in my view, Sarbanes-Oxley is a dramatic failure other than enriching me and my law partners.

Tony, what do you think?

MR. NASHARR: You have not lost your cynicism, Barry.

He and I go back a little ways. I finance them and he takes them into bankruptcy, and then I got to chase him and his clients. But we are still friends.

MR. LEUZ: Let me actually take up Barry's comment and agree with him that I do not think that laws and regulation can completely prevent corporate fraud where people go as far as faking sales or faking accounts receivables. I think these are actions where the auditors are going to have a very hard time, and I do not think that the securities regulation is designed to completely prevent these cases.

For this reason, the issue of whether SOX was worth it or not needs to be debated over cases, not where there is egregious fraud, but where firms, as Kris has described it, have been somewhat negligent, but not in a purposeful way, and where the internal controls have been lax. The question is whether for these firms internal controls have improved in ways that benefit investors. I think it is progress in these areas that we need to judge.

I do not think that it would be right to approach or evaluate regulation by whether it has eliminated fraud. With that same approach, you would probably dismiss the Thirty-Three and the Thirty-Four Act because they have not completely prevented fraud either. I think the issue is, under normal circumstances, does SOX improve a firm's affairs.

MR. SWANSON: If you look at the numbers, just to pick up on Christian's comment, if you look at all the numbers of restatements that a lot of companies have done lately, the restatements were caused by implementing SOX, and it meant that the prior financials had errors in them.

50. Id.
54. Id.
So, clearly, the controls have improved in a number of companies. They will not prevent economic failures. And SOX\textsuperscript{55} was not designed to prevent that. I mean, that is part of the function of capitalism is taking risks and recognizing that there are very few guarantees in life.

MR. GARY LEWIS: A famous Chicago son, Al Capone, could not get arrested for what he may have done, but they found another avenue. In the same way, I feel that the Sarbanes-Oxley\textsuperscript{56} was able to compel people at a high level to be responsible for things that they were not responsible for. And they take a greater risk in avoiding that situation. It makes people wary of acting outside of Sarbanes-Oxley.\textsuperscript{57}

I have a friend of mine who is currently chairman of FASB, Bob Herz; and he was very active in writing this bill. He told me that, obviously, he loves Sarbanes-Oxley.\textsuperscript{58} But he told me that the problems that arise now are because companies are going outside of the New York Stock Exchange to be registered so that they would not be— they would not be responsible for Sarbanes-Oxley.\textsuperscript{59} Because you go to London or you go somewhere else to register, and this is what is putting pressure on changing Sarbanes-Oxley.\textsuperscript{60} Any comments?

MR. SWANSON: You made a number of good points. Thanks.

I think the question is the increasing number of listings in London, is that due somehow to Sarbanes-Oxley?\textsuperscript{61} That is a comment I have heard a number of people make. I have not seen any evidence for that. There may be a number of potential factors. I think that some would argue that the exchanges, the European exchanges, have become more competitive over time. There have been mergers and other things that have caused them to be become more competitive; and, of course, the U.S. dollar has been dropping steadily in value. I think the pound hit an all-time high this week.

So it is an interesting question, but I am not sure the answer is as clear as employees of the New York Stock Exchange would purport.

MR. LEUZ: Let me follow up on that and share a couple pieces of evidence. We have fairly substantial evidence that firms are coming to the United States and cross-listing on the New York Stock Exchange or NASDAQ because of tight regulation, not in spite of.

\textsuperscript{55} Id.
\textsuperscript{56} Id.
\textsuperscript{57} Id.
\textsuperscript{59} Id.
\textsuperscript{60} Id.
\textsuperscript{61} Id.
There are many firms in emerging markets that would find it very difficult to raise capital in their home markets because it would be very difficult for them to reassure outside investors that they are not taking the money or engaging in behavior that primarily benefits insiders, i.e., consume the money in the form of private control benefits.

Firms that have good growth opportunities and want to raise outside capital find the U.S. to be a place where they can come and actually bond and, in some sense, signal to the outside world that they are willing to play by the toughest rules. Consistent with this idea, we do have evidence that the capital markets reward cross-listing in the U.S.; I think this is an important thing to keep in mind.

Now it is true that listings in London are way up and, in particular, the AIM market has picked up a number of firms. But there is research that looks at the characteristics of these firms and asks whether these are firms that would have come to the United States prior to Sarbanes-Oxley. As it turns out, there is very little evidence of that. The AIM market has picked up a lot of very small firms, but it is not clear that they would have come to NASDAQ or NYSE. AIM has picked up a lot of firms from Russia where it is not clear that, even prior to Sarbanes-Oxley, they would have passed the muster or the corporate governance standards that would be imposed by the SEC.

Thus, while it is true that the listings are down, but I am not sure that the U.S. is losing many firms that should be here in the first place. There may be several out there, but I do not think that we are talking about hundreds of firms that are not coming to the United States because of Sarbanes-Oxley.

MR. CHATZ: I do think that it is important, though, that there is a question as to whether this legislation has had some effect upon the value of the dollar. It is possible that the increased costs have, in a micro way, impacted upon that because of the nature of what we do and what we require in this country versus others. And it will potentially have economic consequences to our markets and to our companies down the road.

MR. NASHARR: I would make a comment to that, that while there appears to be an impact on the dollar, or you could argue that there is if the question of "was it worth it" is answered with observation towards the stock indices, which are fairly strong and up and even the last few weeks have continued to rise; the legislation was intended to

62. Id.
64. Id.
enforce public confidence in our public companies, to support investment, and make people confident that when they put their money into a public company, it would be handled in a proper way and they would have a good return on their investment. It was not focused on let's strengthen the dollar.

And regulation—you can have your opinions on what regulation does, but if you look at the focus of this regulation, it seems to have worked; and, therefore, you could answer the question "is it worth it" with an affirmative statement. Maybe not an absolute yes, but it certainly has done the job.

Now you take other focuses, those focuses being what is the cost to U.S. business; does that cost drive others away or cause foreign companies not to want to come here? That is certainly something to look at, and it is certainly something that the media looks at. And the media—I think Professor Leuz would say that the media in looking at—and I do not want to put words in your mouth—but the media, in looking at that, focuses on the negative. They say, oh, look at all these companies that are delisting; foreign companies are not listing on the stock exchange. But if you look at the last five years compared to the previous five years, there has not been that significant of a change. It is just, in my opinion, chicken little calling look at all the negatives that it is causing.

MR. SWANSON: Let me add to that.

MR. CHATZ: Let me interrupt. From a valuation perspective, though, since this legislation has been enacted, the dollar has decreased significantly such that, from a foreign investment standpoint, the stock market's value really has negligibly changed.

MR. SWANSON: Let's add some numbers, some real numbers to the debate.

When President Bush signed SOX, the Dow Jones Industrial Average was at about seven thousand. Yesterday it closed at a record high of over twelve thousand eight hundred. The spread on investment rate bonds at the time it was signed was, I think, about 2.85 percent. Now it is about eighty-five basis points.

So the cost that shows up on the income statement, the cost that management is often most sensitive to, is the out-of-pocket cost of Sarbanes-Oxley because it runs through the income statement. The cost of capital, except for debt, does not show up on the income state-

65. Id.
ment. It is not quantified separately. And, in general, the cost of Sarbanes-Oxley\textsuperscript{68} for a multi-billion dollar company, if the annual run rate is an extra one and a half million, it is just a rounding error.

MR. CHATZ: Good rounding error.

MR. AL CERGOL: Question: U.S. Secretary of the Treasury Paulson made some comments, I believe, in the November time frame regarding this exact subject. I like what the gentleman said about chicken little, but it was something to the effect that—and I do not remember. I cannot paraphrase what he said exactly, but it sounded like just the opposite of what you are referring to, that there is too much regulation, there is too much corporate governance, and it should be reduced.

Did you hear any—you are smiling. You probably saw that same article that I did. Do you have any comment about the Treasury Secretary's comments?

MR. SWANSON: There are a number of things in there—for example, the big four independent accounting firms would like some sort of limitation on liability. Well, so would I. But, so far, there is not a consensus in this country that that is the right thing to do.

So, it is a democracy, as Barry pointed out; and there is a debate, and the debate is good. Barry, you probably would like to add to that question, right?

MR. CHATZ: As you say, this is either good or bad depending on your perspective; and, in my perspective, I think that any crook is going to steal. Anyone can manipulate any financial data that they wish to. We continue to see it in the marketplace. The dollar continues to decline, and it will continue to decline notwithstanding whatever regulations exist because the value of what we provide in the international marketplace continues to recede. And other than people like Kris and Navigant and Tony who provide intellectual services, the value of our commodities will continue to decrease.

With that in mind, the circumstance and the requirements for our businesses to show profits will be potentially at risk. And we should have some interesting analysis going forward.

MR. LEUZ: I would like to make one quick comment back to his question. First of all, I think Kris is exactly right by pointing out that there are some benefits of Sarbanes-Oxley\textsuperscript{69} that are not going to show up in corporate income statements. That said, in our research we have looked at benefits like the cost of capital. We find that firms with

\textsuperscript{68} Id.
\textsuperscript{69} Id.
cross-listings in the United States get, on average, a benefit in their
cost of capital between thirty to eighty basis points. That is a lot if you
consider the average size of firms that come to the United States. The
average is on the order of ten billion dollars. Thus, thirty to eighty
basis points is large in terms of its economic magnitude. Firms are
saving a lot that they can use to counterbalance the extra costs that
are coming from Sarbanes-Oxley.\footnote{Id.}

We have also looked at the equity premium and, in particular,
whether the premium has decreased post Sarbanes-Oxley.\footnote{Id.} We do
not find that the cost of capital has changed substantially. That is, the
cost of capital benefits has not become smaller. I think this is an im-
portant—this is something important to keep in mind.

With that said, one issue is that regulation is often imposed as a
one-size-fits-all regulation rather tailored to than address the needs of
particular sectors of the economy or particular firms in the economy.

If you look at the spectrum you have in public firms in this country,
you have firms out there that are publicly listed with ten million in
total assets. And you have firms that are multi-billion dollar compa-
nies. They are facing, in many regards, the same regulation.

To me, it seems hard to believe that this is optimal. It just—that
does not make sense. I, therefore, think it would be important to think
about scalability. Would it make sense to have different regulations
for different sectors of the economy or different size categories? And
to what extent are we ratcheting it up to a level where the costs out-
weigh the benefits for certain parts of the economy?

I think it is very different whether we are talking about GE or
Microsoft or whether we are talking about a small twenty million dol-
lar firm.

MR. SWANSON: I like, in theory, Christian's point. The hard part,
Internal Revenue Code with a separate version of SOX\footnote{Id.} for every
company out there with a lobby. So it is quite a challenge once you
start trying to modify it for certain groups.

MR. LEUZ: Let me put out a suggestion: Why should we not give
more decision rights to the exchanges? That way, firms are selecting
into a regime by listing on an exchange. Of course, it would be impor-
tant for investors to understand the rules of the particular exchange
on this matter. But I think it is worth considering letting firms choose what regulation they are going to play with, and the markets are going to price that.

MR. CHATZ: Question, particularly to Kris: The issue I have is, going back to the hedge fund question, what do you potentially see as the type of regulation that might impact them, if any? And how would that, in fact, be implemented? Any thoughts of that at all?

MR. SWANSON: Well, I think the big challenge with hedge funds—as they are trying to continue to achieve extraordinary returns—many of them are chasing more and more unusual investment strategies and holding investments that are less and less liquid. Meanwhile, in terms of compensation, most of them receive two percent of assets under management plus a twenty percent share of the upside.

As they invest in more and more things where they themselves get to decide what the market value is prior to a cash-out on any one of these individual investments, we are getting into the impact of the applicable accounting rules. And the question is whether the accounting rules are contributing, along with their fee structure, to incentives that are likely to create higher risks of fraud and whether we are going to see more collapses.

I think that is an important question and it will be very interesting to see how things play out over the next year or so.

MR. JACOB SCHUSTER: There has been kind of a global initiative against corruption with the United Nations's convention on corruption being signed and ratified. I was wondering, from the standpoint of Mr. Leuz's point earlier about how that Sarbanes-Oxley74 was actually attracting capital to the United States, I was wondering—that kind of goes against my traditional notion of how multinationals would go to other countries because they have laxer environmental laws or labor laws and that kind of thing.

So, I am wondering, are other countries discussing or thinking about implementing a similar strategy or implementing similar legislation?

MR. LEUZ: I do know that in Europe several countries have been thinking about implementing rules that mimic or are very close to SOX.75 But despite these efforts, I do not think that securities regulation is nearly as tightly enforced anywhere in the world as it is in the United States. Thus, there is still a lot of catching up to do and many substantial differences remain.

74. Id.
75. Id.
That said, many markets have thought about putting in place requirements (e.g. about independence) either for audit committees or directors. The U.K. is one example. But different countries take different approaches in terms of how these requirements are legislated. Some of it has to do with the fact that, in the United States, these rules are part of the securities regulation; whereas, in Europe, they are part of company law. But while different countries take different approaches, there is a general trend to ratchet up the securities regulation and investor protection around the world. But other countries have not gone as far as the 404 internal controls requirement.

MR. KEN MARCUS: I apologized if I missed it. I looked at the conclusion on the board that says, “There’s little evidence that total costs outweigh the benefits.” Has anybody quantified the costs?

MR. SWANSON: What are the costs? To quote Defense Secretary Donald Rumsfeld, there are the known knowns; there are the known unknowns; and there are the unknown unknowns. We do not know what the but-for world would have looked like without SOX. So it depends: which costs? Certain costs you know, clearly. But did it prevent a massive fraud at some other major company like WorldCom? I do not know. But if it prevented one—recall that Enron was a ninety billion loss with a lot of investors. Ninety billion dollars pays for centuries of ongoing SOX costs.

MR. KEN MARCUS: The answer is we do not know; we are just dancing around.

The only comment I had that makes a lot of sense has to go to the scalability. If you put the same regulations on a small company that you do on a mega company, it may be a lot more difficult for the smaller company to show those costs.

MR. SWANSON: Absolutely. But, remember, smaller companies do not have to go public. They can stay private. And smaller companies go out of business often. And it would be interesting to see over time. Christian may have looked at this, but smaller companies are particularly vulnerable to fraud. They do not have the internal control structure. They may not have the sophistication in certain areas. It may be easier for management to override certain things. And so, again, it is a very interesting question. Fair points all around. But I do not know that conclusive evidence is available yet.

78. Id.
MR. KEN MARCUS: The question, though: has anybody quantified the cost?

MR. LEUZ: Let me try to answer this question. There are a few attempts out there to quantify the costs, or at least the net costs or benefits. Several studies try to infer these from the stock price reaction.

But SOX79 was passed (for the most part) in the second half of July, which was one of the worst time periods in 2002 in terms of stock price performance. Can we attribute the stock price market performance over that time period to Sarbanes-Oxley80 when, at the same time, there was news about the possibility that the U.S. might go to war with Iraq and there were a host of other macro news coming out? I think attributing stock price performance would be extremely difficult.

So the short answer to your question is “yes”—there are people that have looked at the costs it. But, if you ask me if I believe the magnitude of their cost estimates, my response would be I am fairly skeptical.

MR. KEN MARCUS: What about out-of-pocket costs? What about the cost of complying with regulations? What about the accounting costs? The legal cost?

MR. LEUZ: There are some estimates for the per-firm costs of implementation, but they are very size dependent. They typically stem from survey data.

It is important to remember there is always a cost-benefit trade-off, even when a company tells us they spend a million. The big question is what did they get for that million.

MR. KEN MARCUS: That is the question. We are saying there is a conclusion, but we do not know what that cost figure is.

MR. CHATZ: I do not know that you are going to know it. I think the cost figure is—if there is an increase in companies going private, if the market does not allow participation by individual investors because of the lack—because of those costs in the smaller market, if it is discouraging people from investing and discouraging small businesses from going to market, that is a huge cost. But that is pure conjecture.

MS. DEBORAH GRAY: There has been recent talk that the New York Stock Exchange may form some kind of alliance with the Tokyo Stock Exchange, picking up on Professor Leuz’s comments. How

79. Id.
80. Id.
would SOX\textsuperscript{81} have any effect on that situation, if any? In other words, could this be migrated to other companies through stock exchanges if there was some sort of cooperation going on?

MR. NASHARR: That is above my elevation to answer that question.

MR. LEUZ: One of the major concerns about the merger between NYSE and Euronext, and similarly about the attempt of NASDAQ to take-over the London Stock Exchange, was that these combinations would create regulatory spill-over effects where European companies were, all of a sudden, subject to Sarbanes-Oxley.\textsuperscript{82}

I would imagine that similar concerns are going to be brought up when there is a closer alliance between NYSE and Tokyo. But I think such concerns are understandable, or even reasonable, because you have to remember that when you are a company in a different country, you are operating under a very different institutional framework, and it is not clear that U.S. regulations would necessarily be appropriate or a good fit for you.

So for foreign companies, other than those that explicitly choose to come here for a cross-listing, the concern that they may have to deal with Sarbanes-Oxley\textsuperscript{83} is understandable, simply because it might not be a good fit for them.

But you do see firms coming to the United States for cross-listings despite the fact, or in many cases, because of tight regulations. Note that even before Sarbanes-Oxley,\textsuperscript{84} U.S. regulations have been way much than anything we have, for instance, in Continental Europe. Nevertheless, firms have been coming to the U.S. and have been complying with U.S. regulations, presumably because there was a net benefit to doing so.

MR. MIKE KIM: You mentioned in the slide show that there has been a trend of companies going private. I assume there is a corollary or correlation between companies staying private and a decrease in IPOs over the last couple of years. And as practitioners, is that something that you have been kind of advising more often than not in terms of the last five years compared to maybe the five before that?

MR. NASHARR: I would not say that in my—

A PARTICIPANT: Would you repeat the question, please? We cannot hear it in the back.

\textsuperscript{81} Id.
\textsuperscript{83} Id.
\textsuperscript{84} Id.
MR. NASHARR: I will let you try to do it.

MR. MIKE KIM: I was saying with the trend of going private the last couple of years, I wanted to know if there were numbers backing up less IPOs in the same time period. And that as a practitioners, you know, as a young law student trying to figure out what to do in the practice, are they advising clients to stay private rather than go public like the last five years compared to the five years before then?

MR. NASHARR: In my particular practice, I cannot say that I do a lot of IPO work. My firm does, another department than mine, does IPO work.

But I would suggest to you that the answer is not that we are advising companies to stay private, but more as they are considering doing an IPO, you have to advise them. Well, before you even get there, you have got this set of regulations that you got to take into account. And that set of regulations requires audits down the road. And as they take that advice, they make the decision. We do not tell them, well, stay private or go public. They make those determinations on their own. We, as lawyers or lawyers-to-be, try to facilitate their decisions within the bounds of the law. So those are what we deal with.

MR. SWANSON: Remember, also, that there is a lot of stuff going on in the world. As Christian pointed out, one of them is this huge ocean of private equity money floating around. And, the fact that a private equity firm or team of firms might take Chrysler private, is that really due to Sarbanes-Oxley? I do not think Sarbanes-Oxley has anything to do with Chrysler’s problems.

But that kind of a going-private transaction, I assume, Christian, would be captured in your numbers?

MR. LEUZ: I agree. As pointed out before, I do not think the recent mega deals have much to do with SOX. Also, there are companies like Aramark that have gone private several times in its history. Thus, if firms come back to the public markets after five years, then it is hard to argue they left because of SOX in the first place.

That is, for these firms, going private is a way to facilitate restructuring, but it is unlikely to be related to Sarbanes-Oxley because, in the end, they want to be a public firm again.

85. Id.
86. Id.
88. Id.
89. Id.
MR. CHATZ: I want to follow up on Kris. He is exactly right. The private capital, the private equity, the hedge fund money has changed the market for more of my business sector, too, which is the middle market and otherwise. I do not see our securities lawyers advising companies that often to go and take the small IPO when there is availability for reasonable capital and investment cash in the marketplace otherwise.

What the nice thing for smaller businesses is that these things are available, which were products that were not available ten years ago; and the diligence, just from my market basis, which is in distress, the availability of cash and the amount of people looking at deals has increased dramatically in the last two to three years. Whether they buy or not is a different question; but the amount of funds out there continues to grow.

MR. SWANSON: Thank you, Barry. I think we are going to convert you into a true believer by the end of the conference this morning.

MR. CHATZ: No, I do not think so.

MR. JEFF APEL: Don't you think it is a little bit ironic then that you see some of these big private equity firms, like, say, for instance, KBR, who are responsible for taking, you know, these big companies private who are actually going public themselves? Doesn't that kind of say that maybe Sarbanes-Oxley\textsuperscript{90} doesn't really cause these burdens?

MR. NASHARR: That is what Kris is saying. It is not really driving the decision either way. It happens to be a set of regulations that public companies have to deal with; and then, as I observed, certain private companies or foundations choose to observe, but it is not driving the activity that we see from private equity firms taking public companies private.

MR. SWANSON: Picking up on that point, more and more of the big hedge funds are talking about going public, too. So this whole issue of whether SOX\textsuperscript{91} applies to hedge funds, if enough of them go public, that issue will become moot.

MR. AL CERGOL: You mentioned about ten years ago, in the financial markets, I think I remember Alan Greenspan coined the term "irrational exuberance." There has been a lot of theory and conjecture about the fed not raising marginal rates to a hundred percent that caused the two thousand bubble in the equity market.

I am just wondering what the impact of the federal—I mean, yeah, what Federal Reserve policy—Federal Bank Reserve policy is on

\textsuperscript{90} Id.
\textsuperscript{91} Id.
hedge fund growth because, at the same time, I think – you probably
know this better than I do—hasn’t the explosion of hedge funds gone
from, like, maybe double digits to, like, four digits in the last ten
years? I am wondering what impact it might have here on debt policy,
government, future government regulation, or U.S. government regu-
lation on the amount of hedge funds out there and the risks that goes
along with it. Can you answer that in three sentences?

MR. NASHARR: That is a macro economic—

MR. CHATZ: I think the first issue is is the fed even relevant?

MR. AL CERGOL: It is for a small investor.

MR. CHATZ: I do not know that it is relevant for any decision-
making whatsoever regarding what is happening in the markets. It
may have a short-term blip if they choose to raise or lower, but their
decisions are being absorbed much more quickly than when I was like
these law students, twenty years ago, watching their impacts upon the
markets.

MR. SWANSON: I think with hedge funds you are absolutely right.
If memory serves, I believe the hundred largest, on average, have be-
tween thirteen and thirty-one billion under management.

The rise of the hedge fund is a profound phenomenon in the last ten
decade. Are there significant benefits to having hedge funds in our
financial system? Many people say yes.

I think some of the more troubling issues are things like when
teacher pension funds that are looking at big shortfalls start looking at
investing in hedge funds, sort of the double down and bet the house
approach as a way to recover from the fact that they do not have
enough money to meet their obligations. And is that an appropriate
debate involving public policy and other kinds of issues. The debates
are complex, and I think the role and impact of hedge funds are fac-
tors in a lot of those debates.

MR. CHATZ: With that in mind, unless the professor or Tony have
any other comments, we are going to get close to the end. I hope eve-
rybody has found this to be useful, somewhat enlightening and kind of
answered a couple of questions. I am not sure if it did or not, but I
think we are going to find some interesting impacts in the future, and
we should all keep an eye on what everybody is doing.