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Penny Wise, Pound Foolish: Why Investors Would Be Foolish To Pay a Penny or a Pound for the Protections Provided by Sarbanes-Oxley

I. INTRODUCTION

"China executed four people, including employees of two of its Big Four state banks, for fraud totaling $15 million . . . amidst a high-profile campaign against financial crime. The executions [came] after a string of arrests in white-collar crime as China prepared to sell shares in its big banks."[1]

Fortunately, the United States Congress made the decision not to attack financial fraud with the same zeal displayed by the government of China. As a result, Kenneth Lay, Jeffrey Skilling, Andrew Fastow,[2] and Dennis Kozlowski[3] can all breathe a little easier. In the wake of Enron's collapse—with the stock market sagging, investor confidence damaged,[4] and a rash of newly exposed corporate fraud[5]—Congress reacted by passing the Public Company Accounting Reform and Investor Protection Act of 2002, more commonly known as the Sarbanes-Oxley Act of 2002

1. Stephen M. Cutler, Sec. Exch. Comm'n, The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program, Address before the UCLA School of Law (Sept. 20, 2004), *available at* http://www.sec.gov/news/speech/spch092004smc.htm.

2. Kenneth Lay, Jeffrey Skilling, and Andrew Fastow were among sixteen senior mangers of Enron who were sued by the SEC for their role in Enron's fraudulent schemes. *See* Carl Ballard, *Enron: After the Collapse*, Online NewsHour (June 2002), *available at* http://www.pbs.org/newshour/bb/business/enron/player5.html.

3. Dennis Kozlowski is the former Chairman and CEO of Tyco Intl. and was charged with securities fraud, conspiracy, grand larceny, and falsifying business records. It is alleged that Mr. Kozlowski defrauded Tyco to the tune of over six-hundred million dollars. *See Judge Declares Tyco Mistrial*, CNNMONEY, Apr. 2, 2004, http://money.cnn.com/2004/04/02/news/midcaps/tyco_outcome/index.htm.

4. *See* Press Release, Congressman Michael G. Oxley, Oxley Remarks on Second Anniversary of Sarbanes-Oxley, (Oct. 20, 2004), http://oxley.house.gov/News.asp?FormMode=List&ID=1 (noting that the worst month for investor confidence was December 2002).

5. *See* Steve Fraser, *Hopping Down the Money Trail*, N.Y. TIMES, Mar. 27, 2005, § 7, at 17 (listing the companies that suffered tremendous losses due to corporate fraud occurring in the last months of 2001 and early 2002 including Enron, Arthur Anderson, Worldcom, Global Crossing, Tyco, and Adelphia).

(the "Act" or "Sarbanes-Oxley").[6] As the dust begins to settle, the impact of Sarbanes-Oxley continues to unfold.

While the ultimate effects of Sarbanes-Oxley remain uncertain, one thing has become increasingly clear: Congress, in an attempt to protect investors, grossly underestimated the costs of the Act to publicly traded companies and, in turn, the effect of the Act on investors. The cost borne by investors goes beyond the hard dollar price of compliance with Sarbanes-Oxley: investors are also facing the realistic possibility of having fewer investment options as a result of the Act. Due to the prohibitive price of compliance, publicly traded small capitalization ("small-cap") companies and foreign corporations are considering delisting from U.S. stock exchanges rather than complying with the Act. Similarly, privately held small companies will likely opt not to be listed on any of the public exchanges because of the higher compliance costs caused by Sarbanes-Oxley and will seek alternative financing. Publicly traded small-cap and foreign stocks represent an important part of a diversified portfolio, and investors are harmed if fewer publicly traded small-cap and foreign stocks are offered in the marketplace.[7] Additionally, investors are generally exposed to greater risks when investing in privately held companies that are not required to meet the same disclosure standards as publicly traded companies. The protections afforded by public disclosure requirements are thereby eliminated, leaving investors with even less protection against fraud. Ultimately, instead of protecting investors, Congress may have exposed them to greater risks.

Much has been written regarding Sarbanes-Oxley with the focus on how the Act impacts various groups.[8] Practitioners and legal scholars have considered the effect of the Act upon accountants, information technology managers, senior executives, and lawyers. However,

6. Pub. L. No. 107-204, 116 Stat. 745 (to be codified in scattered sections of United States Code Titles 11, 15, 28, and 29).

7. *See generally* Henry T.C. Hu, *Illiteracy and Intervention: Wholesale Derivatives, Retail Mutual Funds, and the Matter of Asset Class*, 84 GEO. L.J. 2319, 2362 (1996) (discussing asset allocation theory as the most important aspect of investor returns). Asset allocation refers to how investments are spread out across asset classes, or how investments are distributed within asset classes. *Id.*

8. *See, e.g.*, Justine Kendall, *Accountants, Attorneys, and Enron: An Analysis of the Debacle and Implications for Future Practice Under the Sarbanes-Oxley Act*, 16 REGENT U.L. REV. 459 (2003) (discussing what Sarbanes-Oxley means for accountants and attorneys); Anjali Parikh, *Expanding Chief Officers' Liability and the Promise To Raise Investor Confidence*, 4 HOUS. BUS. TAX L.J. 357 (discussing the effect of Sarbanes-Oxley on senior management).

forgotten in these analyses is the investor—the very person the Act is intended to protect. This Comment argues that Sarbanes-Oxley, though intended to protect investors from corporate fraud, actually harms investors by increasing compliance costs, which outweigh any protection provided to investors. The additional costs created by Sarbanes-Oxley reduce overall stockholder profit. Furthermore, these costs create an incentive for small and foreign companies to avoid or even remove themselves from the public marketplace.

A summary of the purpose and relevant provisions of Sarbanes-Oxley is presented in Part II. Part III examines the positive aspects of Sarbanes-Oxley in an attempt to measure what investors are receiving for the money spent on compliance. Part IV addresses the additional costs that companies face to be compliant with the Act. Part V discusses the ways in which the Act impacts U.S. investors. Finally, Part VI recommends that small and foreign companies be exempted from compliance with Sarbanes-Oxley, which would eliminate the bulk of the negative bite from the legislation and still allow Congress to determine if Sarbanes-Oxley provides some investor protection.

II. SARBANES-OXLEY

The following is a summary of the first four provisions of Sarbanes-Oxley—provisions that have had a major financial impact on companies that are publicly traded on U.S. markets. The stated purpose of Sarbanes-Oxley is "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."[9] The Act amended the Securities Exchange Act of 1934 and four other Acts[10] to safeguard investors against the possibility of financial failure of publicly traded companies primarily "by improving the accuracy and reliability of corporate disclosures."[11]

Title I of the Act established the Public Company Accounting Oversight Board ("Oversight Board") to oversee the auditing process of public companies,[12] to establish audit rules,[13] and to enforce compliance

9. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. at 745.

10. Sarbanes-Oxley also amended various parts of the Securities Act of 1933, the Employee Retirement Income Security Act of 1974, the Investment Advisor Act of 1940, and parts of related criminal code sections under Title 18 of the United States Code.

11. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. at 745.

12. 15 U.S.C. § 7211(a) (Supp. II 2002).

13. *Id.* § 7211(c)(2).

by accountants.[14] Title I also assigned supervision of the Oversight Board to the Securities and Exchange Commission ("SEC" or the "Commission").[15]

Title II of the Act amended section 10A of the Securities Exchange Act of 1934 by including additional requirements for independent auditors in an attempt to strengthen the meaning of "independent auditor."[16] To this end, under the amended Securities and Exchange Act, auditors are prohibited from contemporaneously providing other consulting services while performing audit services for a publicly traded company.[17] Furthermore, Title II prohibits lead audit partners from performing audit services for the same client for more than five consecutive years, which requires the accounting firm to shift the lead audit partner to a different account after five years.[18] The Act also requires auditors to report to the company's audit committee the procedures and communications carried out between the auditor and management in an effort to ensure independence between the auditor and company management.[19]

Title III of Sarbanes-Oxley amended section 10A of the Securities Exchange Act of 1934 by adding new requirements relating to audit committees for publicly traded companies.[20] This addition to the 1934 Act "directs the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements of any portions of paragraph (2) through (6)."[21] Paragraph (2) outlines the oversight responsibility of the audit committee in relation to the registered public accounting firm.[22] Paragraph (3) requires that the audit committee consist of independent members of the board of directors.[23] Independence, for purposes of the audit committee, precludes anyone from accepting "any consulting, advisory, or other compensatory fee from the issuer."[24] A member of the

14. *Id.* § 7211(c)(3), (4).
15. *Id.* § 7217 (Supp. II 2002).
16. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. at 771.
17. 15 U.S.C. § 78j-1(g) (Supp. II 2002).
18. *Id*. § 78j-1(j).
19. *Id*. § 78j-1(k).
20. *Id*. § 78j-1(m).
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.*

audit committee may not be "an affiliated person of the issuer or any subsidiary thereof."[25] Paragraphs (4) through (6) are not overly burdensome to companies, and thus are not important to this analysis.[26]

Title III also requires that the principal executive certify financial reports.[27] In doing so, the principal executive becomes responsible for establishing and maintaining internal control procedures and certifies that the internal control procedures have been reviewed for effectiveness within ninety days of certification.[28] Additionally, certification requires that the principal executive disclose any deficiencies in the control procedures to the audit committee and the auditor,[29] including any fraud—material or not—involving management or employees who have a role in the company's internal controls.[30] Moreover, if the issuer is required to prepare a restatement due to misconduct with any securities law financial reporting requirement, the chief executive officer and chief financial officer may be required to repay to the company any bonuses received or profits realized from the sale of the issuer's stock for the twelve-month period.[31]

Title IV of the Act amended section 13 of the Securities Exchange Act of 1934, which outlines the requirements for disclosures in periodic reports.[32] The amendment requires the disclosure of off-balance sheet transactions and establishes new rules for pro forma figures.[33] Section 404 of Sarbanes-Oxley commands management to include an "internal control report"[34] in any annual report required by sections 13(a) or 15(d) of the Securities Exchange Act of 1934. The internal control report must contain an assessment of the effectiveness of the internal control structure and of the issuer's procedures for financial reporting.[35] The

25. *Id.*

26. *Id.* Paragraph (4) requires audit committees to establish procedure for complaints; (5) grants authority to the audit committee to hire counsel or advisors; and (6) requires the issuer to provide necessary funding to the audit committee. *Id.*

27. *Id*. § 7241(a).

28. *Id*. § 7241(a)(4).

29. *Id*. § 7241(a)(5)(A).

30. *Id*. § 7241(a)(5)(B).

31. *Id*. § 7243(a)(1).

32. *Id*. § 78m.

33. *Id*. § 78m(j). Interestingly, off-balance sheet transactions were partly to blame for Enron's demise.

34. *Id*. § 7262.

35. *Id*. § 7262(a)(1), (2).

registered public accounting firm that prepares the issuer's audit report must attest to and report on the issuer's assessment.[36]

Additionally, Title IV requires the SEC to engage in a regular and systematic review of financial reports required under section 13(a) of the Securities Exchange Act of 1934.[37] Sarbanes-Oxley places a huge burden on the Commission by requiring it to review, at least once every three years, all issuers required to file under sections 13(a) and 15(d) of the Securities Exchange Act of 1934.[38] Also, the amended Act requires that the company's audit committee contain at least one member who is a "financial expert."[39] The remaining titles within Sarbanes-Oxley do not add significant costs to publicly traded companies.[40]

36. *Id*. § 7262(b).

37. *Id*. § 7266(a).

38. *Id*. § 7266(c).

39. *Id*. § 7265. The Act does not define a financial expert; rather the Act indicates that "the Commission shall consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions," which include

> (1) an understanding of generally accepted accounting principles and financial statements;
>
> (2) experience in
>
> > (A) the preparation or auditing of financial statements of generally comparable issuers; and
> >
> > (B) the application of such principles in connection with the accounting for estimates, accruals, and reserves;
>
> (3) Experience with internal accounting controls; and
>
> (4) an understanding of audit committee functions.

Id.

40. Title V is entitled "Analyst Conflicts of Interest" and deals with analysts' conflicts of interest. Sarbanes-Oxley Act of 2002, § 501, Pub. L. No. 107-204, 116 Stat. at 791.

Title VI is entitled "Commission Resources and Authority" and appropriates funds to the Securities and Exchange Commission to carry out its role. *Id.* §§ 601–604, 116 Stat. at 793.

Title VII is entitled "Studies and Reports" and thus requires the Comptroller General of the United States to conduct a study regarding consolidation of public accounting firms, report regarding credit rating agencies, and report on violators and violations prior to commencement of the Act. *Id.* §§ 701–705, 116 Stat. at 797.

Title VIII of Sarbanes-Oxley is known as the Corporate and Criminal Fraud Accountability Act of 2002, Pub. L. No. 107-204, 116 Stat. at 805 (codified as amended at 18 U.S.C. § 1501 (Supp. II 2002)). It imposes criminal penalties for altering documents, 18 U.S.C. § 1519 (Supp. II 2002), extends the statute of limitations for securities fraud claims, *id*. § 1658, and provides protection to employee whistleblowers, *id*. § 1514A.

Title IX is known as the White-Collar Crime Penalty Enhancement Act of 2002. Sarbanes-Oxley Act of 2002, § 901, Pub. L. No. 107-204, 116 Stat. at 805 (codified as amended at 18 U.S.C. § 1341 (Supp. II 2002)).

Sarbanes-Oxley significantly altered the corporate governance landscape for companies that trade on U.S. exchanges. However, the more difficult question is whether the Act provides investors with adequate protection from corporate fraud at a reasonable price.

III. WHAT INVESTORS ARE RECEIVING AS A RESULT OF SARBANES-OXLEY

Sarbanes-Oxley made noticeable changes to the regulatory landscape for publicly traded companies, and some of the changes may work to positively affect investors. Like any business decision, the positive effects created by Sarbanes-Oxley should be measured against the costs of acquisition. Investors are only paying too much for the Act if the benefits do not exceed the costs. Thus, the positive aspects of Sarbanes-Oxley also must be considered. In analyzing the intended benefit of Sarbanes-Oxley, Part A will focus on the provisions of the Act that clearly add value to investors. Part B will consider whether investors are receiving the right protection by focusing on portions of the Act that are intended to provide positive benefit to investors but will not likely achieve the desired result in practice.

A. The Positive Side of Sarbanes-Oxley

Sarbanes-Oxley is not devoid of positive effects. First, and perhaps most importantly, Sarbanes-Oxley requires that any company listed on a national stock exchange have an audit committee consisting of independent board members,[41] including at least one financial expert.[42] Auditors play a critical role in helping to provide investors with a transparent picture of what is happening within a company. Chief Justice Burger described the auditors' function as follows:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility

Title X provides that the chief executive officer "should" sign the Federal income tax return for the corporations. *Id.* § 1001, 116 Stat. at 807.

Title XI is known as the Corporate Fraud Accountability Act of 2002, Pub. L. No. 107-204, 116 Stat. at 807, which relates to tampering with a record or impeding official proceedings, 18 U.S.C. § 1512 (Supp. II 2002), allows the Commission to order a temporary freeze of the activity and force any potential extraordinary payments into escrow until the conclusion of legal proceedings, 15 U.S.C. § 78u-3 (Supp. II 2002), and gives the Commission the Authority to prohibit people from serving as officers or directors, *id.*

41. 15 U.S.C. § 78j-1 (Supp. II 2002).

42. *Id*. § 7265.

> transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[43]

The role of audit committee members is key to providing investors with a transparent picture. And it appears that audit committees, even those that already employed the best practices before Sarbanes-Oxley, have started to take their duties even more seriously.[44]

At the same time, Sarbanes-Oxley has reminded auditors that they work for, and report to, the audit committee and not senior management.[45] Prior to the Act, auditors who were "preoccupied with the desire to preserve lucrative auditing and consulting contracts" were less than diligent in pointing out aggressive or "creative accounting."[46] By requiring auditors to report to the independent audit committee,[47] Sarbanes-Oxley has increased the auditors' independence. This requirement helps to eliminate the inherent conflict that arises because of the client's ability to punish the auditor who is supposed to serve as the watchdog.[48] In theory, auditors are agents of the shareholders, but in practice, management is the entity that hires the auditor.[49] Thus, if management believes "the watchdog barks too loudly, too often, or at inappropriate times, then the watchdog can be fired at the cost of 'losing an indefinite stream of future audit fees.'"[50] Section 301 of Sarbanes-Oxley[51] can work to alleviate some of the inherent conflict of interest between management and the company's auditor. Removing this conflict

43. United States v. Arthur Young & Co., 465 U.S. 805, 817–18 (1984).

44. *Implementation of the Sarbanes-Oxley Act of 2002: Hearings Before the S. Comm. on Banking, Housing & Urban Affairs*, 108th Cong. 180–81 (2003) (statement of Keith D. Grinstein) [hereinafter Grinstein Statement], *available at* http://banking.senate.gov/_files/grinstn.pdf.

45. *Id.* at 5.

46. Arthur Levitt, *Who Audits the Auditors?*, WASH. POST, Jan. 17, 2002, at A29.

47. Sarbanes-Oxley Act of 2002, § 404, Pub. L. No. 107-204, 116 Stat. at 789.

48. Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited*, 8 STAN. J.L. BUS. & FIN. 39, 47 (2002).

49. *Id.*

50. Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. & FIN. 1, 7 (2002) (describing and quoting work of Ronen, *supra* note 48, at 47). Joseph A. Grundfest was formerly the Commissioner of the U.S. Securities & Exchange Commission (1985–1990). *Id.*

51. 15 U.S.C. § 78j-1 (Supp. II 2002).

certainly provides a benefit to shareholders in that the auditor will be better able to serve the "watchdog" function when no conflict of interest exists.

Ironically, the reduction of the inherent conflict between management and the auditor is even more important now that Sarbanes-Oxley is in place because the stream of audit fees created by the implementation of the Act is developing into a river of audit fees that could otherwise magnify the potential for conflict.[52]

In spite of the costs imposed by Sarbanes-Oxley, some companies are viewing the new regulations as an opportunity to evaluate their business and make positive changes that can benefit shareholders. For example, section 404 requires that companies create and maintain audit controls.[53] Mapping out the internal control processes creates an opportunity to consider a business from a different angle and rethink the ways in which a company operates its business.[54] At many companies, chief information officers play a key role in using technology to gather information for compliance with Sarbanes-Oxley while also gathering information that can be utilized by management for other purposes.[55] This information may remove some of the Act's bite through educating employees about the company's various processes, raising awareness within the organization, and allowing the organization to become more efficient by eliminating duplicate processes and finding ways to operate smarter.[56]

B. Does Sarbanes-Oxley Actually Protect Investors?

Opinions regarding Sarbanes-Oxley's effectiveness in protecting investors are extremely divergent. While nobody is espousing the position that the costs of complying with Sarbanes-Oxley are insignificant or irrelevant,[57] there is some disagreement regarding

52. *See infra* Part IV.A.

53. 15 U.S.C. § 7262 (Supp. II 2002).

54. *See Insider; Profile: Matthew Key, Chief Financial Officer of O2 UK; Upwardly Mobile*, ACCT. AGE, Oct. 7, 2004, at 16.

55. *See* Steven Rainey, *Sarbanes-Oxley 404's Tax Implications*, FIN. EXEC., Nov. 1, 2004, at 50 (providing an example of how companies can benefit by collecting key tax data, which could result in tax savings while collecting information to be in compliance with section 404 of Sarbanes-Oxley).

56. Joel C. Quall, *Implementing Section 404: A Practical Approach to the Sarbanes-Oxley Act; Financial Reporting*, CPA J., Aug. 1, 2004, at 52.

57. *See, e.g.*, Cutler, *supra* note 1.

whether the significant costs of the Act represent a good value for publicly traded companies and, in turn, a good value for shareholders.[58] Determining the value to shareholders requires us to consider whether Sarbanes-Oxley eliminates the root causes of corporate wrongdoing. This Section will discuss the Act's effect on the ethics of senior management and the problem of preventing bad actors from doing bad things. Finally, this Section will identify a separate argument that the Act was not needed in the first place because the drop in share price of companies like Enron was caused by market forces rather than corporate fraud.

1. Mandated codes of ethics for senior managers under Sarbanes-Oxley

The fact that regulations cannot stop misdirected people from doing wrong is illuminated by considering corporate codes of ethics. Sarbanes-Oxley attempts to foster greater corporate self-policing by requiring companies to adopt a code of ethics ("code") for senior financial officers.[59] In the alternative, companies that fail to adopt a code are required to report and give an explanation as to why they have not adopted a code.[60] Legislators have required these types of codes "after each modern wave of corporate wrongdoing."[61] Nevertheless, fraud continues to occur. For example, Enron had a corporate code that prohibited an employee from

> participat[ing] . . . in the profits of any other entity which does business with or is a competitor . . . unless such ownership or participation has been previously disclosed in writing to the Chairman of the Board . . . and such officer has determined that such interest . . . does not adversely affect the best interests of the Company.[62]

58. *Multiple Impacts of Sarbanes-Oxley*, PRACTICAL ACCT., Jan. 1, 2005, at 6. This article reports on the results of the J.D. Power and Associates 2004 Audit Firm Performance Study. *Id.* For the study, 1007 audit committee chairs and 944 chief financial officers were interviewed. *Id.* The study indicated that "almost nine out of ten CFOs say the cost of implementing the new rules and procedural requirements of Sarbanes-Oxley are greater than the benefits of those changes." *Id.*

59. 15 U.S.C. § 7264 (Supp. II 2002).

60. *Id.*

61. Note, *The Good, the Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 HARV. L. REV. 2123, 2124 (2003) [hereinafter Note, *Problems with Legislating Good Behavior*].

62. WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 44 n.8 (2002), *available at* http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf (quoting Enron's Code of Conduct).

The Special Investigative Committee of the Board of Directors of Enron Corporation pointed out that Enron's officers failed to comply with the firm's stated code of ethics.[63]

This example emphasizes that people who choose to be dishonest will not be deterred by a code of ethics. Representative Jackson-Lee explained to her colleagues that corporate codes may just be "empty gesture[s] since 'those corporations with a sound moral base do not need it and for the others it is just a fig leaf.'"[64] Therefore, while some companies do not need a code of ethics to act morally, and others may use these codes as a shield, it is important to consider what effect mandatory codes of ethics will have on publicly traded companies.

One potential effect of the Act's mandate to draft codes is that companies might draft ambiguous codes to avoid requirements of waiver disclosure. Companies can give investors a false sense of security that senior managers are concerned with ethics while a nebulous code could allow senior managers the necessary wiggle room to act in a manner that is contrary to what an investor would deem ethical but still be in compliance with the drafted document. Thus, the Act's code-of-ethics requirement might hurt, rather than benefit, investors by giving them a false sense of security.

The SEC's regulations relating to section 406 of the Act require companies to make their codes of ethics available to the public[65] and report any waivers to their codes of ethics on a Form 8-K or on their websites.[66] This disclosure requirement is a crafty way to encourage a company to exercise caution in granting code-of-ethics waivers lest investors criticize the company for granting too many waivers.[67] But shareholders and regulators perceive waivers to the codes of ethics in a negative light.[68] Therefore, to avoid such negative reaction by investors, shareholders, and regulators, the companies might relax the ethical standards of their codes, which ultimately will hurt the shareholders.

63. *Id.* at 1–28, 46–47, 68–72, 77.

64. 148 CONG. REC. H5462-02, 5472 (daily ed. July 25, 2002) (statement of Rep. Jackson-Lee) (quoting an unnamed CEO's description of corporate codes of ethics).

65. This disclosure is required by Sarbanes-Oxley Act of 2002, § 406–407, Pub. L. No. 107-204, 116 Stat. 745, 789 (codified as amended at 15 U.S.C. 7262 (Supp. II 2002). See also 17 C.F.R. §§ 228.406, 249.406 (2003).

66. *Id.*

67. *See* Note, *Problems with Legislating Good Behavior*, *supra* note 61, at 2131–35.

68. *Id.* at 2137–38.

In addition to negative perceptions, companies and their shareholders will be exposed to a greater risk of litigation if investors begin to second-guess code waivers as hindsight makes it apparent that the issuance of a particular waiver by a corporate board was a bad business decision.[69] Armed with hindsight, and under the careful command of aggressive securities lawyers, investors are more likely to bring harassing lawsuits if a stock-price drop occurs subsequent to a company's code-of-ethics waiver.[70] To protect themselves from harassing lawsuits, companies will likely begin drafting "nebulous documents that are not illuminating either to their own management [or] the public."[71] This increased cost of defending lawsuits (sometime even frivolous ones) ultimately hurts investors when the litigation costs negatively impact earnings and impair investor confidence.[72]

2. Bad actors subject to fear and greed are unlikely to be deterred by Sarbanes-Oxley

Sarbanes-Oxley does not protect investors because the Act does not address the real problem—fear and greed.[73] Fear and greed were fed by the distribution of options, combined with increased control by investors in managing their pensions and with the introduction of online trading,

69. *Id.* at 2138.

70. *Id.* at 2140.

71. *Id.* (alteration in original) (quoting Letter from Dov Seidman, Chairman and Chief Executive Officer of LRN, The Legal Knowledge Company, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 2, 2002), *available at* http://www.sec.gov/rules/proposed/s74002/dseidman1.htm).

72. Frivolous lawsuits were addressed by Congress with the adoption of the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. §§ 77–78 (2000) and 18 U.S.C. § 1964 (2000)). The Act codified a securities fraud action and adopted stronger pleading requirements in an attempt to prevent claims that lacked merit. Prior to the passing of the PSLRA, plaintiffs' lawyers would use professional plaintiffs (investors who had small holdings in all publicly traded companies) to bring securities fraud claims against any company that suffered a significant decline in share price. By being first to file, the attorney would become lead counsel and would benefit from any fees generated by settlement. Companies would often settle claims rather than go through the expense of discovery. Requiring the filing of notice when a company allows a waiver from the company's mandated code of ethics could resuscitate this race to the courthouse as plaintiffs' lawyers watch for price drops and then look to see if a waiver had been granted. *See generally* Tiffany M. Wong, *Defendants' Standing To Oppose Lead Plaintiff Appointment Under the Private Securities Litigation Reform Act of 1995*, 2003 U. CHI. LEGAL F. 833 (discussing the market conditions that led to the passing of the PSLRA, which included the use of professional plaintiffs and the filing of a lawsuit prior to knowing if the company has engaged in any wrongdoing).

73. John L. Latham, *The Legislative and Judicial Response to Recent Corporate Governance Failures—Will It Be Effective?*, 5 TRANSACTIONS: TENN. J. BUS. L. 73, 81 (2003).

thus creating an environment that exerted tremendous pressure on senior management to reach earnings expectations in the marketplace.[74] Under such pressure, companies became fearful of disappointing the market and wiping out value, which created incentives to “finesse financial issues.”[75]

As management was feeling pressure to exceed the earnings expectations of Wall Street, a scenario for disaster began to unfold as employers began to shift away from traditional pension plans to defined contribution plans (401(k) plans).[76] Additionally, retail investors began to trade stocks more actively with the advent of online trading.[77] Investors, now with more control over their retirement assets and instant access to the marketplace with low transaction costs,[78] feared that they would miss out on the tremendous growth in the stock market.[79] Everyone wanted a piece of the action.[80] Fear and greed affected people in unexpected ways: now, many were actually afraid *not* to invest in the market.[81] Investors believed that not being in the market exposed them to the risk of not getting their share of the money. Valuations reached extraordinary levels, and many companies traded at very high prices[82] despite the fact that some of these companies had very few prospects of actually generating earnings within the foreseeable future.

Significant wealth was at stake each quarter. Investors anxiously awaited earnings announcements that resulted in huge market swings upward when companies exceeded the expectations and, conversely,

74. *Id.* at 82.

75. *Id.*

76. *See* Salvatore J. Papa, Note, *The Current Crisis of I.R.C. § 401(k): Is Providing Investment Advice the Proper Solution? The Misguided Focus on Investment Advice Instead of Investment Education*, 38 NEW ENG. L. REV. 371 (2004). Employer sponsorship grew by 900% between 1984 and 1993. *Id.* at 377. In 1984, there were 7.5 million participants in 401(k) plans. *Id.* at 378. The number of participants in 401(k) plans grew to over 42 million people by 2000. *Id.*

77. *See* Jason F. Bedell, Comment, *Web Site Outages: Isn’t It Time To Do More?*, 82 OR. L. REV. 159 (2003). In 1994, online trading did not exist. *Id.* at 161. By 1999, there were over 9.7 million online trading accounts. *Id.* at 161–62.

78. For example, at Scottrade online brokerage, an investor can trade an unlimited number of shares for seven dollars. *See* http://www.scottrade.com.

79. *See* Theresa A. Gabaldon, Book Review, *The Role of Law in Managing Market Moods: The Whole Story of Jason, Who Bought High*, 69 GEO. WASH. L. REV. 111, 112 (2000) (reviewing Robert J. Shiller’s Irrational Exuberance, which describes nonparticipation as a “loser’s game”).

80. *See id.* at 115.

81. *See id.*

82. Ordinarily, this would be phrased as “trading at high multiples” by investment professionals. However, the term “multiples” implies that companies had earnings—something that was often missing in the late 1990s.

huge market swings downward when companies disappointed Wall Street. However, in some cases, finessing by management went beyond what is legal and, upon discovery, management actions resulted in substantial losses by investors. Unfortunately, Sarbanes-Oxley does not address the fear and greed that caused the pressures upon senior management leading them to finesse the system.[83] Thus, under similar conditions, the "finessing" would simply happen again as managers try to figure out how to try to make the system work to their advantage rather than disappoint shareholders.[84] This type of behavior has led one management expert to warn in response to Sarbanes-Oxley that managers may "begin to gear the system to comply with the regulations in such a way that you're adhering to the letter of the law but the actual spirit of it has totally evaporated."[85] As managers begin to spend time navigating around the disclosure regulations to avoid violations, investors are harmed by not receiving the information the Act intends them to receive.[86] In turn, it becomes apparent that Sarbanes-Oxley provides, at most, only limited protection against corporate fraud to investors.

The lesson for investors becomes simple: "one should not assume that an effective system of corporate governance will always prevent fraud by skilled and determined bad actors."[87] For example, one provision of the Act states that the chief executive officer (CEO) and the chief financial officer (CFO) may be required to repay bonuses received if they are found to have committed a fraud.[88] However, not everyone "believes that a CEO or CFO standing at the crossroads between committing a financial fraud that will probably be worth millions of dollars to him" will be deterred by the requirement of returning his or her bonus if caught.[89] Thus, Sarbanes-Oxley may do very little "to deter the

83. Latham, *supra* note 73, at 81–82.

84. *Id.*

85. Jeffrey L. Seglin, *The Right Thing; Will More Rules Yield Better Corporate Behavior?*, N.Y. TIMES, Nov. 17, 2002, § 3, at 4 (quoting Jeffrey E. Garten, Dean of the Yale School of Management).

86. *Id.*

87. Peter C. Kostant, *Sarbanes-Oxley and Changing the Norms of Corporate Lawyering*, 2004 MICH. ST. L. REV. 541, 543.

88. 15 U.S.C. § 7243 (Supp. II 2002).

89. Latham, *supra* note 73, at 79 (mentioning how preexisting provisions of the Securities Exchange Act of 1934, which dealt with relationships between companies and their auditors, allowed the SEC to bring actions for aiding and abetting and contained provisions detailing the obligations of officers or directors regarding the accuracy of financial reporting).

crooks, those people that really intend to do bad things."[90] History shows us that some managers will succumb to temptation regardless of the regulatory environment at the time. This is evidenced by corporate wrongdoings that have occurred under various regulatory schemes over the last one hundred years.[91] Congress reacted to these wrongdoings by promulgating new legislation, yet corporate fraud still exists.[92]

3. Corporate fraud is not to blame for investor losses in companies like Enron

Some argue that Sarbanes-Oxley was not needed at all and point out that the Act was passed in response to a rash of corporate fraud.[93] The supporters of this position aver that there is actually no consensus that the post-Enron market decline was caused by the Enron scandal.[94] For example, Ken Lehn, a former Chief Economist at the SEC, has demonstrated that post-Enron price declines in U.S. equity markets were comparable to the declines in equity prices in other developed countries that had not experienced "high profile accounting and governance scandals."[95] Lehn notes that stock prices had begun to decline before the discovery of scandal at Enron and other companies.[96] Lehn thus argues that fundamental factors in the marketplace, rather than a "crisis in confidence," are to blame for market declines in March 2000, and that corporate scandals had only a "small effect on stock prices in the U.S."[97] Proponents of this view contend that if Enron's effect on stock prices was not significant, there was no need for Congress to make significant changes in the regulatory landscape. Accordingly, an argument exists that Sarbanes-Oxley was not a reaction by Congress but an overreaction.

90. *Id.* at 82.

91. *See generally* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET, A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (1995) (giving a historical perspective of the market crises and related regulatory reactions beginning with the stock market crash in 1929 through the late 1970's).

92. *See generally id.*

93. *See* Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 132 (2002) (arguing that in addition to Sarbanes–Oxley, more regulation of public companies is necessary to "protect investors against the risk of accounting fraud and insider trading").

94. Grundfest, *supra* note 50, at 3 (citing Kenneth Lehn, *Fixing the Corporate and Financial Sectors: What to Do?*, Katz Sch. of Bus., Univ. of Pittsburgh, presented before the Pa. Newspaper Ass'n (Sept. 2002)).

95. Lehn, *supra* note 94.

96. *Id.*

97. *Id.*

IV. THE COST OF THE ACT ON PUBLICLY TRADED COMPANIES

Any new regulatory framework has costs, and Sarbanes-Oxley is not an exception. Due to the hasty passage of the Act, Congress failed to ascertain the magnitude of all possible costs and the resulting financial drain on the companies that would be required to comply with the Act's provisions. Compliance with Sarbanes-Oxley imposes four types of costs on a corporation. First, there are increased costs associated with the required additional auditing services. Second, compliance places additional responsibilities on members of corporate boards, increasing board members' workloads, and requiring increased compensation. Third, compliance also creates an opportunity cost as companies spend time and resources complying with Sarbanes-Oxley rather than focusing on core business activities that could lead to increased earnings. Finally, indirect costs are incurred by corporations when they expend resources as part of the compliance effort that could have been utilized in a more productive and profitable manner. This Part will examine these types of costs and then focus on the effect the costs are having on small and foreign companies trading on U.S. markets. Ultimately, investors would be better off if companies were not required to comply with Sarbanes-Oxley. The damage to investors from increased costs and inefficient allocation of resources and time by the companies outweighs the protections provided by the Act.

A. Costs Resulting from Additional Auditing Services

First, the Act creates an increased need and demand for auditing services.[98] Section 404 of the Act requires companies to establish internal audit controls that are attested to by the audit firm.[99] Today, audit firms report having more work than ever before,[100] resulting in vastly increased auditing costs to companies. By one estimate, in the first year after the enactment of Sarbanes-Oxley, the total increased cost for auditing services caused by section 404 alone will reach approximately

98. For example, Title III of Sarbanes-Oxley established additional guidelines for audit committees and requires procedures to certify a company's internal control structure. 15 U.S.C. § 7241 (Supp. II 2002).

99. *Id.* § 7262.

100. James Greiff, *Sarbanes-Oxley Becomes "Open Checkbook" for KPMG, Ernst & Young*, BLOOMBERG, Nov. 4, 2004, *available at* http://www.bloomberg.com/apps/news?pid=10000103&sid=aAlUCtlfw9DI&refer=us.

seven billion dollars.[101] Unfortunately for companies, the compliance costs are recurring because attestation is required annually.[102]

The impact of these compliance costs varies, however, depending on the company's size and existing practices. Naturally, companies that need to implement more controls will have higher costs. At the high end, American International Group Inc. (AIG) warned its shareholders during recent shareholder meetings that the new regulations could cost the company as much as three hundred million dollars.[103] Even when compared with AIG's annual operating expenses of twenty billion dollars, three hundred million is no small figure.[104] Few other companies have claimed their compliance costs as being in the same range, but that does not mean that compliance costs have been insignificant. For example, General Electric has indicated that its compliance costs with Sarbanes-Oxley will reach thirty million dollars annually.[105]

A recent survey conducted by Financial Executives International[106] (FEI) provides a broader understanding of the increased costs companies are being forced to pay in order to comply with Sarbanes-Oxley. In March of 2005, compliance cost data was gathered from 217 companies with average annual revenues of five billion dollars.[107] For the companies responding to the survey, the average cost to comply with section 404 was over four million dollars.[108] While this number represents average compliance costs, larger companies paid substantially more in compliance costs.[109] For example, companies with revenues in excess of five billion dollars reported that compliance costs were

101. Amy Borrus & David Henry, *Honesty Is a Pricey Policy*, BUS. WK., Oct. 27, 2003, at 100.

102. 15 U.S.C. § 7262.

103. John Gray, *Down the Drain?*, CANADIAN BUS., July 19, 2004, at 67. The new regulation costs are in addition to what the company was spending previously on auditing services.

104. *Id.*

105. Bruce Bartlett, The Crimes of Sarbanes-Oxley: Washington's Rushed Post-Enron Regulations Are Hurting Business, NAT'L REVIEW ONLINE, ¶ 5, May 25, 2004, http://nationalreview.com/nrof_bartlett/bartlett200405250811.asp.

106. Financial Executives International is a professional organization consisting of chief financial officers and other senior executives. *See* http://www.fei.org.

107. Press Release, Fin. Executives Int'l, Sarbanes-Oxley Compliance Costs Exceed Estimates (Mar. 21, 2005), *available at* http://www.fei.org/download/404_pr_3_21_2005.pdf.

108. *Id.* (noting that the actual figure was $4.36 million). Again, these costs are in addition to what the company was spending previously on auditing services.

109. FIN. EXECUTIVES INT'L, FEI SPECIAL SURVEY ON SARBANES-OXLEY SECTION 404 IMPLEMENTATION EXECUTIVE SUMMARY 2–3, (July 2004), http://www.fei.org/download/SOXsurveyjuly.pdf.

approximately eight million dollars.[110] Not surprisingly, the costs reported by the various companies corresponded to the size of the business—larger companies having higher costs than smaller ones.[111]

While costs are higher for large companies, small companies bear a disproportionately negative burden because small companies are less capable of coping with the additional costs, which do not generate additional revenue.[112] Some smaller companies are paying as much as larger companies to comply with the Act. For example, FlowServe, an industrial equipment maker, will pay fifteen million dollars during a six-month period to comply with Sarbanes-Oxley.[113] This figure represents almost one-third of FlowServe's 2003 profits.[114] Typically, a reduction in profits of this magnitude does not bode well for a company's stock price. In fact, stock price can fall significantly when a company misses its earnings forecast by even a small margin.[115] Thus, if a company's earnings dropped by as much as one-third due to the increased compliance costs caused by Sarbanes-Oxley, the stock price would also likely suffer a significant decrease. Because publicly held smaller companies do not have the resources to rebound after spending huge amounts on accounting services, they could face serious challenges trying to stay afloat.

Audit costs have risen to the point that even the accounting firms that stand to benefit from the increased spending are concerned about Sarbanes-Oxley related spending levels. Sarbanes-Oxley was originally viewed by accountants as a regulation that punished the profession for ethical breaches; however, companies now view the Act as a "full employment Act" for those same accountants.[116] In fact, the public accounting industry has become one of the Act's biggest beneficiaries

110. *Id.* at 4.

111. *Id.* at 2–3.

112. Del Jones, *Sarbanes-Oxley: Dragon or White Knight?*, USA TODAY, Oct. 20, 2003, at 1B.

113. *Finance and Economics: 404 Tonnes of Paper; Internal Audits*, ECONOMIST, Dec. 18, 2004, at 142 [hereinafter *404 Tonnes of Paper*].

114. *Id.*

115. Studies have shown that when growth stocks report small earnings shortfalls, this leads to disproportionately large share price declines. For a summary of this phenomenon, see Patricia M. Dechow & Douglas J. Skinner, *Earnings Management: Reconciling the Views of Accounting Academics, Practitioners, and Regulators*, 14 ACCT. HORIZONS 235, 245–46 (2000).

116. Michael Alles, Alexander Kogan, & Miklos Vasarhelyi, *The Law of Unintended Consequences?: Assessing the Costs, Benefits and Outcomes of the Sarbanes-Oxley Act*, 1 INFO. SYS. CONTROL J. 1, 1 (2004), *available at* http://www.isaca.org/Template.cfm?Section=Home&Template=/ContentManagement/ContentDisplay.cfm&ContentID=16769.

despite the American Institute of Certified Public Accountants' initial description of Sarbanes-Oxley as a "de facto government takeover of the accounting profession."[117] Grant Thornton LLP, the sixth largest accounting firm in the United States, has "more audit work than ever . . . before."[118] The director of audit practice at BDO Seidman, LLP, the seventh largest accounting firm in the United States, reported that audit business is "like nothing I've seen, and I've been in the field 35 years."[119] With the huge increase in demand for auditing services, average audit costs have increased by sixty percent since the Act was passed.[120] And companies should expect to pay more for auditing services since the potential shortage of qualified auditors will likely grow as provisions that apply to the largest 4000 companies will be expanded to cover more than 10,000 companies next year.[121] Audit costs have risen so fast that even accounting firms are concerned. James H. Quigley, CEO of Deloitte & Touche, has called for an assessment of the costs and benefits after the first year of compliance because "[y]ou just can't have clients this unhappy."[122]

B. Costs Associated with a Company's Board of Directors

Second, the Act has indirectly increased the costs associated with a company's board. According to Keith D. Grinstein, a member of three different boards of directors[123] who testified before the Senate Committee on Banking, Housing, and Urban Affairs shortly after implementation of Sarbanes-Oxley,[124] the Act has led to more frequent meetings for boards of directors. Such increase in board meetings has unsurprisingly led to an increase in compensation to board members.[125] These expanding roles have added further complexity to the responsibilities of members of the board of directors and, in turn, have

117. *See* Greiff, *supra* note 100.

118. *Id.*

119. *Id.*

120. Nanette Byrnes, *Cleaning Up by Cleaning Up*, BUS. WK., Jan. 10, 2005, at 121.

121. *Id.*

122. *Id.* (illustrating the point that costs must be significant if the group which benefits the most from the legislation is concerned about the burden it imposes on the companies it services).

123. In 2003, Grinstein was serving on the boards of directors for Coinstar Inc., F5 Networks, and Nextera Enterprises, Inc. Grinstein Statement, *supra* note 44.

124. *Id.*

125. *Id.*

led to higher director pay.[126] Board member compensation at Fortune 200 companies is up fourteen percent, and compensation for board members for S&P 500 companies on average has increased by fifteen percent in both 2003 and 2004.[127] Furthermore, due to the new regulations, boards are hiring outside lawyers and consultants to help them navigate through the new regulatory landscape, thus increasing corporate costs even more.[128]

C. Opportunity Costs of Increased Compliance

The third cost that Sarbanes-Oxley imposes on companies results from the fact that companies are now required to spend additional money on auditing costs instead of focusing spending on more important corporate outlays to grow their businesses. Scott McNealy, the CEO of Sun Microsystems, compared complying with Sarbanes-Oxley to throwing "buckets of sand into the gears of the market economy."[129] In other words, as management spends time figuring out how to be compliant, it is unable to focus on the company's core business needs. According to the Financial Executives International survey, public companies on average expect to spend 25,668 internal hours initially to be compliant with the Act.[130] By comparison, an automobile can be manufactured in approximately twenty staff hours.[131] Companies are spending their time testing internal controls rather than on profit-making tasks. Mario J. Gabelli, the CEO of Gabelli Asset Management, called the Act "a major drag on the economy"[132] after his company had to delay the hiring of twelve needed security analysts in order to pay compliance costs.[133] A security analyst provides an investment management business with research and analysis that can be used by money managers or investment advisors to improve money management performance. Such enhanced performance adds value to the organization

126. *See* Gary Strauss, *Board Pay Gets Fatter as Job Gets Hairier*, USA TODAY, March 7, 2005, at 1B.

127. *Id.*

128. Jill M. D'Aquila, *Tallying the Cost of the Sarbanes-Oxley Act*, CPA J., Nov. 2004, at 6, 8.

129. Jones, *supra* note 112.

130. FINANCIAL EXECUTIVES INT'L, *supra* note 109, at 1.

131. Jones, *supra* note 112.

132. David Henry, Amy Borus, Louis Lavelle & Diane Brady, *Death, Taxes & Sarbanes-Oxley?; Executives May Be Frustrated with the Law's Burdens, but Corporate Reform Is Here To Stay*, BUS. WK., Jan. 17, 2005, at 28.

133. *Id.*

by increasing revenue to the organization as new clients are attracted to an improved investment performance. When profit-making tasks are preempted by compliance duties and expenses, companies' core businesses are likely to suffer.

However, not everyone is discouraged by the high cost of compliance. William McDonough, the Chairman of the Public Company Accounting Oversight Board created by Sarbanes-Oxley, has stated that "[s]ection 404 is such an important part of restoring investor confidence that it is worth the costs."[134] Of course, many would expect the head of the Oversight Board to make this assessment. Donald Nicolaisen, one of the SEC's chief accountants, indicated that the "soaring costs are a sign that companies are fulfilling the goals of Sarbanes-Oxley" and making financial reporting more transparent.[135] Nevertheless, these tributes fail to acknowledge that a financial reporting system that is perfectly transparent may not inspire an investor when reported earnings are lower, which, in turn, causes stock prices to decline. If the costs of compliance with the Act are too high, resulting in lower reported earnings, Sarbanes-Oxley may actually damage rather than enhance investor confidence.[136] Such confidence is not built by trust in financial statements alone: investor confidence also contains an element of the investor's beliefs about a company's business prospects going forward, which is largely driven by the company's ability to increase its earnings.[137]

D. The Indirect Costs of Sarbanes Oxley

The fourth cost of Sarbanes-Oxley is the indirect effect of compliance costs on small public and foreign companies. This Section will focus on the response of these companies to lower earnings caused by the Act and the regulations promulgated under the Act and the ways in which this response is damaging to the investors.

134. Greiff, *supra* note 100, ¶ 47.

135. *Id.* ¶¶ 43–44. However, nowhere in Sarbanes-Oxley did Congress mention that "soaring costs" were a desired result of the legislation.

136. *See* Chiaki Kitazawa, *Corporate Governance Still Needs Reform*, NIKKEI WKLY., Aug. 19, 2002 ("In order to attract long-term investors, it is crucial to increase earnings steadily and gain investor confidence.").

137. *Id.*

1. Small companies' reaction to Sarbanes-Oxley

Sarbanes-Oxley and related regulations apply to publicly traded companies that list their stock on national market exchanges or national security associations[138] regardless of market capitalization. Some companies are avoiding the burdens of the Act by delisting from these exchanges or trading networks.[139] In 2003, the year following the passage of Sarbanes-Oxley, the number of companies that delisted from U.S. exchanges increased by three-hundred percent from the previous year.[140] Most of the delisting companies indicated they did so to escape the high cost of regulatory filings.[141] While not conclusive, one study found evidence that some of these companies delisted to avoid the outside monitoring and scrutiny caused by Sarbanes-Oxley.[142] The end result is the same: companies are delisting to avoid the high costs or to avoid the outside monitoring and scrutiny required by the Act.

Unfortunately for the investing public, delisting does not come without costs—companies that delisted after Sarbanes-Oxley experienced a larger decline in their stock price compared to companies that delisted before the Act was passed.[143] It is possible to infer that the larger decline in value is the result of a view among investors that companies have chosen to delist rather than face regulatory scrutiny that might uncover accounting irregularities. Despite such a negative reaction from investors, a different study by the law firm Foley & Lardner found

138. 15 U.S.C. § 78j-1(m) (Supp. II 2002) (including stocks that list on the NYSE, AMEX, NASDAQ, or other lesser-known national exchanges).

139. As a recent example, Allen Organ Co. announced that it would delist rather than pay compliance costs for Sarbanes-Oxley. Steven Markowitz said that Allen Organ Co. would save $500,000 in the first year and between $250,000 to $400,000 annually after delisting. Mr. Markowitz said that he did not believe that "paying these costs [was] in the best interest to our shareholders." Dan Shope, *Allen Organ To Delist from Nasdaq*, MONITOR, Apr. 12, 2005, *available at* 2005 WLNR 5721294.

140. JH, *Study Finds Varied Reasons for Rise in De-listings After Sarbanes-Oxley Enactment*, SEC. WK., Nov. 29, 2004, at 8, *available at* 2004 WLNR 14196385. Delistings rose from 67 companies in 2002 to 198 in 2003. *Id*. It is also important to note that delisting is not an option for most large companies because large companies generally exceed the SEC requirements for delisting. *Id*. In order to terminate its registration, a company must have fewer than three hundred stockholders of record, or alternatively, a company can have up to five hundred stockholders as long as the company's assets have not exceeded ten million dollars at the end of the last three fiscal years. *Id*.

141. *Id.*

142. *Id.*

143. *Id.* Companies that announce their intention to delist typically drop in price. This drop in price is caused by investors' expectations relating to liquidity and uncertainty regarding the reasons for delisting. *Id*.

that twenty percent of companies involved in the survey were considering going private to avoid the costs of Sarbanes-Oxley.[144] A more pessimistic view was expressed by one commentator who suggested that one-third of all companies with a market capitalization below ten million dollars would eventually either be liquidated, sold, merged, or privatized within the next few years due to the increased compliance costs.[145] Several delisting companies, in their required SC13e3 filings,[146] blame the amount of resources and management time expended to comply with the Act as reasons for going private.[147] Chris Kramer, an analyst of Strategic Equity Group, believes that "[t]here are a lot of public companies out there that will find it increasingly expensive to operate without the corresponding benefits of being public because of Sarbanes-Oxley."[148]

A direct result of delisting is that the delisted company is less transparent than one that is publicly traded. Private companies are less transparent because they are not required to make public filings or to comply with the Act. A CEO of a small company pointed out this irony of Sarbanes-Oxley: "Sarbanes-Oxley was designed to provide additional corporate transparency and safeguards for the investing public . . . . Instead, it is prompting companies like ours to become less transparent."[149] This sentiment contradicts the Act's purpose of providing an increased level of transparency to investors.[150] Instead, it makes sense to try to encourage small companies to maintain their public status, which provides investors with at least some level of transparency even though it may have been imperfect prior to the Act.

Not only is Sarbanes-Oxley pushing publicly held small companies towards delisting, it is also stopping privately held small companies from

144. Bartlett, *supra* note 105, ¶ 7.

145. William D. Holyoak, *Corporate Reform: Can Utah's Small Public Companies Survive Sarbanes-Oxley?*, UTAH BUS., June 1, 2003, at 42 (discussing the statements of Ronald J. Klammer, managing director and president of OEM Capital Corp., in a recent issue of M&A Insider).

146. Form SC13e3 is the SEC form for reporting going-private transactions.

147. Tim Reason, *Off the Street*, CFO MAG., May 2003, at 54, 56 (describing the SC13e3 filings of Coast Dental Services, Inc. and Landair Transport, Inc.).

148. Mike Allen, *Garden Fresh a Healthy Buy for Fairmont Capital*, SAN DIEGO BUS. J., Oct. 13, 2003, at 13.

149. Claudia H. Deutsch, *The Higher Price of Staying Public*, N.Y. TIMES, Jan. 23, 2005, § 3, at 5 (quoting Donald R. Neel, the CEO of Fidelity Federal Bancorp).

150. *See supra* text accompanying note 9.

going public because of high compliance costs.[151] Small companies must determine if the benefits of being public outweigh the costs of compliance with Sarbanes-Oxley. A company must consider several factors when deciding whether to be listed on an exchange due to the risks associated with such a step. For example, more than half of NASDAQ-listed companies with market capitalizations below $50 million do not have analyst coverage.[152] Without analyst coverage, companies are typically unable to attract institutional investors, leaving them with depressed and volatile trading prices.[153] In turn, low and volatile trading prices expose small companies to the risk of a potential takeover, litigation, and limited liquidity.[154] Conversely, if a public company can attract analyst coverage and institutional investors, it has significant opportunities for attracting additional financing by issuing additional public debt or equity. Such additional financing can be a tremendous benefit to a company.

2. Foreign companies' reaction to Sarbanes-Oxley

Foreign issuers have reacted to Sarbanes-Oxley similarly to small domestic companies by considering delisting from U.S. exchanges rather than complying with the Act. However, the reasons for foreign companies contemplating delisting are slightly different than the reasons for domestic companies. Sarbanes-Oxley applies to all corporations that choose to list their stock on a U.S. exchange regardless of where they have incorporated.[155] While serving as SEC Chairman, Harvey Pitt stated that the regulations promulgated under Sarbanes-Oxley "appl[y] equally to all who seek to access U.S. capital markets"[156]—a stance that went against the SEC's traditional practice of accommodating foreign issuers by exempting foreign companies from certain requirements.

151. Jill M. D'Aquila, *Tallying the Cost of the Sarbanes-Oxley Act*, CPA J., Nov. 1, 2004, at 6, *available at* http://www.nysscpa.org/printversions/cpaj/2004/1104/p6.htm (stating that costs of going public for small companies has increased almost one-hundred percent since Sarbanes-Oxley was passed).

152. John Sinnenberg, *The Pros and Cons of Going Private*, FIN. EXEC., Jan. 1, 2005, at 24, 25.

153. *Id.*

154. *Id.* at 24.

155. *In Search of Honesty*, ECONOMIST, Aug. 17, 2002, at 49, 50.

156. Anupama J. Naidu, Comment, *Was Its Bite Worse Than Its Bark? The Costs Sarbanes-Oxley Imposes on German Issuers May Translate into Costs to the United States*, 18 EMORY INT'L L. REV. 271, 276 (2004).

Previously, one of the major accommodations given to foreign issuers was to allow them to prepare financial reports either according to their home standards or International Accounting Standards (IAS), as long as the company included an addendum that reconciled the differences between the IAS standards and the U.S. Generally Accepted Accounting Principles (GAAP).[157] Similar exemptions have not been provided by the SEC with respect to Sarbanes-Oxley; thus, foreign issuers are subject to the same expensive compliance costs as domestic corporations.

Foreign issuers are now forced to consider the costs of complying with Sarbanes-Oxley when analyzing the costs and benefits of being listed on U.S. exchanges. For most foreign issuers, a listing on a U.S. exchange is done in the form of an American Depository Receipt (ADR),[158] and their shares typically trade both in the U.S. as ADRs and overseas as actual shares. Traditionally, foreign issuers have been attracted to listing their shares on the New York Stock Exchange (NYSE) and on the NASDAQ due to the large market capitalizations of these markets.[159] Being cross-listed in the U.S. markets also provided foreign issuers with increased liquidity, generated excitement over the prospect of the company's expansion, and provided currency for the company to acquire other companies within the U.S. market.[160] Historically, companies from less-developed or less-regulated countries would also purposely list in the United States to subject themselves to the stringent U.S. regulatory standards, thereby providing investors with confidence. Being listed on a U.S. exchange gave these companies credibility so they could attract investors who ordinarily might not have

157. *Id.* at 278.

158. Most investors in the U.S. do not buy actual foreign stock shares but instead buy American Depository Receipts (ADR), which are receipts issued by U.S. depository banks representing actual shares. *See* SEC. & EXCH. COMM'N, INTERNATIONAL INVESTING: GET THE FACTS 10, *available at* http://www.sec.gov/pdf/ininvest.pdf (last visited Feb. 1, 2006). Actual shares of the foreign company are placed in escrow, and the ADR is traded on a U.S. exchange. *Id*. Buying an ADR provides certain benefits to investors. *Id*. First, buying and selling of shares occurs in U.S. dollars. *Id.* Second, the depository bank converts dividends into U.S. dollars and distributes the dividends to ADR holders. *Id.* Finally, the depository bank will arrange to vote the shares per the instructions given by the receipt holder. *Id.* at 11. In practice, most investors do not recognize a significant difference between purchasing an ADR or the actual shares—partly because most large-multinational corporations will often have annual reports prepared in English, so U.S. investors may not even be aware that they are buying stock in a foreign company.

159. Naidu, *supra* note 156, at 310.

160. *Id.* at 310–11.

purchased their shares in a foreign marketplace.[161] But with high compliance costs under Sarbanes-Oxley, many foreign issuers are opting to list on foreign markets, which do not have the same compliance costs and have become more trusted over time.

But if foreign issuers refrain from listing on U.S. exchanges, U.S. investors will be negatively affected. Possessing foreign investments is another method of diversifying an investor's portfolio. Having foreign issuers listed on U.S. exchanges provides benefits to U.S. investors in two respects. First, it simplifies the investment in foreign companies by allowing U.S. investors to make dollar-denominated purchases on an exchange in which investors already have confidence. Second, as Judge Frank Easterbrook noted in a speech on corporate governance, "firms that list their securities in multiple nations' markets experience both lower costs of capital and lower volatility,"[162] which benefits U.S. investors.

Judge Easterbrook nonetheless understood the potential negative effects of strict regulatory schemes over securities. He warned that the costs of complying with multiple national disclosure systems represented a "serious impediment"[163] to attracting foreign issuers to U.S. exchanges. Indeed, foreign companies have not been sitting idly by, with checkbooks open, eager to comply with Sarbanes-Oxley. Instead, they have threatened to delist from U.S. exchanges.[164] The Confederation of British Industry (CBI) recently met with SEC Chairman William Donaldson to deliver the message that New York was in danger of losing its preferred role as an international location to raise capital.[165] This threat became more real when Air China chose to list its shares in London rather than New York.[166] In response to the criticism from foreign issuers, the SEC has indicated that it is considering "tweaking"

161. *Id.* at 311–12.

162. Frank H. Easterbrook, *Derivative Securities and Corporate Governance*, 69 U. CHI. L. REV. 733, 739–40 (2002).

163. *Id.* at 740.

164. *Analysis: The State of America*, LAWYER, Jan. 24, 2005, at 19 (explaining that British Petroleum, Rank Group, and Siemens have all threatened to delist from the NYSE as a reaction to the costs of compliance with Sarbanes-Oxley).

165. *Id.*

166. *404 Tonnes of Paper*, *supra* note 113, at 142. Losing out on a listing from a major Chinese company represents a significant opportunity cost to U.S. investors as China's economy continues to modernize and grow. *Id.*

some rules for overseas companies.[167] For now, as Sir Christopher Bland, Chairman of British Petroleum, stated, companies have "just got to grit [their] teeth and get on with it."[168]

V. THE IMPACT ON INVESTORS

While well intentioned, Sarbanes-Oxley is negatively impacting investors. The Act was passed with the purpose of protecting investors from the type of severe losses suffered by Enron shareholders. But Congress may not have envisioned the possible negative effect of the Act on investors. This Part considers direct and indirect ways in which investors have been negatively impacted by Sarbanes-Oxley. First, U.S. investors have suffered because of the lower earnings caused by the high compliance costs mandated by Sarbanes-Oxley. Next, the Act has had a negative impact on U.S. investors because some small-cap companies and foreign companies have decided to delist or avoid the public marketplace rather than comply with Sarbanes-Oxley. Finally, the regulatory framework of Sarbanes-Oxley creates an environment that discourages companies from staying public or entering the public marketplace thereby reducing transparency for investors in those companies.

A. Compliance with Sarbanes-Oxley Results in Lower Earnings, Which Hurts Investors

Investors are ultimately injured by Sarbanes-Oxley due to its stringent disclosure requirements that lead to reduced earnings of publicly traded companies. When people invest money in stocks, they become equity owners. As owners, they are investing in a future stream of income. Investors place a value on streams of income, which can be measured by a company's price-to-earnings ratio—a measurement used by analysts to determine what investors are willing to pay for a company's earnings.[169] This ratio measures the price of the stock against its current earnings. Stocks within a particular segment of the market will

167. Heather Timmons, *SEC Gives Foreign Firms Some Hope on New Rules*, N.Y. TIMES, Jan. 26, 2005, § C, at 4.

168. Kevin Reed, *BT Chairman Slams Cost of Sarbox*, ACCT. AGE, Nov. 23, 2004, *available at* http://www.accountancyage.com/accountancyage/news/2036433/bt-chairman-slams-cost-sarbox/index.htm.

169. InvestorGuide.com, Fundamental Analysis, http://www.investorguide.com/igustockfundamental.html#peratio (last visited Feb. 1, 2006).

typically have similar price-to-earnings ratios. When a company's earnings increase, typically investors will still pay a corresponding increase in stock price for those earnings. Thus, rather than the ratio changing, stock prices will adjust in a manner that maintains the same ratio. When a company's earnings increase, for the price-to-earnings ratio to remain near its previous level, the price of the stock will have to rise in relation to the increased earnings.[170] Not all stocks within a particular market segment will have similar price-to-earnings ratios; if investors believe that earnings for a particular company will increase in the future, that company's price-to-earnings ratio will be higher.

Earnings are also important because investors have more confidence in stocks that have steadily increasing earnings.[171] By the same token, investors have less confidence in stocks that have decreasing earnings. Despite its goal to increase investor confidence, the effect of the Act has been increased compliance costs leading to decreased earnings, which, in turn, has led to decreased investor confidence.[172] This result would be different if Sarbanes-Oxley could guarantee to remove any potential for fraud because investors may be willing to consider earnings diverted into compliance costs as a payment for fraud protection insurance. Of course, this guarantee cannot exist because, as discussed above,[173] bad actors determined to cheat the system will simply adjust to the rules. Unfortunately, a company's reduced earnings are not the only way that Sarbanes-Oxley negatively impacts investors.

170. For example, suppose that a stock trading at $100 per share has earnings of $10 annually. The stock's price-to-earnings ratio is 10. If the company's earning increased to $12 per share, and market conditions were such that a stock of this nature is fairly valued with a price-to-earnings ratio of 10, one would expect the stock to trade at $120. Conversely, if earnings weakened so that the company's annual earning was just $8 per share, one would expect the company to trade at approximately $80 per share. It is important to note that price-to-earning ratios are not a determinate of share price, but are measurement tools to compare one individual stock with another.

171. *See* Kitazawa, *supra* note 136.

172. Providing empirical evidence of investor confidence levels measured for the period before Sarbanes-Oxley was enacted as compared to the present is difficult because investor confidence is not widely measured like consumer confidence. Also, measuring levels between two periods when market circumstances are drastically different (e.g., oil trading at over $60 a barrel) make it difficult to determine whether Sarbanes-Oxley has had a positive impact on investor confidence levels. However, with these limitations in mind, according to the State Street Investor Confidence Index, investor confidence was at a lower level in December of 2005 than in December of 2002. *See* STATE STREET, INVESTOR CONFIDENCE INDEX HISTORICAL DATA, http://statestreet.com/industry_insights/investor_confidence_index/historicaldata.pdf (last visited Feb. 1, 2006).

173. *See supra* Part III.B.2.

B. Delisting of Small Capitalization Stocks Negatively Impacts Investors

Because Sarbanes-Oxley also hurts small companies, it limits the availability of small capitalization stock for investors, which represent an important part of a diversified portfolio. Small companies—the source of small-capitalization stocks—are unable to absorb the compliance costs as well as large companies, and some small companies are beginning to delist or alternatively refuse to go public in the first place. However, small-cap stocks are important to investors because they offer more potential for growth than large-capitalization ("large-cap") stocks.[174] The trade-off for the growth potential provided by small-cap stocks comes in the form of increased volatility.[175] This is partly because the companies that are considered small-cap are typically newer companies that are aggressively growing. Inevitably, because some small-cap companies fail every year, investing in them inherently contains more risk than investing in large-cap stocks trading in highly developed markets.[176] Despite the additional volatility, many money managers recommend that investors include small-cap stocks as part of an investor's asset allocation strategy.[177]

At first glance, the concept of making small-cap companies more transparent seems appealing for investors. However, the cost of providing transparency is either driving small-cap companies from the

174. *See* Ted Griffith, *Investment Club Optimistic for 2005; Members Say Choosing Stocks not Easy with Falling Dollar, Inflation*, NEWS J., Jan. 9, 2005, at 1C (quoting Robert Strauss, senior vice president of Greenville Capital Management and a manager of a small-cap mutual fund, as saying that "smaller businesses have the potential to deliver profit growth that will outpace larger counterparts").

175. Fidelity Investments, one of the largest mutual fund companies in the world, describes the risks of small-cap stocks within its Fidelity Small Cap Stock Fund prospectus as follows:

> The value of securities of smaller, less well-known issuers can be more volatile than that of larger issuers and can react differently to issuer, political, market, and economic developments than the market as a whole and other types of stocks. Smaller issuers can have more limited product lines, markets, and financial resources.

FIDELITY, SUPPLEMENT TO THE FIDELITY SMALL CAP STOCK FUND, FIDELITY MID-CAP STOCK FUND, AND FIDELITY LARGE CAP STOCK FUND, PROSPECTUS, June 29, 2005, http://content.members.fidelity.com/epro/PROS/315912501/?format=pdf&app=retail; s*ee also* Walter Updegrave, *The Risk in Small Caps*, CNNMONEY, Jan. 7, 2005, http://money.cnn.com/2005/01/07/pf/expert/ask_expert/index.htm (detailing that small-cap stocks have been sixty percent more volatile than large-cap stocks).

176. *See* Updegrave, *supra* note 175.

177. *See generally id.* (suggesting that in spite of increased volatility, equity investors should still limit their equity portfolio to ten to fifteen percent in small-cap stocks).

marketplace through delisting or keeping small businesses from the marketplace as they choose to stay private in order to avoid compliance with Sarbanes-Oxley. Delisting as well as staying private result in even less transparency to shareholders. The market for small-caps is already difficult because fifty percent of all small-cap companies trading on NASDAQ do not have analyst coverage, making it difficult for investors to obtain quality and trustworthy research.[178] Without an abundance of small companies' information in the marketplace, the data available to investors through mandatory quarterly and annual filings is significantly better than the information that investors would be able to obtain from private issuers. When companies go dark, or choose to avoid public status, investors are no longer protected against fraud as Congress intended. Furthermore, not only is there less transparency when companies delist, but there are also fewer investment choices in the marketplace. Investors are hurt when they have fewer choices.

Reducing investment choices through mass delisting could also cause problems for mutual funds.[179] For most defined contribution plans, mutual funds are typically the vehicle of choice for plan administrators. As money flows into mutual funds on a monthly basis, money managers have a duty to invest the money within the guidelines outlined in the fund's prospectus. Many mutual funds, to ensure proper diversification, place restrictions on the fund manager to prevent the manager from taking a large position in any one holding. If fewer small-cap companies are available in the marketplace, money managers may not be able to find suitable investments for their clients.

Most important, though, is the fact that investors will have fewer choices within a beneficial area of the market if publicly traded small companies delist or stay out of the public market altogether. And since the Act places extreme burdens on public companies, especially small ones, it ultimately injures investors.

178. The author of this Comment does not intend to assert that "analyst coverage" is necessarily equivalent to "quality and trustworthy research."

179. Mutual funds represent a popular way for investors to invest in small-cap companies. Investors pool their money, and a professional money manager chooses the securities to purchase. This approach provides investors with instant diversification within an asset class.

C. Investors Are Negatively Impacted as Foreign Companies Avoid U.S. Markets

Investors are attracted to the potential growth opportunities available in international stocks, particularly in developing economies.[180] Foreign stocks can also play a role in reducing overall portfolio volatility. Taken individually, foreign stocks have been historically more volatile than U.S. stocks.[181] However, because foreign stocks do not trade in lockstep with U.S. markets, owning foreign stocks can reduce overall portfolio volatility.[182] Thus, foreign stocks are an important part of an equity investor's asset allocation strategy.[183]

Increased compliance costs will affect foreign issuers in different ways. Foreign companies list on U.S. exchanges for different reasons. With the world economy rapidly changing, not all foreign issuers need access to U.S. equity markets. Traditionally, companies list on U.S. exchanges to give themselves additional credibility and access to capital. Today, these benefits play a less significant role for foreign companies because these companies can list on well-developed European exchanges that now offer similar benefits. This trend becomes problematic when the SEC tries to increase its regulatory influence across borders: foreign companies may choose to take their shares and go home. If foreign companies delist, U.S. investors will be limited to buying those shares directly in foreign markets. Expatriating dollars and investing abroad creates various headaches[184] for U.S investors.

Purchasing foreign stocks that trade on U.S. exchanges is the most practical and least costly method for investors to purchase foreign stocks. If foreign issuers choose to delist, or if fewer foreign companies choose to list on U.S. exchanges, investors are hurt by not having the ability to diversify their portfolio with foreign investments.

180. *See generally* Jeffrey Margolies, *International Investing: Is It Right for You? The World Is Shrinking and Opportunities Are Growing*, LEGAL INTELLIGENCER, Feb. 22, 1994, at 6.

181. *Id.*

182. *Id.*

183. *Id.*

184. *See* SEC. & EXCH. COMM'N, INTERNATIONAL INVESTING: GET THE FACTS 5-8, http://www.sec.gov/pdf/ininvest.pdf (last visited Feb. 1, 2006). Some countries impose "currency controls" that restrict or delay movement out of a country. *Id.* Other problems include reduced trading hours, potential for higher prices charged to foreign investors, limitations on potential legal remedies, and different rules of operation for markets. *Id.*

VI. SARBANES-OXLEY: THE ALTERNATIVES

In the case of Sarbanes-Oxley, the regulations are excessively onerous for small and foreign companies. For these types of companies, the results of the Act are contrary to its stated purposes because the Act harms rather than protects investors by negatively impacting companies' earnings. Operating under the assumption that Congress wants to give the Act more time to see if it reduces fraud, Congress can still amend the Act to limit its application to large publicly traded companies and simultaneously provide relief for U.S. investors by exempting small-cap and foreign stocks from the provisions of Sarbanes-Oxley.

The Act's continued application to large companies will reduce the potential for massive investor losses like the losses experienced in the Enron fiasco. Enron was the seventh largest company in the world at the time it restated its earnings and revealed its wrongdoings. Investors' losses were measured in the billions of dollars. This level of risk does not exist when it comes to small-cap companies. Losses caused by fraud are not insignificant at any level, but losses are limited to the individual company's market capitalization. Thus, if a company has a market capitalization of twenty million, total losses can not exceed that amount.

While the losses are limited for small companies, compliance costs are still substantial. Compliance costs for a small company are still likely to be several hundred thousand dollars annually. For a small company, compliance costs can significantly detract from earnings.[185] Investors in small-cap stocks are better served by managing the risk of fraud through traditional method of diversification. Ultimately, investors in small-cap companies are paying too high a price for a limited amount of risk protection.

Costs of compliance create a disproportionate burden on the small-cap issuer while offering less potential-investor protection due to small market capitalizations.[186] Even modestly educated investors are aware of the increased risk of investing in small-cap stocks. If small-cap stocks are exempted, investors uncomfortable with the reduced standard of corporate transparency are not required to invest in these companies. Investors who are not comfortable investing in a company not required to comply with Sarbanes-Oxley can choose to invest in those small

185. *See Socked*, CORP. COUNSEL, July 1, 2003, at 16 (detailing the average compliance for mid-cap stocks of $2.5 million and providing simple math to illustrate the effects of Sarbanes-Oxley on earnings).

186. *See supra* Part IV.A.

companies that have voluntarily decided to comply with the Act. This allows investors to knowingly take on the potential risk without having to suffer through reduced earnings. Exempting small companies does not mean that all small companies would not comply. Conceivably, some small companies would choose to adopt voluntarily various provisions of Sarbanes-Oxley as their business allowed them to both manage the costs and attract investors who are ultra-sensitive to transparency concerns.[187] If the benefits of the Act outweigh the costs, companies will voluntarily comply in order to attract capital from investors who would only invest in companies that have complied with Sarbanes-Oxley.

For many of the same reasons that apply to small domestic companies, Congress should also exempt foreign issuers from compliance with the Act. The SEC has historically exempted foreign issuers from many SEC regulations,[188] and this tradition should continue with regard to Sarbanes-Oxley. U.S. investors benefit from being able to diversify their portfolios with foreign issuers. Investing in foreign stocks on U.S. exchanges is the most desirable option for U.S. investors. On the other hand, foreign issuers have options to list on well-developed overseas markets and do not necessarily need to be listed on the U.S. exchanges. As a result, the domestic exchanges are now forced to compete for the listings of foreign issuers, and driving foreign companies away due to high compliance costs will only hurt U.S. investors.

Alternatively, more appropriate legislation could be passed that would protect investors without hurting a company's bottom line. Determining where to start does not require us to look past the happenings at Enron. Investors who felt the greatest impact are those employees who lost their retirement savings and their jobs on the same day. To some degree, the tremendous losses[189] suffered by Enron employees were the result of the same fear and greed that controlled

187. Assuming that voluntary compliance were an option, it is unlikely that very small companies would voluntarily comply because of the prohibitive cost. Even small companies that have internal audit staff may have limited ability to implement a proactive approach because compliance with the Act requires a significant amount of the internal audit staff's time. According to a recent survey conducted by the Institute of Internal Auditors, 63 out of 160 chief audit officers polled reported that fifty percent of internal audit staff's time was being devoted to Sarbanes-Oxley. Donald E. Tidrick, *"Seize the Moment!:" An Interview With IIA Chairman Betty McPhilimy*, CPA J., Nov. 1, 2004, at 14, 18.

188. Naidu, *supra* note 156, at 277.

189. Enron's true losses are difficult to determine. Since Enron's stock price was artificially inflated due to misstated earnings created by accounting irregularities, shareholder losses were exacerbated by the market removing the artificial inflation.

senior managers.[190] Enron management encouraged employees to purchase Enron stock within the company's defined contribution plan. Rapidly increasing stock prices proved to be too large of a temptation for most employees, and when the stock collapsed, employees' retirement savings were gone. Congress could better protect against a repeat of this situation by simply amending ERISA[191] to not allow employers to include company stock within retirement plans. Then, if a company fails, the employees' retirement assets will still be available. As another alternative, Congress could protect investors by offering incentives to companies that provide appropriate investment options to defined contribution participants and that provide training to participants regarding effective asset allocation. By following effective asset allocation theory, investors who diversify their portfolios will not be wiped out when a single holding fails.

VII. CONCLUSION

Congress passed Sarbanes-Oxley to try to jumpstart investor confidence by improving transparency. In hindsight, the costs of Sarbanes-Oxley outweigh the benefits for small and foreign companies. Because the costs outweigh the benefits, Congress should exempt small and foreign companies from complying with Sarbanes-Oxley.

The Act is filled with good intentions. But good intentions in this case are too expensive. Investors would be better off without Sarbanes-Oxley because small and foreign companies' earnings would be higher as these companies spend the money earmarked for compliance on growth of the companies' businesses. Furthermore, the Act's reach extends beyond its helpful role when it begins to create an environment in which small-cap and foreign companies seek to delist rather than comply with the Act because delisting leads to less transparency and more potential danger for investors.

Cory L. Braddock[*]

190. *See supra* Part III.B.2.

191. Employee Retirement Savings Act of 1974, 29 U.S.C. 1001 (2000).

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