

Suite 502

1150 Seventeenth Street, N.W., Washington, D.C. 20036

Telephone: (202) 777-3000 Facsimile: (202) 777-3010

## ECONOMIC NEWS UPDATE

IRWIN M. STELZER

05 May 2006

Senator Paul Sarbanes and Congressman Mike Oxley are both retiring from congress at the end of this year. The business community will be delighted to see the back of them— and to get on with the task of pushing through changes to the law that bears their names, and is better known as SOX. That legislation was designed to improve the quality of corporate governance in the wake of the collapse of Enron and WorldCom, and scandals at other companies.

But, say its critics, the costs of complying with the reporting and governance requirements of Section 404, exceed any benefits generated by SOX. Key legislators are complaining to Securities and Exchange Commission chairman Christopher Cox that US securities exchanges are losing market share to overseas rivals because companies can avoid SOX's burdens by doing their capital-raising beyond the statute's reach.

Florida Congressman Tom Feeney agrees. He claims that because of SOX "we are out-sourcing America's lead in world capital formation." Late last week Feeney was putting finishing touches on a bill that would relax some of SOX's provisions.

Worse still, say the law's critics, fear of running afoul of Sarbanes-Oxley has turned red-blooded entrepreneurial managers into risk-averse pussy cats by creating what economist Harry Butler and law professor Larry Ribstein call "a climate of fear" in America's boardrooms.

The retirement of the bill's authors at year-end will follow by about six months the conclusion of the trial of Enron executives Jeff Skilling and Ken Lay, after which the Enron saga will quickly recede from memory. That would clear the way for the law's opponents to take up Feeney's bill, or something like it, early in the new year, and to act on the proposal of an SEC advisory committee to exempt completely firms with a market capitalization of under \$128 million (Feeney would move that cut-off to \$700 million), and to partially exempt firms in the \$128-\$787 million size class.

If Section 404 does come up for review, look for the auditing profession to oppose any changes. A study prepared for the Institute of Internal Auditors Research Foundation concludes that "there are significant benefits associated with" the procedures mandated by section 404, and that costs

of compliance, high initially because the costs of control systems are front-loaded, will fall further in the next several years.

They would say that, wouldn't they, grouse the law's critics. Alex Pollock, a fellow at the American Enterprise Institute in Washington, calls SOX "a revenue and profit bonanza" for the large accounting firms. Audit fees are soaring – for three reasons. First, these auditors worry that firm-destroying law suits might follow a too-lenient interpretation of SOX's requirements, and so gold-plate – some prefer to say bullet-proof – their audits. Second, they know their clients have no choice but to grin and bear, or at least to bear it. Finally, auditing is now a highly concentrated industry, which inevitably reduces the intensity of competition.

Complicating all of this is a new surge of interest in executive compensation. Just as gasoline prices were piercing the psychologically upsetting \$3-per-gallon mark (about half of what the stuff costs in Europe), Exxon Mobil announced that its retiring CEO, Lee Raymond, would receive a goodbye award of nearly \$400 million, which includes payment of his country-club dues. There is little question that Raymond's management talents contributed to what Oppenheimer & Co. analyst Fadel Gheit estimates to be the 223% return to Exxon Mobil shareholders in the past decade. That's well above the industry average. But soaring oil prices did their part, and in the past five years returns to Exxon Mobil shareholders have fallen below the industry average.

Raymond's compensation package is a gift for three sets of corporate critics: politicians playing the blame game with gasoline prices; trade

unions, academics and politicians interested in dramatizing the increasing gap between board room and shop floor pay; and SOX supporters who cite the need to restrain executive compensation as one reason for opposing any relaxation of Sarbanes-Oxley's requirements that directors be truly independent of management, and that executive compensation be made transparent to shareholders.

Sarbanes-Oxley certainly has its costs. But it also has benefits. Corporate capitalism depends for its survival on a broadly held feeling that the system is fair, and that potential conflicts of interest between managers and shareholders can be contained. Perception matters, and the passage of Sarbanes-Oxley added to the perception that politicians are prepared to act if executive behavior becomes excessively unseemly.

SOX might also have contributed to a more sensible approach to mergers and acquisitions. The premiums that acquirers are willing to pay for the companies they woo, or stalk, are running at about half those characteristic of earlier periods of high M&A activity. And a recent, although limited study by the Cass Business School in London and consultants Towers Perrin found that transactions completed in the post-SOX era have outperformed the market by seven percent. Similar deals in earlier merger booms significantly underperformed the market.

It is not unreasonable to assume that independent directors, now well paid for their time and with access to outside advisors, are reining in executives who favor sheer company size, and the prestige that goes with it, over the harder slog of increasing

shareholder value. Economists contrast such “gross sales maximizers” with “net profits maximizers”.

Nor is it far-fetched to guess that the rise of the independent director and greater transparency, both a result of SOX, have something to do with the recent tapering in the rate of increase of executive compensation, and increased interest in relating pay to performance. SOX may have its flaws, but tinkering around the edges, rather than caving in to extreme critics, seems to this writer the better course.

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**THE SUNDAY TIMES**

A version of this Update appeared in  
The Sunday Times (London)