BETTER MARKETS

FINANCIAL REGULATION

FACT SHEET

The Cost of Noncompliance with Financial Regulation

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Introduction

Why don't we treat corporate crime like all other crime? With most crimes, we pass laws to prevent the crimes from occurring, and if those laws are successful, we keep them on the books. But with corporate crime, we pass laws to prevent the crimes from occurring, and then when those laws are successful, we entertain calls for those laws to be revised.

That is exactly what is happening now as calls for deregulation persist in the financial industry. On June 25, the House Financial Services Committee will hold a hearing entitled "Reassessing Sarbanes-Oxley: The Cost of Compliance in Today's Capital Markets." The hearing presages calls to roll back some of the provisions of the Sarbanes-Oxley Act of 2002 (SOX). But it's worth remembering why we passed SOX in the first place, and the potential consequences of curtailing its provisions. The cost of weaker corporate governance standards is likely to be far higher than the cost of complying with SOX.

That's because what led to SOX's passage was a series of accounting scandals that rocked the economy. As discussed below, those scandals cost investors billions of dollars and wiped out hundreds of thousands of jobs. One estimate put the total cost to the economy at $35 billion off of Gross Domestic Product. The scandals were so destructive that they spurred a bipartisan legislative response. SOX has been largely successful at preventing a recurrence of such scandals. The fact that it has been successful and those scandals have faded from memory is no reason to consider loosening the standards SOX put in place.

Enron

Enron was once the seventh-largest company in the United States. In August 2000, its stock reached a high of $90. Sixteen months later, its stock was at less than $1. The Wall Street Journal said that "rarely in the annals of American business has an enterprise so mighty and so highly regarded fallen so far so fast." One analyst observed that it took Enron 16 years to go from $10 billion of assets to $65 billion of assets and 24 days to go bankrupt.

Enron Stock Price from August 23, 2000 to January 11, 2002

Enron's fall stemmed from a massive accounting scandal, which only came to light due to whistleblowers, outside financial analysts and investigative journalists. These individuals revealed that the company illegally used a variety of accounting techniques to vastly boost reported income while lowering reported debt. One report that was issued after the scandal broke found that such techniques accounted for 96% of Enron's reported net income in 2000. The report found further that Enron improperly transferred as much as $5 billion in assets to other entities as part of its manipulation of its financial statements. The disclosure of the accounting scandal vaporized $60 billion in Enron's stock market value.

Enron became synonymous with corporate fraud. It declared bankruptcy, with its bankruptcy filing listing $64 billion in assets. After its bankruptcy, 25,000 employees lost their jobs as well as $2 billion in pension savings and $1 billion in retirement funds. The scandal led to the indictment of several of the company's executives. Arthur Anderson, its accounting firm, was convicted of obstruction-of-justice. Enron was considered the most significant corporate collapse since the failure of many savings and loan banks in the 80s, demonstrating the need for significant reforms in accounting and corporate governance.

WorldCom

Enron's bankruptcy in December 2001 was the largest in US history at the time, but it held that distinction for less than a year. In July 2002, WorldCom listed more than $107 billion in assets in its bankruptcy petition. Like Enron, WorldCom declared bankruptcy after it disclosed an accounting scandal that created billions in illusory earnings.

Similar to Enron, WorldCom improperly accounted for $3.8 billion in expenses. This allowed WorldCom to report a profit of $1.4 billion in 2001 and $130 million for the first quarter of 2002. Without the expenses improperly booked as capital expenditures, WorldCom would have reported a net loss for 2001 as well as the first quarter of 2002.

Unsurprisingly, once the fraud was revealed due to the brave discovery and disclosure by a whistleblower, the company's internal auditor, WorldCom's stock price collapsed.

The plunge in WorldCom's shares cost investors over $175 billion. Although this did not help investors, as with Enron, multiple WorldCom executives went to prison for the fraud.

WorldCom's demise exemplifies the cost of not properly regulating public companies.

> The losers are pretty easy to identify. You can start with the nearly 30,000 employees who lost their jobs. Then there are the investors who lost their money and now hold worthless shares of WorldCom stock.

25 years later, it's easy to forget about these investors. But we shouldn't. For example,

> Stephen Teel spent 23 years working for [WorldCom], investing all of his 401(k) contribution in company stock. . . . After the massive fraud that brought down WorldCom . . . and led to the collapse of its stock, his $1 million retirement nest egg was worth less than $1,000.

SOX

The magnitude of the frauds at Enron and WorldCom and their consequences spurred legislative action. Congress passed SOX to prevent such scandals from recurring.

> After Enron and then WorldCom foundered amid multibillion-dollar accounting scandals, exposing layers of corporate malfeasance . . . Washington moved belatedly but forcefully to stiffen regulations, toughen enforcement and improve corporate audits. . . .The goal was to shore up confidence in Wall Street, particularly among individual investors . . . . Tales from thousands of investors who lost their life savings were a powerful indictment of lax government oversight. . . . The Sarbanes-Oxley law was approved in 2002 as lawmakers grew concerned that they might be swept out of office by millions of middle- and lower-income investors who owned their share of the marketplace through mutual funds, IRAs, 401(k)s, and 529 college-savings plans.

The reasons for SOX's passage are best captured by the words of Sherron Watkins and Cynthia Cooper, the whistleblowers who exposed the frauds at Enron and WorldCom:

> The collapse of Enron and WorldCom exposed a broken system for verifying financial honesty. . . . The cost of their deceit was staggering. More than 50,000 employees lost their jobs and the companies entered bankruptcy, leaving investors and creditors with catastrophic losses. At the time, these were the largest bankruptcies and civil settlements in corporate history. In response to these and other failures, Congress came together in 2002 to pass the Sarbanes-Oxley Act, which created a strong framework to detect and deter fraud.

This framework had several components, all of which are still relevant today.

- PCAOB: SOX created the Public Company Accounting Oversight Board (PCAOB) and charged it with exercising independent oversight of public accounting firms
- Auditor Independence: SOX established new standards intended to preserve auditor independence and prevent related conflicts of interest
- Executive Responsibility: SOX added new rules associated with the certification of financial statements by senior executive officers; the prohibition of executive interference in the audit process; and the forfeiture of executive compensation elements in certain circumstances following an accounting restatement.

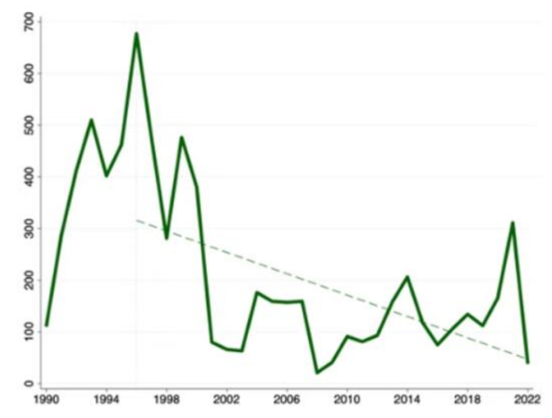
The effectiveness of these components can be seen in what has transpired since. In the US, there hasn't been another Enron. But in the UK, Enron and WorldCom led to little or no reform. And since 2001, there has been a series of high-profile accounting scandals in the UK. The fact that SOX has prevented further accounting scandals here is the reason we should consider not the cost of complying with SOX but the cost of not complying.

Criticisms

In light of these scandals and SOX's effectiveness in preventing their recurrence, the question is why we would want to curtail SOX. Proponents of doing so say SOX is too costly and is the reason for the decline in initial public offerings (IPOs). But that is not the case.

> Despite the widespread belief that SOX and other regulations have contributed to the decline in public companies, some scholars have rebutted this view. They note that the number of public firms had been declining before SOX's passage, and IPO activity actually rose in the years immediately following its enactment.

Number of IPOs, 1990-2022



The truth is that it is the deregulation of private securities offerings that has killed IPOs, as going public becomes less attractive when companies can raise the same amount of money privately while providing fewer disclosures and legal rights to investors.

This is not the first time the industry has tried to roll back some of the tough new measures that SOX implemented after Enron and WorldCom. In 2006, a deregulatory mood again pervaded Washington as the scandals receded to the back pages. Business groups suggested that more companies were listing their stock overseas "because of the regulatory climate in the United States." Although experts discounted the idea that America's laws made foreign markets more attractive than domestic ones, what was most notable about the business groups' effort then was its limited nature.

> 'We are still living in the shadow of Enron and WorldCom and that has tempered the business community's attempts at more precipitous action' said Joel Seligman, a securities law expert and authority on the history of the SEC who is also the president of the University of Rochester.

In other words, it was too soon to push for a return to a pre-SOX regime. There was also a "broad consensus that the bigger changes that [SOX] made were reasonable ones."

Twenty years later, there is less hesitancy to suggest that we go back to the way things were before Enron and WorldCom. But there is no more reason to consider the changes SOX made less reasonable today than in 2006 (or in 2002 when SOX passed). Indeed, the passage of time has demonstrated the effectiveness of those changes.

> Its limitations notwithstanding, there is a strong argument that [SOX] has accomplished its core goal of preserving public confidence in the financial markets and in financial reporting. The law has fundamentally changed the relationship between the company and the audit/auditor, enhanced the reliability of financial reporting, established the PCAOB and sparked the corporate responsibility movement—thus creating a more robust respect for corporate compliance, fiduciary duty to shareholders, attentive board oversight and ethical behavior. It is also undeniable that there has been a drastic reduction in the number of public company financial accounting scandals since its enactment.

These are reasons SOX should be celebrated, not castigated. Indeed, SOX's success in preventing a recurrence of the accounting scandals that led to its passage shows that to promote wealth creation what we need is "[n]ot deregulation, but good regulation."

> Truly supporting the private sector, innovation, and wealth creation, requires more government regulation, not less. . . . The Enron and related Arthur Anderson accounting scandals did prompt new laws and regulations . . . . But while this may have helped avoid another specific Enron . . . it was way too specific to this crisis and missed the bigger lesson of making sure that any incentives to cheat in the marketplace are not rewarded. . . . [L]aws must align profit making with incentives not to cheat or to police others in the industry . . . . Deregulation is not the same as creating wealth. . . . The answer is enacting more nuanced laws and much more effective enforcement . . . . Such regulations enhance wealth creation by ensuring that open and fair market players only gain rewards for actual, non-harmful innovations.

Conclusion

It is true that the cost of preventing massive accounting scandals is higher than the cost of allowing companies to cook their books. But the cost of those scandals is higher than the cost of preventing them. If we retreat from the protections SOX introduced, we will invite a return to the conditions that allowed Enron and WorldCom to transpire. The fact that memories of Enron and WorldCom have faded, and such accounting scandals have not recurred, is no reason to abandon SOX. As Sherron Watkins and Cynthia Cooper said in response to recent proposals to abolish some of its reforms, the "silent, immeasurable value of well-designed safeguards lies in the scandals they prevent from happening."

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