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The Sarbanes-Oxley Act and the Making of Quack Corporate Governance

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Abstract

This paper provides an evaluation of the substantive corporate governance mandates of the Sarbanes-Oxley Act of 2002 that is informed by the relevant empirical accounting and finance literature and the political dynamics that produced the mandates. The empirical literature provides a metric for evaluating the mandates' effectiveness, by facilitating identification of whether specific provisions can be most accurately characterized as efficacious reforms or as quack corporate governance. The learning of the literature, which was available when Congress was legislating, is that SOX's corporate governance provisions were ill-conceived. The political environment explains why Congress would enact legislation with such mismatched means and ends. SOX was enacted as emergency legislation amidst a free-falling stock market and media frenzy over corporate scandals shortly before the midterm congressional elections. The governance provisions, included toward the end of the legislative process in the Senate, were not a focus of any considered attention. Their inclusion stemmed from the interaction between election year politics and the Senate banking committee chairman's response to suggestions of policy entrepreneurs. The scholarly literature at odds with those individuals' recommendations was ignored, while the interest groups whose position was more consistent with the literature - the business community and accounting profession -- had lost their credibility and become politically radioactive. The paper's conclusion is that SOX's corporate governance provisions should be stripped of their mandatory force and rendered optional. Other nations, such as the members of the European Union who have been revising their corporation codes, would be well advised to avoid Congress' policy blunder.

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[1] Earlier versions of this paper were presented as a plenary lecture at the 20th Annual Conference of the European Association of Law and Economics, the Matthews lecture at the University of Mississippi School of Law, the Harald Voss Memorial Lectures at the Institute for Law and Finance of Johann Wolfgang Goethe-Universität in Hamburg, and at the Vienna University of Economics and Business Administration and UNCITRAL Forum für Internationales Wirtschaftsrecht in Vienna, the University of Pennsylvania Institute of Law and Economics Roundtable, the Centre for European Policy Studies Roundtable on Corporate Governance Reform in the EU, the Kirkland & Ellis LLP Corporate Law & Economics workshop, and workshops at the University of Chicago, University of Denver, University of Iowa, University of North Carolina, and University of Virginia law schools. In addition to participants at those presentations, I would like to thank Jennifer Arlen, John Core, Alan Gerber, Jonathan Macey, Paul Mahoney and Mathew McCubbins for helpful comments.

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"It's hard to argue logic in a feeding frenzy."[2]

I. Introduction

The Sarbanes-Oxley Act (SOX), in which Congress introduced a series of corporate governance initiatives into the federal securities laws, is not just a considerable change in law but also a departure in the mode of regulation.[3] The federal regime had until then consisted of disclosure requirements, rather than substantive corporate governance mandates, which were traditionally left to state corporate law and were not part of the federal securities regime. Federal courts had, moreover, enforced such a view of the regime's strictures, by characterizing efforts of the SEC to extend its domain into substantive corporate governance as beyond its jurisdiction.[4] SOX alters this division of authority by providing explicit legislative directives for SEC regulation of what was previously perceived as the states' exclusive jurisdiction.

SOX was enacted in a flurry of congressional activity in the runup to the midterm congressional election campaigns, after the spectacular failures of once highly regarded firms, the Enron Corporation and WorldCom, Inc. Those firms entered bankruptcy proceedings in the

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[2] Sen. Phil Gramm, quoted in Jim Drinkard, Scandal publicity drives accounting bill forward, USA Today, July 25, 2002, p.10A.

[3] Pub. Law No. 107-204, 15 U.S.C. §§ 7201 et seq. (2003). Politicians heralded the act as the most important financial market legislation since the initiation of federal securities regulation in the 1930s. E.g., "President's statement on signing of H.R. 3763," Administration of George W. Bush, 2000, at 1284 (calling legislation the "most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt"); 148 Cong. Rec. S 7356 (July 25, 2002) (remarks of Sen. Corzine) (legislation "may well be the most important step" taken since the enactment of the securities laws).

[4] See Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (striking down SEC action through its stock exchange rule-making authority to require one-share one-vote).

wake of revelations of fraudulent accounting practices and executives' self-dealing transactions. But many of the substantive corporate governance provisions in SOX are not in fact regulatory innovations devised by Congress to cope with deficiencies in the business environment in which Enron and WorldCom failed. Rather they may more accurately be characterized as recycled ideas advocated for quite some time by corporate governance entrepreneurs. For instance, the independent director requirement and the prohibition of accounting firms' provision of consulting services to auditing clients, had been advanced as needed corporate law reforms long before the Enron corporation appeared on any politician's agenda.[5] That is not, of course, unique or surprising, as congressional initiatives rarely are constructed from whole cloth; rather, successful law reform in the national arena typically involves the recombination of old elements that have been advanced in policy circles for a number of years prior to adoption.[6]

There is no rigorous theory of how policy proposals come to the forefront of the legislative agenda, but the political science literature identifies shifts in national mood and

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[5] See, e.g., Stephen M. Bainbridge, A Critique of the NYSE's Director Independence Listing Standards, 30 Sec. Reg. L. J. 370 (2002) (comparing the independent directors' provisions to the abortive ALI corporate governance project of the 1980s). Efforts to separate auditing from consulting services were not new: Congress considered the issue in the 1970s, see Report on Improving Accountability of Publicly Owned Corporations and Their Auditors, Subcomm. On Reports, Accounting, and Management of the Sen. Comm. on Governmental Affairs, 95th Cong., 1st Sess. (1977); and more recently, under Arthur Levitt's term as SEC chairman, the agency vigorously pursued the issue in two rule-making processes over 1999-2000, see Audit Committee Disclosure, Final rule, Release No. 34-4226 (Dec. 22, 1999), 64 Fed. Reg. 73389 (1999); and Revision of the Commission's Auditor Independence Requirements, Final Rule, Release No. 33-7919 (Nov. 21, 2000), 65 Fed. Reg. 76008 (2000) (hereafter Auditor Independence Rule).

[6] John W. Kingdon, Agendas, Alternatives, and Public Policies (1984).

turnover of elected officials, coupled with focusing events, as key determinants.[7] At least two of those three elements were without question present to create the window of opportunity for advocates of the corporate governance legislation included in SOX: as indicated in Table 1, there was a shift in public mood regarding big business,[8] and, as shown in Figure 1, a sharp decline in the stock market, coinciding with high profile corporate scandals causing significant displacement and financial distress. There was no turnover of elected officials prior to the enactment of SOX, the third element that is thought to be important in propelling proposals onto the legislative agenda, but it was widely perceived in the media that members of Congress were motivated by reelection concerns when a statute was hurriedly enacted in the summer prior to the mid-term elections, after months of languishing in committee, following heightened attention on corporate malfeasance when the WorldCom scandal erupted post-Enron.[9] The suggestion from

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[7] Id.

[8] As indicated in Table 1, the proportion of the public having either a great deal or quite a lot of confidence in big business in 2002, 20 percent, was the lowest percentage in over a decade, and represented a substantial drop from the relatively high level of confidence, averaging 29.33 percent (range of 28-31 percent) in the prior five years, 1997-2001. It is also more than 10 percent lower than the average, 23.86 percent, over 1990-96 (range of 21-26 percent), and 20 percent below the average for the decade 1990-2001, of 26.38 percent. Of course, it is quite probable that the two variables, public opinion of business and the level of the stock market, are integrally related, that is, when the stock market is doing well, the public has a positive perception of business, and similarly, its perception turns negative when the market drops, whether or not the change in price is related to corporate scandals. There is some credence to this conjecture: the correlation between the percentage of the public expressing a great deal of confidence in business and the S&P 500 composite index is significantly positive (at less than 5 percent), ranging between .55 and .59, depending on whether the closing price of the S&P is measured at the end of the month preceding the poll, the end of the month in which the poll was taken, or the average of the two months.

[9] The House Committee on Financial Services held its first hearing on Enron in December 2001, and it reported a bill, which was passed shortly after its introduction, in April 2002. The Senate did not act on the House bill until after the WorldCom bankruptcy filing in

the media was that the priority of members of Congress was to enact something, with the specific content of less concern and importance.[10]

The failure of Enron, then, provided the occasion for implementation of corporate governance initiatives that were already in the policy soup. What is perhaps most striking in the legislative process is how successful policy entrepreneurs were in opportunistically coupling their corporate governance proposals to Enron's collapse, offering as ostensible remedies for future "Enrons", reforms that had minimal or absolutely no relation to the source of that firm's demise. The most opportunistic coupling in response to Enron's collapse was the Bipartisan Campaign Reform Act of 2002 (commonly referred to as McCain-Feingold, after its principal sponsors), which was enacted many months before SOX's passage,[11] as Enron's campaign contributions had nothing to do with Enron's financial collapse, nor were there allegations to that effect.

July 2002. For an example of press coverage that election concerns figured prominently in that timetable, see e.g. David E. Sanger, Corporate Conduct: The Overview, Bush on Wall Street Offers Tough Stance, N.Y. Times, July 10, 2002, A1 (reporting on a speech by President Bush to Wall Street on his approach to the corporate scandals, the article noted that the "Democrats have now seized on (the need for drastic legislative change in response to the corporate scandals) as a crucial issue for the November elections," and emphasized how "partisan the battle has become.") Similarly, press reports suggested that the Senate Democrats were not coming up with a consensus party bill, or compromise bill capable of obtaining some Republican votes, following the House action because the Democrats "[did]n't want Bush and the Republicans to steal their thunder" and it "was not in the Democrats' interest to compromise." Amy Borrus and Mike McNamee (edited by Richard S. Dunham), Accounting: Congress Only Looks Like It's Getting Tough, Business Week 51 (Apr. 29, 2002). News accounts that considered the House bill as too "lax," maintained that legislators "were more interested in using accounting reform to score political points for the November elections than in reining in (accountants)." Id.

[10] E.g., Wall St. J., July 11, 2002. As one television reporter put it, "This was a stampede... The House Republicans dropped their opposition to this legislation because there was simply too much pressure on them to pass something." ABC News, World News Tonight, Congress passes new reform bill, July 24, 2002 (Linda Douglass, reporting).

[11] Pub. Law 107-155, 116 Stat. 81 (Mar. 27, 2002).

The aim of this paper is not, however, to analyze the peculiar disjuncture between the substantive corporate governance provisions of SOX and the source of the failure of Enron. Rather the objective is to evaluate SOX's substantive governance provisions on their own terms (and the political dynamics that produced those provisions). This can be done because there is a substantial body of empirical corporate finance literature on key substantive provisions of SOX. The fact that SOX codified ideas that had been circulating in policy circles over many years has two salutary consequences for such an analysis: research motivated by prior policy debates bears on the SOX initiatives, and variations in firms' practices related to the SOX initiatives permits cross-sectional analyses that shed light on the probable efficacy of the legislation. The existence of a literature that addresses the efficacy of some of the long-standing proposals that were enacted in SOX also highlights an even more troubling feature of the legislative process than the opportunistic packaging of specific initiatives as preventatives for future "Enrons" when their relationship to the problem at hand is, at best, attenuated: the gist of the literature was available to legislators while they were formulating the provisions in SOX, yet it went unnoticed or was ignored. With the scholarly literature at odds with the proposed governance mandates being treated as though it did not exist, the quality of decisionmaking that went into the SOX legislative process was, to put it mildly, less than optimal.

The substantive corporate governance mandates in SOX that are the focus of this paper consist of the statutory provisions that require independent audit committees, restrict corporations' purchases of non-auditing services from their auditors, prohibit corporate loans to officers, and require executive certification of financial statements.[12] In contrast to provisions in SOX entirely within the bounds of traditional securities regulation, such as the direction for

[12] One substantive corporate governance provision, the forfeiture of CEO and CFO bonus, incentive and equity compensation in the event of a material restatement of the company's financials (section 304) is not discussed because it has not been the subject of research. Although much research exists on executive compensation, it is not helpful for evaluating the efficacy of the provision (the research does not bear upon the relation between the form of compensation and accounting misconduct). Studies with results tangentially-related to the issue are: Shane A. Johnson, Harley E. Ryan and Yisong S. Tian (manuscript 2003) (finding that executives of firms charged with accounting fraud had higher incentive and equity compensation than executives at matched firms); Jeffrey L. Coles, Naveen D. Daniel and Lalitha Naveen, Executive Compensation and Managerial Risk-taking (manuscript 2003) (finding that a higher sensitivity of the CEO's wealth to stock volatility is correlated with riskier investment, measured by research and development and capital expenditures, and riskier debt policies); and Jap Efendi, Anup Srivastava and Edward P. Swanson, Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation, Corporate Governance, and Other Features (manuscript 2004) (finding managers of firms restating earnings had a higher number of in-the-money options then managers of non-restating firms). It should be noted that effective regulation of the form of managerial compensation is difficult because firms can readily adapt compensation contracts to maintain managers' wealth level regardless of legislative intent. See, e.g., Tod Perry and Marc Zenner, Pay for Performance? Government Regulation and the Structure of Compensation Contracts (manuscript 2000) (finding that firms changed the mix of managerial compensation to reduce salaries and increase incentive pay to adapt to Congress' limitation on the tax deductibility of non-performance based compensation over $1 million). SOX is not an exception: Daniel Cohen, Aiyesha Dey and Thomas Lys find that subsequent to SOX, firms decreased CEOs' incentive compensation, increasing their non-forfeitable fixed salaries, thereby providing insurance to managers for the increased risk. Daniel A. Cohen, Aiyesha Dey and Thomas Z. Lys, The Sarbanes-Oxley Act of 2002: Implications for Compensation Structure and Risk-Taking Incentives of CEOs (manuscript 2004). Of course, such adaptation comes at a cost, since it is probable that prior to the regulation, firms had optimized compensation contracts. Moreover, that cost is borne by shareholders, the purported beneficiaries of the regulation, and not managers, the objects of the regulation. Further, there may well be unintended negative consequences of such legislation. During the debates over SOX, for example, some members of Congress contended that the federal legislation limiting the tax deduction for managerial compensation to $1 million unless it was performance-based caused firms to increase managers' stock and option compensation, the increased use of which was now being identified as the reason for the accounting misconduct by the managers of Enron and other scandal-plagued firms. E.g., 148 Cong. Rec. S6628 (Jul. 11, 2002) (Sen. Gramm). It is therefore altogether possible that, as with the governance mandates discussed in this paper, the forfeiture provision will not function as Congress anticipated.

increased disclosure of off balance sheet transactions,[13] and those provisions outside the scope of issuer regulation, such as the creation of a new public board to oversee auditors,[14] the substantive corporate governance provisions overstep the traditional division between federal and state jurisdiction, although they did not have to do so. They could have been formulated as disclosure mandates.[15] Had that been done, those provisions would have fallen within the conventional regulatory apparatus. Instead, they were imposed as substantive mandates, a novel (and more costly) regulatory approach for the national government with regard to securities regulation. None of the fifty states, nor the District of Columbia whose corporate laws governed the matters covered by the new SOX provisions, mandated the practices that Congress did in SOX. It is instructive that the SOX initiatives are not to be found in any state corporation codes: the message conveyed by the empirical corporate finance and accounting literature that bears on the specific SOX provisions is that this is not fortuitous as it suggests that the mandates will not provide much in the way of benefit to investors.

Questioning the efficacy of the core governance reforms in SOX is not an original contribution: other commentators have critiqued the legislation for not addressing the cause of Enron's collapse, and emphasized that the national government is an inappropriate actor in this

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[13] Section 401(j).

[14] Section 101.

[15] The loan prohibition was adopted without discussion or debate on the Senate floor in an amendment offered by Senators Charles Schumer and Dianne Feinstein; the provision in the Senate bill was in the traditional form of a disclosure requirement. 148 Cong. Rec. S6689-6690 (July 12, 2002).

context.[16] But demonstrating that the SOX initiatives would not prevent future "Enrons," or that the states are better actors than the federal government in the corporate governance context, does not preclude the possibility that specific SOX provisions could still be beneficial to investors. The value added of this paper compared to those analyses is that the critique of SOX's corporate governance provisions is informed by the body of empirical research on the substance of the legislation, independent of their connection to Enron's woes and federalism. That finance and accounting literature provides a metric for evaluating the effectiveness of the legislation, by facilitating identification of whether specific pieces of the legislation can be most accurately characterized as efficacious reforms or as quack corporate governance.

The fact that the literature indicates that the corporate governance provisions in SOX are ill-conceived raises the puzzling question why Congress would enact legislation that in all likelihood would not fulfill its objectives? The paper therefore examines the political dynamics that produced the legislation. Simply put, the corporate governance provisions were not a focus of deliberation by Congress. SOX was emergency legislation, enacted under conditions of limited legislative debate, during a media frenzy involving several high profile corporate fraud and insolvency cases,[17] in conjunction with an economic downturn and what appeared to be a

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[16] E.g., Stephen M. Bainbridge,The Creeping Federalization of Corporate Law, Regulation 26, Spring 2003 (states more appropriate actors); Frank Partnoy, A Revisionist View of Enron and the Sudden Death of "May", 48 Villanova L. Rev. 1245 (2003) (derivatives source of collapse); Larry E. Ribstein, Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 J. Corp. L. 1 (2002) (market more appropriate "responder").

[17] The media coverage would appear to have had an impact on congressional deliberations. The debates are replete with members of congress referring to newspaper editorials and articles criticizing congressional action or inaction, presumably as a means of rationalizing their positions. See, e.g., 148 Cong. Rec. H1547-48 (April 24, 2002) (Rep. Jones of Ohio

free-falling stock market, and the prospect of an election campaign in which the corporate scandals would be a looming issue. The healthy ventilation of issues that occurs in the usual give and take negotiations over competing policy positions and which works to improve the quality of decisionmaking did not occur in the case of SOX because the collapse of Enron and its auditor, Arthur Andersen, politically weakened key groups affected by the legislation, the business community and the accounting profession. Democratic legislators who crafted the legislation relied for policy guidance on the expertise of trusted policy entrepreneurs, most of whom were closely aligned with their political party. Insofar as they were aware of a literature at odds with their policy recommendations, those individuals did not attempt to square their views with it, nor did legislators of either party follow up on the handful of comments that hinted at the existence of studies inconsistent with those recommendations. The political salience accorded Congress' consideration of the legislation made Republican legislators, who tended to be more sympathetic to the regulatory concerns of accountants and the business community, convinced that it would be politically perilous to be perceived as obstructing the legislative process and being portrayed as on the wrong side of the issue.

The central policy recommendation of the paper is that the corporate governance provisions of SOX should be stripped of their mandatory force and rendered optional for registrants. The findings of the empirical literature are consistent with the view that the more efficacious corporate and securities law regimes are the product of competitive legal systems,

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referring to Washington Post editorial); 148 Cong. Rec. S6692 (July 12, 2002) (Sen. Craig referring to Wall Street Journal editorial). Senator Gramm, a reluctant supporter of the legislation, referred to its "high profile" and noted that it was "impossible in the environment" in which they were operating to correct what he considered serious flaws in the legislation. 148 Cong. Rec. S7353 (July 25, 2002) (Sen. Gramm).

which permit legal innovations to percolate from the bottom up by trial and error, rather than those imposed from the top-down, by regulators or corporate governance entrepreneurs, far removed from the day to day operations of firms.[18] In that regard it is important to point out that the bulk of the provisions of competitive corporate codes are enabling, permitting firms to tailor their internal organization to their specific needs. The best path to ameliorating the misguided congressional promulgation of substantive governance mandates through SOX is to conform it to the states' enabling approach to corporate law.

If past agency conduct is a guide, however, it is implausible that the SEC will acknowledge the problematic character of the SOX initiatives and use its exemptive power to render optional the provisions found wanting. Indeed, in the current political environment in which the states have been beating the SEC to the courthouse with allegations of misconduct against entire sectors of the financial industry, the agency would not be in a position to reexamine any of its expanded powers under SOX, as politicians and a media chorus have been castigating it as "asleep at the wheel."[19] Nor will Congress in the near future be likely to exercise

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[18] See Roberta Romano, The Advantage of Competitive Federalism for Securities Regulation (2002).

[19] E.g., Feds Flubbed Mutual Fund Oversight, The News Tribune (Tacoma, Washington), Nov. 5, 2003 ("Asleep-at-the-wheel federal regulators have helped give 95 million American investors something they don't need - yet another major stock market scandal to worry about. . . Congress should find out how the SEC allowed a scandal of this magnitude to slip under its radar screen for so long and require the agency to shape up"); Steve Bailey, Asleep at the Switch, The Boston Globe, Oct. 24, 2003 ("As the scandals roll out across Wall Street and beyond ... the question "Where was the SEC?" is becoming part of the lexicon. . . It has been left to New York Attorney General Eliot Spitzer to uncover one problem after another in the securities business and to show the SEC and its boss, William Donaldson, what regulation is about"), Jon Birger, Whose Jurisdiction Is It?, Money (Oct. 2003) ("One question arises from Eliot Spitzer's shocking charges against the fund industry: Why was it the New York AG and not the SEC doing the charging?); The State of the Securities Industry, Hearing of the Sen. Comm. on Banking,

the political will necessary to recognize its legislative error and revamp the legislation. Any attempt that appears to tamper with the posture of being "tough on corporate crime" will therefore be difficult, if not impossible, until the scandals recede from public memory and some perspective can be attained on what transpired. It can only be hoped that the point in time when Congress will revisit SOX will not, for instance, require the sixty-plus years it took to repeal the New Deal financial market legislation, the Glass-Steagall Act, which is now widely recognized as having greatly contributed to the banking debacle of the 1980s, and that it will not similarly require extensive damage to the viability of the public corporation as an organizational form for doing business in order to galvanize Congress to action. Calling attention to the illusory efficacy of the SOX corporate governance mandates and the intellectual vacuity of the SOX legislative process will hopefully encourage an atmosphere of sober congressional reassessment of the legislation and improve the quality of decisionmaking.

A second conclusion to draw from the empirical literature is that it would be prudent for other nations to resist joining the post-Enron bandwagon by adopting SOX's strictures in their regulation of public corporations. The member-states of the European Union, for example, have been modifying their company laws in response to reports filed by national corporate governance reform committees in the aftermath of the Enron scandal, although many began their work prior to Enron's collapse. At the time of these initiatives, the European Commission issued a communication directed at enhancing corporate governance and modernizing member-states'

Housing and Urban Affairs, 108th Cong., 2d Sess. (Sept. 30, 2003) (Sen. Shelby, chair) ("Mr. Chairman (of the SEC), many are questioning why it was the attorney general of New York, Eliot Spitzer, and not the SEC that discovered and initiated the current investigation involving trading practices in the mutual fund industry.")

company laws.[20] Thereafter, in response to a spectacular accounting scandal at an Italian firm, Parmalat SpA, the European Commission announced that "auditing and corporate governance rules throughout the European Union will be tightened," noting plans to "reinforce the importance and independence of [outside] directors and audit committees" and to "strengthen" the regulatory oversight of auditors.[21] The thrust of this paper's analysis suggests that in reacting to Parmalat's collapse the European Commission appears to be drawing a mistaken inference from the U.S. experience, and that the member states, and European Parliament members, should press the Commission to proceed with great care on its proposed initiatives so as to avoid the U.S. Congress's public policy blunder.

II. Evaluating the Substantive Corporate Governance Mandates in SOX

A considerable body of corporate finance and accounting research bears on the efficacy of the substantive corporate governance mandates of SOX. After describing the federal provision and contrasting the states' approach to the issue, the relevant empirical literature is discussed.[22]

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[20] Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward (May 21, 2003). As with many of the national law reforms, the EC action was in response to advice provided by a High Level Group of Company Law Experts, which had been formed prior to the Enron scandal, but completed its report after the scandal's occurrence.

[21] Paul Meller, European Commission Plans to Raise Auditing Standards, N.Y. Times, Jan. 8, 2004, C10.

[22] The analysis is necessarily qualitative because there are not a sufficient number of studies to undertake a quantitative meta-analysis: no more than three of the 15 studies of audit committee independence use a comparable performance measure, and no more than seven of the 24 studies of the provision of non-audit services use a comparable measure of audit quality; the number of observations in meta-analysis regressions, controlling, as the analysis requires, for variables differentiating studies' functional forms and data sets, would therefore have insufficient degrees of freedom for estimation. For a recent discussion of the use of meta-analysis to review economic literature see T.D. Stanley, Wheat from Chaff: Meta-Analysis As Quantitative

This literature review is the basis for the conclusion that the data do not support the view that the SOX initiatives will improve corporate governance.

A. Independent Audit Committees

1. Statutory mandate

Section 301 of SOX requires all listed companies to have audit committees composed entirely of independent directors, as defined by Congress.[23] Congress also mandated disclosure of whether any of those directors were "financial experts," along with an explanation - for firms with no expert on the audit committee - of why no committee members were experts.[24] The statute contains additional mandates that are not the focus of concern here because they have not been the subject of empirical research. These include making the audit committee responsible for the appointment of the outside auditor, directing corporations to provide the audit committee with independent counsel and other advisors the committee deems necessary for fulfilling its duties, and requiring the audit committee to establish procedures to receive and investigate

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Literature Review, J. Econ. Perspectives, Summer 2001, p. 131. A criticism of a "vote-counting" survey approach, as undertaken in this paper (compared to a meta-analysis), is that when the power of the statistical test is low, vote-counting will be biased toward finding no effect. Id. at 145. That criticism is inapt here: the studies discussed in this paper typically have thousands of observations and it is therefore highly unlikely that a finding of insignificance is due to low-powered tests rather than the absence of a relation between the variables of interest.

[23] Codified as §10A(m) of the Securities Exchange Act. To qualify as independent, the director may not accept any "consulting, advisory or other compensatory fee" nor be an "affiliated person" of the issuer or a subsidiary. Id.

[24] Section 407. SOX's substantive corporate governance mandates in this context are expressed as directions to the SEC to adopt rules rendering the governance provisions mandatory.

employee complaints about accounting policies and practices.[25]

The highly detailed requirements specifying the responsibility, authority and obligations of the audit committee go far beyond what had been existing corporate law. Indeed, the statutory language would appear to override state law's provision of authority to the entire board and the shareholders: SOX's plain language would prevent shareholders from hiring or firing an outside auditor as it places that authority solely in the audit committee (although the practical import of this may be minimal as the incidence of shareholders ever attempting to fire the auditor, or rejecting a management proposal to approve an auditor is unknown, and in all likelihood, quite rare). Similarly, while state law permits boards to delegate tasks to committees, such as auditing oversight, it does not restrict the full board's ability to retain or retract delegated authority, or to select the auditors, as does SOX. Most important for the concern of this paper, mandates that have been the subject of empirical research, state corporation codes do not mandate the composition of the board of directors, let alone that of board committees, such as the audit committee.

State courts have, however, fashioned doctrines that encourage the use of independent directors. For instance, Delaware courts apply a lower level of scrutiny to actions undertaken by independent directors.[26] That approach undoubtedly created an incentive for firms that furthered

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[25] Section 301. This provision is similar to the corporate governance recommendations of a U.K. group reporting on audit committee initiatives post-Enron, chaired by Sir Robert Smith, whose recommendations were incorporated into the Higgs' Committee's proposed corporate governance code changes; see Derek Higgs, "Review of the Role and Effectiveness of Non-Executive Directors" 59-60 (Jan. 2003).

[26] In Delaware case law, director independence figures prominently in assessments of defensive tactics; derivative litigation procedural requirements; and the business judgment rule's applicability.

the trend throughout the 1980s and 90s toward a supermajority of independent directors on boards. But the courts' approach to director independence is highly contextual, considered in the evaluation of whether fiduciary standards have been met, in contrast to the bright line rule approach in SOX, that simply bans entire categories of individuals from audit committee service. Moreover, state legislatures have not codified a definition of what constitutes independence, as was done in SOX. The absence of a statutory definition facilitates the courts' adaptation of the concept to a changing business environment. For example, the Delaware court's definition of independence has focused on an absence of financial interest, although a recent chancery opinion found other factors-- philanthropic contributions and personal relations among directors involving the same university-- created a lack of independence.[27]

Since 1999, the stock exchanges have had listing standards requiring audit committees comprised of all independent directors, but they gave boards the discretion to appoint a non-independent director and also exempted small businesses from the requirement.[28] These listing requirements were adopted at the prodding of the SEC.[29] In implementing the SOX audit

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[27] In re Oracle Corp. Derivative Litigation, 824 A.2d 917 (2003 Del. Ch. Lexis 55).

[28] See 17 C.F.R. parts 210, 228, 229 and 240, Audit Committee Disclosure, Final Rule, SEC release no. 34-42266, 64 Fed. Reg. 73389 (1999). These listing standards required audit committees consisting of three independent directors, but permitted one non-independent director "under exceptional and limited circumstances" if the board determined it was "required by the best interests of the corporation and its shareholders," and the American Stock Exchange and National Association for Securities Dealers required small businesses (companies with less than $25 million in revenues and market capitalization) to have only two-member audit committees, a majority of whom were independent. Id. at 73395.

[29] The exchange requirements were recommended by the SEC and exchange-created Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, whose report dovetailed with the investigation of the independence of the auditing profession by the Independence Standards Board, an organization created by the SEC and the accounting

committee independence provisions, which require the delisting of any firm that does not comply with them, the SEC eliminated the exemptions contained in the pre-SOX listing standards.[30]

2. Studies on Audit Committee Independence

A large literature has developed on whether independent boards of directors improve corporate performance. Across a variety of analytical approaches, the learning of that literature is that independent boards do not improve performance and that boards with too many outsiders may, in fact, have a negative impact on performance.[31] There are fewer studies of the relation between audit committee composition and firm performance (four in total). There has been only one study investigating whether the proportion of independent directors on the audit committee, among other committees (the nomination and compensation committees), of U.S. firms affects

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profession to undertake the investigation. See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (New York, NY: NYSE and NASD, 1999). The Board concluded, much to the then SEC chairman's chagrin, that consulting services should not be severed from auditing firms, and focused its recommendations on audit committees instead. The stock exchanges submitted to the SEC proposed rules that would tighten the definition of independence and impose an independence requirement on compensation and nominating committees as well as audit committees in 2002 (the proposal was the exchanges' response to Enron predating the enactment of SOX). The SEC did not publish those proposed rules for public comment, as it desired uniformity in the exchanges' definitions of independence; a year later, after obtaining the desired convergence in the exchanges' proposals, the agency released amended proposals by the exchanges for comment, see SEC Release No. 34-47672, 68 Fed. Reg. 19051 (2003) (amendment to proposed rule, dated April 11, 2003), which were revised in October and approved as exchange rules by the SEC on November 4, 2003, see 68 Fed. Reg. 64154 (2003).

[30] See 17 C.F.R. parts 228, 229, 240, 249 and 274, Standards Relating to Listed Company Audit Committees, Final Rule, SEC Release No. 33-8220, 68 Fed. Reg. 18788 (2003).

[31] For literature reviews see Sanjai Bhagat and Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 Business Lawyer 921 (1999); Roberta Romano, Corporate Law and Corporate Governance, 5 Industrial and Corporate Change 277 (1996).

performance.[32] It found that the independence of the audit committee had no effect on performance, nor did the independence of any other committee, paralleling the well-established finding in the literature that the independence of the full board does not improve performance. That finding has been replicated in three studies of the relation between audit committee composition and performance in other countries. A study of whether audit committee independence affects firms' market value in Australia found that there was no relation between independence and performance.[33] Similarly, a study investigating the relation between audit committee independence (among other governance characteristics) and various market and accounting measures of performance for U.K. firms found no relation.[34] A second U.K. study examined the relation between audit committee independence and Tobin's Q, a measure of firm value that is often equated with performance because it indicates by how much a firm's market value exceeds its book value; this study also found no association between independence and

[32] April Klein, Firm Performance and Board Committee Structure, 41 Journal of Law & Economics 275 (1998). Klein finds that having insiders on the finance and investment committees does, however, improve performance. The sample consists of 485 (486) firms in the S&P 500 in 1992 (1993); performance measures include both accounting and market measures (return on assets and stock market returns) and a measure of investment strategies and productivity of long-term assets, Jensen productivity.

[33] Julie Cotter and Mark Silvester, Board and Monitoring Committee Independence, 39 Abacus 211 (2003). The sample consists of 109 large Australian firms from 1997. They find that there is also no relation between board independence and firm value. Because of the endogeneity of board and committee composition and the difficulty in controlling for all factors affecting firm value besides effective monitoring by independent directors, the analysis measures independence relative to industry medians.

[34] Nikos Vafeas and Elena Theodorou, The Relationship between Board Structure a nd Firm Performance in the UK, 30 British Accounting Rev. 383 (1998). The sample consisted of 250 firms from 1994. The performance measures included stock returns, market value and accounting measures such as return on assets.

performance.[35]

While not as extensive as the literature on board composition and performance, many more studies have examined the impact of the independence of audit committees on the probability of financial statement misconduct, than on performance. Table 2 compiles the findings of studies on audit committee independence. The definition of independence used by researchers is the same as that adopted by Congress in SOX, which excludes individuals employed by or otherwise affiliated with the issuer or a subsidiary, or receiving consulting or other compensatory fees from the issuer (other than for director service).[36] The question raised by this research, from the perspective of the SOX mandates, is whether Congress has accurately matched a problem with a solution. Of the 16 studies collected in Table 2, 11 studies (including the four studies of explicit performance measures already noted) do not find that 100 percent independence of the audit committee improves performance, whether measured conventionally

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[35] Charlie Weir, David Laing and Phillip J. McKnight, Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Public Companies, 29 J. Bus. Fin. & Accounting 579 (2002). The sample consisted of 311 firms from the 1996 *Times1000*, which lists the largest companies operating in the United Kingdom.

[36] Section 301. To the extent that language does not cover relatives of officers, the studies' definition is broader as they exclude relatives. Researchers identify independent (as opposed to "affiliated" or "grey" non-officer) directors from information disclosed in proxy statements which identify business relationships and transactions between the issuer and directors, as well as family relationships and other affiliations, under the SEC's disclosure regulations. See Schedule 14A, item 7, referencing items 401 and 404 of Regulation S-K. There are five exceptions: The two studies of U.K. firms exclude from the definition of affiliated (non-independent) outsider directors, individuals associated with an issuers' bank; the two earliest studies, as noted in the discussion, use an inadequate definition, by considering director independence only in relation to employment by the issuer; and the study by Hatrice Uzun and colleagues includes affiliated directors in the computation of the percentage of independent directors, but it also provides a separate analysis of the percentage of grey directors (but not of the percentage of true outsiders).

or by the existence of accounting improprieties. (The data are mixed on whether a committee with a majority of independent directors improves performance; the issue for SOX, however, is whether 100% independence improves upon the effect of a majority independent committee.) Moreover, as will be elaborated, valid inferences can be drawn from only one of the four studies finding improved performance; the remaining study, which has inconsistent results, does not contain a direct test of the impact of independence.

April Klein examined the relation between audit committee characteristics (director independence) and abnormal accruals of large public corporations.[37] Abnormal accruals are considered a proxy for earnings management, a practice by which firms manipulate their reported accounting figures by, for example, accelerating revenues, and/or delaying (capitalizing) expenses, so as to smooth out earnings across reporting years.[38] Although earnings management

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[37] April Klein, Audit committee, board of director characteristics, and earnings management, 33 Journal of Accounting and Economics 375 (2002). Klein's sample consists of 692 firms in the S&P 500 in 1992-93. Forty-three percent of the sample audit committees are comprised solely of independent directors, while 87 percent have a majority of independent directors. On average, 79.6 percent of audit committee members are independent.

[38] Accruals are an accounting convention to recognize changes in value (revenues and expenses) independent of when cash flows into and out of the firm. A firm's total accruals, from which abnormal accruals are derived, are calculated as net income before extraordinary items minus cash flows from operations. Because not all accruals are evidence of earnings management, accounting researchers have developed econometric models to determine what firms' expected accruals would be in the absence of earnings management. Klein uses the conventional methodology to model expected accruals for the sample firms, and the difference between estimated and actual accruals is the abnormal accrual, or earnings management measure. Because these models estimate accruals with error, it is possible that the statistical tests will either fail to detect abnormal accruals when they exist or erroneously find abnormal accruals when there are none; studies estimating the models' accuracy indicate that while in some cases the models are well-specified, in many cases the power of the statistical tests is quite low and the estimates are therefore inaccurate. See, e.g., Patricia M. Dechow, Richard G. Sloan and Amy P. Sweeney, Detecting Earnings Management, 70 Accounting Rev. 193 (1995); and Jacob Thomas and Xiao-jun Zhang, Identifying Unexpected Accruals: A Comparison of Current Approaches, 19

is often consistent with generally accepted accounting principles,[39] the SEC considers it inappropriate.[40] For the purpose of this paper, I will follow the accounting literature's convention

J. Accounting and Pub. Policy 347 (2000). This paper places credence in the earnings management studies' findings, despite this concern, because, as surveyed in this section, the results regarding audit committee independence are consistent across studies using different metrics of audit quality that are not subject to the same estimation difficulties as are abnormal accruals. In addition, several studies use the technique identified by Dechow et al. as producing a well-specified model of accruals. This is also true of the literature discussed in part II..B.2, infra, on the provision of non-audit services.

[39] It should be noted that earnings management may be in the shareholders' interest. See Anil Arya, Jonathan C. Glover and Shyam Sunder, Are Unmanaged Earnings Always Better for Shareholders?, 17 Accounting Horizons 111 (Supplement 2003) (model in which earnings management aligns managers' incentives with owners' interest). It should further be noted that an association between earnings management and weak corporate governance features may not evidence that lax governance results in management opportunism; to reach such a conclusion, one should ideally determine whether the act of accounting discretion adversely affects share value. See Robert M. Bowen, Shivaram Rajgopal and Mohan Venkatachalam, Accounting Discretion, Corporate Governance and Firm Performance (manuscript 2003). The idea is that, from an efficient contracting perspective, the observed relation between accounting discretion and poor governance characteristics may indicate either management opportunism that was unexpected by the contracting parties (shareholders) or poor model specification of the economic determinants of the efficient investment contract. These alternative hypotheses can be distinguished by examining the relation between accounting discretion attributable to governance quality and future performance, with a negative relation indicating opportunism (that is, that "managers exploit lax governance structures to exercise accounting discretion at the shareholder's expense"). Id. at 3. Bowen and colleagues do not find a negative association between accounting discretion due to governance and subsequent performance, and conclude that the association between poor governance and accounting discretion is most likely due to omitted economic determinants of discretion. (The governance characteristics they examine are not related to the SOX mandates; they are takeover defenses, the separation of the positions of CEO and board chairman, the percentage of executive officers on the board, officers' interlocking positions, the number of board meetings, managerial stock ownership and incentive compensation.)

[40] See, e.g., Accounting Reform and Investor Protection, Hearings before the Sen. Comm. on Banking, Housing and Urban Affairs, 107th Cong. 2d. sess. 190 (Feb. 26, 2002) (hereafter Senate Hearings) (Walter Schuetze, former Chief Accountant of SEC) ("Earnings management is a scourge in this country.... We need to put a stop to earnings management"); Arthur Levitt, Remarks to New York University Center for Law and Business (Sept. 28, 1998) ("I'd like to talk to you about another widespread, but too little-challenged custom: earnings management [which

that the SEC's characterization is appropriate and that data suggestive of earnings management evidences questionable behavior.

Klein finds that abnormal accruals are inversely related to audit committee independence. Firms with a majority (or a higher proportion) of independent directors on the audit committee had significantly smaller abnormal accruals than firms with a minority of independent directors on the audit committee. She finds no significant relation between abnormal accruals and all-independent (100 percent outsider) audit committees, the SOX requirement. She further finds, for the subset of firms with available data, that companies moving from majority-independent to minority-independent audit committees experienced large increases in the abnormal accruals in the year of the change compared to the other firms in the sample.[41]

As is inherent in regression analysis, Klein's study cannot demonstrate causality; one could interpret her data as indicating that firms with "large accruals inherent in their earnings structure are less inclined" to have independent audit committees,[42] rather than the reverse, that firms with independent committees are less likely to have large abnormal accruals. But it is

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has] "evolved into...a game that, if not addressed soon, will have adverse consequences for America's financial reporting system."), available at http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt. Enron engaged in what could euphemistically be characterized as particularly aggressive earnings management, in its use of complicated off-balance sheet transactions to realize gains so as to offset investment losses and maintain a positive earnings level. For a description of Enron's accounting maneuvers see e.g., Mimi Swartz and SherronWatkins, Power Failure: The Inside Story of the Collapse of Enron (2003).

[41] Three hundred and thirty-nine of the sample firms had data available for both 1992 and 1993. It should be noted that all of Klein's results regarding the relation between abnormal accruals and audit committee independence hold for the independence of the full board.

[42] Klein, supra note 37, at 399.

entirely plausible to conclude from her study both that having a majority of independent directors on audit committees may benefit investors by providing a mechanism to control management's ability to smooth earnings inappropriately, and that audit committees with only independent directors add little in additional benefit beyond majority-independent ones and consequently, that the SOX mandate is unnecessary.

Sonda Chtourou, Jean Bédard and Lucie Courteau also examine the relation between audit committee independence and abnormal accruals.[43] Although the model formulation differs somewhat from Klein's,[44] the results are the same: 100 percent independent audit committees are not associated with lower levels of abnormal accruals. They consider further whether the presence of a financial expert on the audit committee affects the level of accruals: it does not.[45]

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[43] Sonda Marrakchi Chtourou, Jean Bédard and Lucie Courteau, Corporate Governance and Earnings Management (manuscript 2001). The sample consists of 300 firms, the 100 firms with the largest positive and negative abnormal accruals and the 50 firms with the smallest positive and negative accruals, from 3,451 firms' estimated accruals in 1996.

[44] The dependent variable is a dichotomous indicator variable (0-1) for whether the firm is in the highest or lowest abnormal accrual category; three models are estimated, one using only the high positive accruals, one using only the high negative accruals, and one combining both types of high accruals; the 100 low accrual firms are used in all three estimations. In addition to an indicator variable for 100 percent audit committee independence, a variable is constructed for the proportion of independent audit committee members who are not managers of other firms, on the view that outsider directors who are also managers may not criticize incumbent management or monitor, even though there is no financial relation between their firms to consider them non-independent. This variable is significantly negatively related to high positive discretionary accruals.

[45] The variable is insignificant in both the positive and combined high accrual estimations. In the negative accrual estimations, it is significantly negative at 5 percent using a one-tailed test, which would equal a level of 10 percent significance in a two-tailed test, which would not be considered significant. It should be noted that positive abnormal accruals are often considered to be of greater concern than negative abnormal accruals because they indicate that earnings have been inflated which would increase stock prices (although the SEC has expressed concern about reporting earnings that are "too" low, as well as those that are inflated).

The final study, by Biao Xie, Wallace Davidson and Peter DaDalt, in which abnormal accruals is the performance measure, restricts its analysis to current accruals (on the theory that such accruals are easier for managers to manipulate than long-term accruals, which are included in the total accruals calculated in the other two studies).[46] Xie and colleagues find as well that there is no association between accruals and committee independence.[47]

Anup Agrawal and Sahiba Chadha study the relation between several of the SOX corporate governance initiatives, including audit committee independence, and earnings restatements, which, as they plausibly contend, is a more direct measure of corporate misconduct

[46] Biao Xie, Wallace N. Davidson III and Peter J. DaDalt, Earnings Management and Corporate Governance: The Role of the Board and the Audit Committee, 9 J. Corp. Fin. 295 (2003). This study examines the proportion of the committee that is independent and does not include a separate full independence variable. The sample consists of 282 S&P 500 firms from 1992, 1994 and 1996. There is a fourth study relating abnormal accruals to board composition, M.E. Bradbury, Y.T. Mak and S.M. Tan, Board Characteristics, Audit Committee Characteristics and Abnormal Accruals (manuscript 2004). It is not included in the discussion because its sample consists of Singapore and Malaysian firms, countries reported to have the highest level of earnings management, id. at 2, whose legal and regulatory environment the authors consider markedly different from the United States, and whose firms' governance characteristics differ substantially from those of U.S. firms because they have controlling shareholders and less independent boards. These differences render the study uninformative for evaluating the behavior of managers of U.S. firms, as the incentives and constraints are not comparable. Bradbury and colleagues find that for Singapore and Malaysian firms, 100 percent independent audit committees significantly reduce income-increasing accruals. It would be of interest to know whether the firms in the sample with 100 percent committees significantly differ from the rest of the sample on any other dimension (particularly ownership), as there could be selection effects at work. It should be noted that studies using data from other foreign countries (Australia, New Zealand and the United Kingdom), are included in the review because those nations' firms' ownership characteristics are similar to U.S. firms. See Rafael LaPorta, Florencio Lopez-de-Silanes and Andrei Shleifer, Corporate Ownership Around the World, 54 J. Fin. 471 (1999).

[47] The study further finds that the proportion of investment bankers and of corporate executives are negatively associated with the level of abnormal accruals. Neither of these classes of directors would fall within the suggested definition of an expert in SOX (accounting expertise), and they are over-inclusive with respect to the broader definition of expertise of the stock exchanges, which include finance or financial management background.

regarding financial accounting than the abnormal accruals measure in the Klein, Chtourou et al., and Xie et al. studies, because the act of restating indicates that the prior accounting was incorrect.[48] The vast majority of restatements in their study resulted in a decrease in earnings.[49] The proportion of independent directors on the audit committee in the Agrawal and Chadha study, which is very high, was not significantly different across the restating firms and the non-restaters.[50] The absence of a significant difference in committee independence, and the near full committee independence again suggests that audit committee independence is not of help to investors in preventing accounting misconduct.

Restaters in the Agrawal and Chadha study were, however, significantly less likely to have a director on the audit committee with an accounting or finance background (a SOX "financial expert") or on the full board, than non-restaters.[51] In addition, the CFO was less likely

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[48]Anup Agrawal and Sahiba Chadha, Corporate Governance and Accounting Scandals (manuscript May 2003). Their sample consists of 159 firms that restated their earnings in 2000-01 due to misstatements and not technical reasons, and 159 matched firms that did not issue restatements. David Larcker and Scott Richardson are more skeptical of the benefit of this approach over the accruals one, as they note that a restatement could alternatively "be the result of an effective auditor imposing its will on the firm and forcing restatement." David F. Larcker and Scott A. Richardson, 42 Fees Paid to Audit Firms, Accrual Choices and Corporate Governance, J. Accounting Res. 625, 629 (2004). It might be possible to distinguish the two hypotheses by controlling for whether there was an auditor change at the time of the restatement, the presence of an SEC investigation prior to the restatement, and possibly by how many years were restated (on the assumption that an effective auditor will catch a problem rapidly enough so as to minimize the number of years that need to be restated).

[49] One-hundred and thirty of the 159 restatements showed a decrease, with a mean change of -114 percent (median of - 6 percent).

[50] It was 94 percent in both samples.

[51] Of restaters, 15 percent had an expert on the committee compared to 33 percent of the non-restaters. The respective proportions for an expert on the full board are 18 percent for restaters compared to 44 percent for non-restaters.

to be on the audit committee of the restaters than the non-restaters. The findings suggest that having a director with financial expertise is of value to investors, with independence possibly less significant than expertise with respect to the relation between audit committee composition and the probability of a restatement. These results are notable from the perspective of SOX in that SOX does not mandate the presence of a financial expert on the audit committee (it has only a disclosure requirement regarding financial expertise on the committee), while it does mandate fully independent audit committees.

When the probability of an earnings restatement is analyzed using a multiple regression analysis including several governance features in the Agrawal and Chadha study, the result regarding financial expertise holds up. Having an independent director with financial expertise is, in fact, the sole governance variable that is significantly correlated with the presence of an earnings restatement.[52] The presence of the CFO on the audit committee is only marginally significant (significant at 8 percent) in the multiple regression model. Thus, the multivariate analysis replicates the univariate results, that one director with expertise appears to be more valuable for investor protection against accounting fraud than a fully independent audit committee.

There are, however, interpretive questions that should be noted regarding the Agrawal and Chadha study's finding concerning director expertise. It is possible, as already noted, that the statistical significance of the director expertise variable should be interpreted as evidence that independent directors with expertise are effective monitors of accounting controls and audit

[52] The other governance variables include separation of the chair and CEO positions, presence of an outside blockholder, the extent of non-audit services provided by the auditor, and the independence of the full board.

quality. But another interpretation of that finding is also possible. Namely, it is also possible that firms that are better managed, and hence less likely to restate their financial statements, choose to have directors with expertise. That is, the finding of significance may be a function of self-selection: the managers of firms that are not likely to engage in accounting fraud actively seek to have outsiders with expertise on their boards, and it is thus not the presence of the experts that causes the reduced probability of a restatement, but the quality of the managers who placed those experts on their boards in the first place. Agrawal and Chadha seek to test whether the alternative interpretation is correct by examining whether operating performance varies across the two samples, characterizing operating performance as a proxy for management quality. They find that performance is not significantly related to the presence of a director with financial expertise, and conclude that the causality in their data runs from expert director absence to restatement and not the reverse.

A second interpretive difficulty is that the result on director expertise may speak to revelation, not incidence, of accounting irregularities. The idea is that although expert directors could help firms avoid serious accounting problems and thereby reduce the incidence of fraud, it is alternatively possible that expert directors are better able than non-expert directors at assisting firms' concealment of accounting problems – a revelation hypothesis – and that is the explanation for their firms' fewer restatements. As Agrawal and Chadha plausibly contend, however, the revelation hypothesis would appear to be an improbable explanation of the data because outside directors have little incentive to assist in management's concealment of accounting problems: in contrast to inside managers, their compensation is incommensurate with the potential liability and reputational harm they would suffer if they were found to have aided in the cover-up of accounting irregularities.[53] Thus neither of the limitations of the analysis are sufficiently troubling to raise concerns about the conclusion implied by Agrawal and Chadha's data that the SOX mandate of complete independence is misdirected, adding a superfluous requirement to firms' corporate governance that is not likely to reduce the likelihood of accounting misconduct. Having one director with financial expertise is apparently more valuable for investors than a committee of all independent directors. Yet that was decidedly not the direction taken by Congress.[54] It should be noted that no states have mandated expertise of audit committee members, in keeping with the absence of state code mandates of specific committees and the composition of the board of directors, but the 1999 national stock exchange rules required audit committees to have at least one member with accounting or financial expertise.[55]

Mark Beasley studied the relation between financial statement fraud and characteristics of boards.[56] To isolate the impact of the governance characteristics of interest, board composition

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[53] Agrawal and Chadha, supra note 48, at 23. A time series data set could possibly distinguish between those hypotheses, as one would expect that expert directors cannot conceal serious accounting problems indefinitely, rather than simply serve to delay the inevitable, and in the long term restatements will be undertaken, such that, if firms were tracked over time, the difference in incidence would disappear if it was not a true effect of director expertise and the revelation hypothesis was correct.

[54] As discussed in part III.C.3, infra, some witnesses at Senate hearings emphasized the need for directors with expertise on audit committees.

[55] See NYSE Listing Manual section 303.01; NASD Manual Marketplace Rules 4350(d)(2). This requirement was adopted in accordance with the recommendations of the Blue Ribbon Committee.

[56] Mark S. Beasley, An Empirical Analysis of the Relation between the Board of Director Composition and Financial Statement Fraud, 71 Accounting Review 443 (1996). His sample consisted of 75 firms that over 1980-91 publicly reported an instance of financial statement fraud matched by size and industry with firms that did not.

and audit committees, the analysis controlled for other factors that studies have found to affect the likelihood of fraud, such as financial distress and duration as a public company. Beasley found that board composition affected the likelihood of fraud: the coefficient on the variable measuring the independence of the board (percent outsiders) was significantly negative. The presence of an audit committee, however, had no significant impact on the probability of financial statement fraud.[57] As with the Agrawal and Chadha study, these results are at odds with the premise of SOX, that audit committee independence will benefit investors by reducing financial fraud. For the subsample of firms for which both the fraud firm and its match had an audit committee,[58] Beasley found that the independence of the audit committee had no significant relation to the probability of fraud.[59] It is possible that the lack of significance is due to the small size of the subsample. It is also possible that it is due to a poor definition of independence; in contrast to other studies, Beasley classified directors' independence solely in terms of employment by the issuer. But it is entirely consistent with Agrawal and Chadha's finding that the composition of the audit committee does not appear to influence accounting statement

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[57] The impact of the audit committee was tested by adding a dummy variable for the presence of a committee and interacting that variable with the proportion of outside directors, as well as including the dummy variable. This was done because the presence of an audit committee may indirectly affect board composition, if outsiders are added to the board to serve on that committee. Id. at 458. Neither the dummy variable nor the interaction term was significant.

[58] There are 26 such pairs: 63 percent of the no-fraud firms and 41 percent of the fraud firms had audit committees; all but two of the firms without audit committees were listed on NASDAQ. The year of the financial fraud for most of the NASDAQ firms without audit committees precedes the year that NASDAQ required an audit committee. Id. at 457.

[59] On a univariate comparison, the audit committees of the firms that had committed financial statement fraud had fewer outsiders than the matched no-fraud firms (84 percent compared to 94 percent).

misconduct.

Lawrence Abbott, Susan Parker and Gary Peters also examine audit committee characteristics in relation to financial reporting misstatements and fraudulent reports.[60] The restatement and fraud firms have fewer independent directors on audit committees as well as fewer experts.[61] In the multiple regression analysis, the results do not differ whether the analysis

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[60] Lawrence J. Abbott, Susan Parker and Gary F. Peters, Audit Committee Characteristics and Financial Misstatement: A Study of the Efficacy of Certain Blue Ribbon Committee Recommendations (manuscript March 2002). They constructed a sample of 129 firms from SEC Accounting and Auditing Enforcement Releases alleging fraud (41 firms) or financial misstatement (2 firms) and news reports of restatements (86 firms) with respect to annual earnings from 1991-99. These firms' audit committee characteristics were compared to those of a matched sample that experienced no fraud or restatements, with control variables for non-audit committee related determinants of financial misstatements and fraud. Another study examined audit committee independence in relation to SEC AAER releases, although it did not restrict the sample to allegations of fraud so citations for negligence were included; the sample consisted of 34 firms from the last 82 releases to have been filed at the time of the study, matched by size and industry. David W. Wright, Evidence on the Relation Between Corporate Governance Characteristics and the Quality of Financial Reporting (manuscript 1996). The study found that the audit committees of the control firms were more independent. Although the finding is similar to that in the Abbott et al. study discussed in the text, the study is not included in Table 2 because the test is not a clean test: many firms in Wright's sample did not have audit committees, and he substituted the composition of the full board (on the view that in the absence of an audit committee the board fulfills its functions) for the audit committee variable instead. While it is correct as a matter of law that the full board must undertake the work of an audit committee when there is no such committee, it is inappropriate to combine full board and audit committee composition data into one variable rather than separately analyze the two sets of firms or eliminate firms lacking such a committee from the test (as done in other studies). That would control for any systematic differences in the behavior of the two entities, which is important because other studies, such as Beasley's study of the same issue, find that the performance effect of boards and audit committees differ significantly. At the least, descriptive statistics should have been provided for the firms' board and committee composition, to permit some assessment of the reliability of a test combining the variables, such as gauging whether the combination might have affected the results in a systematic way. For discussion of the Wright study's investigation of another performance measure in addition to accounting fraud, see note 74, infra.

[61] Half of the restatement firms and 22 percent of fraud firms, compared to 72 percent and 73 percent of their respective matches, had an audit committee composed of all outside directors, and 24 percent of the restatement firms and 36 percent of the fraud firms lacked a director on the

consists of the full sample, only the firms that restated their earnings (financial misstatement firms), or only the firms the SEC alleged to have filed fraudulent reports (fraud firms). In all three samples, Abbott and colleagues find that the presence of a fully independent audit committee (all outsiders) is significantly related to a lower incidence of misstatement or fraud, and the absence of a financial expert on the audit committee is significantly related to a higher incidence of misstatement or fraud.

In contrast to Beasley's study, Abbott and colleagues find that the independence of the full board is unrelated to financial misstatement or fraud. This study, which was conceived as a test of the Blue Ribbon committee's recommendations on audit committees that were adopted by the stock exchanges in 1999, in contrast to the other studies, does suggest that the SOX mandate on audit committee composition may have a beneficial effect on firms' accounting controls. The study does not, however, compare the effect on misstatement and fraud of a majority independent audit committee, compared to a fully independent committee, as was done in the previously discussed studies (because the authors' objective was to evaluate the Blue Ribbon Committee recommendation that audit committees should consist solely of independent directors). This omission makes it impossible to determine whether all of the effect on restatement incidence is driven by the presence of a majority of independent directors, such that, had the authors distinguished between the two settings, they would have found that an increase from a majority to a fully independent committee produced no further benefit in incidence reduction in their

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committee with financial expertise, compared to 8 and 10 percent of their respective matches. The firms in the fraud sample were significantly less likely to have an independent audit committee than the firms in the restatement sample, and they were also from earlier years in the sample period.

sample, tracking the other studies' findings.

In another take at the relation between audit committees and fraud, Lawrence Abbott, Young Park and Susan Parker create a measure of audit committee effectiveness that combines the independence of the committee with its activity level, and investigate whether that measure reduces the likelihood of fraudulent or misleading financial reporting.[62] Their hypothesis is that audit committee independence will not result in effective monitoring without a minimum level of activity by the committee (meeting several times a year). Controlling for variables thought to increase the probability of fraud,[63] they find that firms with audit committees that meet what they consider to be minimum thresholds of both activity (two meetings a year) and independence were less likely to be sanctioned by the SEC. When only the firms against which the SEC alleged intentional fraud are studied,[64] the audit committee effectiveness variable is only marginally significant (significant at 10 percent). In contrast to Beasley's findings, Abbott and colleagues do not find that an independent board is associated with a reduction in misleading or fraudulent reporting.

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[62] Lawrence Abbott, Young Park and Susan Parker, The Effects of Audit Committee Activity and Independence on Corporate Fraud, 26 Managerial Finance 55 (2000). They construct a matched sample of 156 firms, 78 firms subject to SEC enforcement releases between 1980-96, and 78 control firms that were not.

[63] Control variables related to the opportunity to commit fraud, taken from studies identifying the determinants of financial misstatements, include variables relating to firms' internal control environment (proxied by outside block ownership, board size and independence, presence of an internal audit function, and length of years publicly traded), pressures and incentives (proxied by financial distress, external finance needs and growth rate) and management capacity or CEO dominance (proxied by management voting control, separation of CEO and board chair positions, and whether the CEO is the founder of the company).

[64] This subsample consists of 43 firms.

Compared to other studies in the literature, however, the research design in the Abbott et al. study is not useful from the perspective of evaluating SOX's mandate. Because the statistical analysis does not separate out the effect of audit committee independence and activity and tests only their joint presence, one cannot ascertain whether it is the composition of the committee, or its activity level, or an interaction effect in which both committee characteristics are equally important, that is driving the association between the variable measuring audit committee effectiveness and the presence of accounting fraud. This concern is particularly troubling because the study by Chtourou et al., which found no impact from 100 percent audit committee independence, also found that a variable for an active committee (more than two meetings a year) was positively related to (that is, increased the probability of) earnings management, but an interaction variable between the independence and activity variables reduced the occurrence of earnings management, suggesting that it is committee activity in conjunction with independence, and not independence alone, that matters.[65] In addition, the insignificance of the board composition variable in the Abbott et al. study suggests further that the statistical significance of the measure of audit committee effectiveness is being driven by the audit committee's activity rather than its composition.[66]

Two remaining studies using fraud or reporting problems as the performance measure offer support for the SOX perspective on audit committee independence, but the findings are problematic given the limitations of the statistical analysis. Mark Beasley and colleagues

[65] Chtourou et al., supra note 43, at 24.

[66] The Chtourou et al. study, which separately examined independence and activity effects, also found the independence of the full board to be unrelated to earnings management.

examine audit committee characteristics in relation to financial statement fraud in different industries.[67] While the type of accounting fraud varied systematically by industry, the impact of governance features did not. Beasley and colleagues find that, compared to an industry benchmark of firms of comparable size, the fraud firms are less likely to have audit committees comprised of solely independent directors,[68] as well as boards with a majority of independent directors. A study by Dorothy McMullen and K. Raghunandan, which compares the composition of the audit committee of firms experiencing financial reporting problems to firms without such problems, similarly finds that the problem firms are less likely to have fully independent committees, and they were also less likely to have a director with accounting expertise on the audit committee.[69]

However, in contrast to the studies discussed earlier, both the Beasley et al. and McMullen and Raghunandan studies' statistical analyses consist solely of univariate comparison

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[67] Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson and Paul D. Lapides, Fraudulent Financial Reporting: Consideration of Industry Traits and Corporate Governance Mechanisms, 14 Accounting Horizons 441 (2000). They study three industries: technology, health care and financial services. The sample consists of 66 firms against whom the SEC alleged fraudulent financial statement reporting from 1987-97. The corporate governance data for those firms are compared to industry benchmarks obtained from a survey by the National Association of Corporate Directors.

[68] The difference was only marginally significant at 10 percent in one industry, the health care sector.

[69] Dorothy A. McMullen and K. Raghunandan, Enhancing Audit Committee Effectiveness, 182 J. of Accountancy 79 (1996). The study compared the committees of 51 firms that were the subject of SEC enforcement actions or had material restatements of quarterly earnings pre-1989, to a random sample of 77 firms with no such reporting problems. The univariate comparisons are 2/3 of the problem firms had solely independent audit committees and 6 percent had a financial expert on the committee compared to 86 and 25 percent of the control firms, respectively.

tests. It is therefore possible that the significant difference in committee or board composition would not hold up if other firm characteristics, including variables associated with the opportunity for committing fraud used in other studies, were included in the analysis. That is, there is a well-founded concern that the results of these studies are not robust. Studies using more sophisticated multiple variable analysis often find that univariate differences do not hold up after controlling for variables affecting governance and performance.[70] A further difficulty with drawing inferences from the McMullen and Raghunandan study is that they appear to have adopted an unsatisfactory definition of director independence, referring solely to employment by the issuer.[71]

Hatice Uzun, Samuel H. Szewczyk and Raj Varma examine the effect of board composition with a broader definition of fraud beyond financial misstatements (harm to shareholders): cheating on third party or government contracts (such as overcharging) and regulatory violations, including, among others, pollution, employment discrimination and antitrust law violations.[72] Comparing the governance characteristics of firms accused of any of

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[70] For a striking textbook example of how an omitted variable can bias results, that moves from a single to a multiple variable analysis, see William H. Greene Econometric Analysis 334-36 (4th ed. 2000) (showing bias in price elasticity produced when demand is estimated without controlling for income).

[71] They do not provide a definition of independence but in interpreting their results they state that "it is possible to speculate that financial reporting problems are less likely when audit committees consist solely of outsiders who are not employees of the company." McMullen and Raghunandan, supra note 69, at 80.

[72] Hatice Uzun, Samuel H. Szewczyk and Raj Varma, Board Composition and Corporate Fraud, 60 Fin. Analysts J. 33 (May/June 2004). The sample consists of 133 firms accused of fraud from 1978-2002, and 133 firms, matched by industry and size, that were not accused of fraud over those years. The most frequent type of frauds in the sample fell into the regulatory violation (43) and government contract (38) categories.

those types of fraud to firms that were not so accused, they find that the percentage of affiliated ("grey") directors on the audit committee is positively associated with being accused of fraud. The percentage of outside directors (which includes grey directors) was insignificant. It is curious that they estimate the impact of affiliated directors rather than the impact of the proportion of truly independent directors, on the presence of fraud, as that is the approach of other researchers, and it is presumably the variable of greatest interest. The result on affiliated directors provides only indirect support for SOX's mandate of fully independent audit committees, since it suggests that the less-independent the audit committee, the higher the probability of a fraud allegation (of course, this does not prove that non-independence is associated with actual fraud, as the data set does not distinguish between true and false or unproven allegations). Because of the different independence variable, and the aggregation of disparate types of fraud accusations which prevents a separate analysis of the effect of governance on financial statement fraud, the source of the corporate misconduct in the scandals leading to SOX,[73] their analysis is not comparable to that of the other studies nor directly probative on the plausibility of the SOX prescriptions.

Two remaining studies take somewhat different tacks in examining the efficacy of independent audit committees. Andrew Felo, Srinivasan Kristhnamurthy and Steven Solieri examine financial analyst's scores of the quality of firms' financial reporting ("AIMR scores"), in

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[73] The reason the study combines the disparate fraud accusations is, in all likelihood, to obtain a sufficient number of observations for reliable statistical testing, as only 21 percent of the sample (28 firms) were alleged to have engaged in a financial reporting fraud.

conjunction with audit committee characteristics.[74] Felo and colleagues analyze the relation between the AIMR score and the composition of the audit committee along two dimensions, director independence and expertise.[75] They find that a company's AIMR score is positively related to the proportion of financial experts on the audit committee in one of two sample years,[76]

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[74] Andrew J. Felo, Srinivasan Kristhnamurthy and Steven A. Solieri, Audit Committee Characteristics and the Perceived Quality of Financial Reporting: An Empirical Analysis (manuscript April 2003). The study consists of a sample of firms from the financial reporting quality database of the financial analyst's organization, the Association for Investment Management and Research (AIMR), 119 firms from 1992-93 and 130 firms from 1995-96. The AIMR evaluates the quality of firms' financial reporting on three dimensions: annual published information (mandatory disclosures); quarterly and other published information (voluntary disclosure) and information provided through investor relations programs (which category includes evaluating such items as the helpfulness of the firm's contact person, interviews with firm personnel, and presentations to analysts). The scoring is done by separate industry subcommittees of analysts. As is common in the literature using AIMR rankings for statistical analyses, Felo and colleagues adjust the sample firms' scores for their industry (that is, they subtract the industry average score from the firm's score, and then divide by the industry average), to account for the fact that some industries have more difficult reporting issues that result in overall lower quality scores than other industries. An earlier study examining audit committee independence and AIMR scores did not make such an adjustment. In that study, a sample was constructed consisting of the firms in the highest and lowest quartiles of AIMR scores of the seven largest industries in the 1988-89 survey (82 firms), and of firms in those same industries in the highest and lowest quartiles in 1992-93 (69 firms). Wright, supra note 60. The study found that committee independence was significantly associated with higher scores in one of the two years. Because the scores were not adjusted by industry, one cannot ascertain whether the finding is due to certain industries being clustered in the one of the two quartiles, given their complexity, and the committee structures of that industry differing systematically from those industries clustered in the other quartile. See, e.g., Stuart L. Gillan, Jay C. Hartzell and Laura T. Starks, Industries, Investment Opportunities, and Corporate Governance Structures. University of Delaware College of Business & Economics Center for Corporate Governance Working Paper No. 2002-003 (2003) (governance characteristics vary with industry). As a consequence, Wright's study is not included in Table 2.

[75] On average, 73 percent of the sample firms' audit committee members are financial experts, and over 74 percent of their audit committee members are independent. But only 30 (35) percent of the firms have an audit committee comprised solely of independent directors in 1992-93 (1995-96).

[76] The year in which the result is significant is the later year, 1995-96.

whereas the proportion of independent directors on the committee, or on the full board, has no relation to the score.

If expertise is defined solely as having an accounting background, then the relation between score and committee expertise is insignificant. This result may be a function of the small number of directors with accounting, as opposed to financial, experience. But it may also indicate that either type of background (finance or accounting) makes for an effective audit committee member. Whichever the explanation, this finding suggests a further irony of SOX; while Congress left the definition of financial expertise to the SEC, it suggested that it be defined in terms of accounting.[77] However, it should be noted that Mark DeFond and colleagues examined stock market reactions to the announcement of newly appointed independent audit committee members with expertise, and found a significant positive reaction only to directors with accounting expertise, as opposed to those who would qualify as experts under a broader definition.[78] While this suggests that Congress' approach to expertise was in accord with investor perceptions of what enhances corporate performance, DeFond and colleagues further found that the effect was present only for firms that already had in place strong (high quality) corporate governance (as measured by an index evaluating the level of firm takeover defenses)

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[77] In implementing Congress' instructions requiring disclosure of audit committee experts, the SEC backed off from a proposed definition of expertise restricted to accounting experience, in keeping with the statutory language, to a broader definition after having received much public commentary objecting that a restrictive definition would unduly limit the pool of qualified directors. SEC, Final Rule, Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg 5110 (Jan. 31, 2003). It should be noted that in their pre-SOX listing requirements, the stock exchanges defined expertise for audit committee service more broadly than a knowledge of accounting, as emphasized in SOX.

[78] Mark L. DeFond, Rebecca N.Hann and Xuesong Hu, Does the Market Value Financial Expertise on Audit Committees of Boards of Directors (manuscript 2004).

prior to the director's appointment. That undercuts any inference that mandating such expertise would benefit all firms, as it appears to complement, not substitute, for a firm's quality of corporate governance.

The second study that takes a different tack to studying audit committee independence, by Kirsten Anderson, Daniel Deli and Stuart Gillan, examines the stock market reaction to unexpected earnings announcements (earnings informativeness) in relation to audit committee independence and other corporate governance characteristics (board independence and the separation of the position of chairman and chief executive officer).[79] Anderson and colleagues hypothesize that firms with higher quality corporate governance (more independent audit committees and boards) should have more informative earnings and therefore higher stock market responses to unexpected earnings (because the market has a better fix on those firms' expected earnings). They find that board independence is significantly related to the information

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[79] Kirsten L. Anderson, Daniel N. Deli and Stuart L. Gillan, Boards of Directors, Audit Committees, and the Information Content of Earnings, University of Delaware Weinberg Center for Corporate Governance Working Paper No. 2003-04 (2003). The relation between abnormal stock returns and unexpected earnings (the difference between announced earnings and expected earnings) is referred to as the earnings response coefficient, and is considered to be a measure of the information content or informativeness of a firm's earnings. Anderson and colleagues consider this variable a better test of the concerns expressed in SOX regarding the quality of financial information being provided to investors than the abnormal accrual measures used in other studies for two reasons. First, by not focusing on the quality of a firm's earnings they avoid the problems entailed in properly measuring abnormal accruals, and second, they contend that low quality earnings may still be informative of a firm's underlying value (even if unrelated to the firm's cash flows) and the "central issue" for accounting numbers is how well they inform the market about a firm's financial condition, "irrespective" of the quality of a firm's earnings. Id. at pp. 3-4. The sample consists of 1,241 firms that held annual meetings in 2001; as the sample was obtained from the Investor Responsibility Research Center's database, it consists of the larger, and more widely followed public corporations. The mean (median) proportion of independent directors is 63 (67) percent and the mean (median) proportion of independent audit committee members is 88 (100) percent.

content of earnings but audit committee independence is not; audit committee independence is significantly related to the market response to earnings in only one formulation when board composition is omitted from the regression model.[80] Anderson and colleagues speculate that the lack of an incremental effect from audit committee independence compared to board independence may be due to non-independent directors' having expertise that is valuable for audit committees (for example, former insiders would be knowledgeable about the firm's financial reporting systems and internal controls and hence better able to ask "the right" question than outside directors).

The compelling thrust of the literature on the composition of audit committees, in sum, does not support the proposition that requiring audit committees to consist solely of independent directors will reduce the probability of financial statement wrongdoing. Not only is that the case for the overwhelming majority of studies, but also, and more important, that is so for the studies using the more sophisticated techniques. It should be noted that using conventional confidence standards with properly specified statistical tests, false positives – statistically significant results – can be expected 5 percent of the time, even though there is no significant relation between variables. Indeed, a commonly expressed concern regarding literature reviews that is not applicable to these data is that significant results are overstated because papers finding

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[80] They also do not pick up a nonlinear effect from audit committee independence as was found in the Klein study, but they model the effect somewhat differently than she does, by adding a square term. This is a standard way to test for a nonlinear effect. It does not, however, directly test whether there is a different impact of 100 percent independent committees, which is what Klein tests through separate regressions with different audit committee variables, a dummy variable for 100 percent independence, a dummy variable for majority independence, and a continuous variable for the percent independent. In this regard, they are not replicating Klein's analysis, but that may not matter much for comparative purposes, as they do not identify an effect for the percent independence variable (their linear term).

insignificant relations between the variables of interest typically do not get published in academic journals (the "file-drawer problem").[81] In the audit committee literature, the finding of insignificance was considered important enough by journal editors to merit publication, and it is easier to grasp that the significant results in a small number of papers are likely to be the product of random error.

Some data, moreover, suggest that it might be more efficacious to have a committee member with financial or accounting expertise than to have all independent members, in order to reduce financial misconduct. It is ironic, however, that Congress followed the conventional securities law approach to director expertise rather than independence: it required firms to disclose whether there were such members serving on the audit committee and to provide an explanation for the absence of any such members. Independence, not expertise, was mandated. In this respect, Congress would seem to have gotten the requirement of disclosure versus mandates precisely backwards, if its goal in overriding state corporate law regarding board committee organization was to benefit shareholders. It does not follow, however, that a federal mandate of expert directors is the solution, not only because the data are mixed and the benefit of expertise may depend on firms' other governance characteristics: it would also be largely beside the point as director expertise is already a stock exchange listing requirement.[82]

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[81] See, e.g., Stanley, supra note 22, at 146.

[82] The stock exchanges' audit committee rules that were in place pre-SOX required financial literacy of all audit committee members and accounting or finance expertise of one member. E.g., NYSE Listing Manual 303.01(B)(2)(b) and (c). It should be noted that flexibility was an important component of the exchanges' approach: for example, the New York Stock Exchange rule left the definition of expertise and literacy to the board of directors. Id. A stock exchange is a more appropriate locus of authority for such requirements as it is capable of moving far more rapidly than Congress, should the business environment change and necessitate

B. Provision of Non-Audit Services

1. Statutory mandate

Section 201 of SOX prohibits accounting firms from providing a list of specified non-audit services to firms that they audit.[83] The banned services include financial information system design and implementation, appraisal or valuation services, internal auditing services, investment banking services, legal and expert services unrelated to the audit, brokerage services, and actuarial services. Although this provision is included in SOX's cluster of provisions directed at the accounting profession, it is, in fact, a substantive corporate governance mandate. Congress is substituting its judgment for corporate boards, or shareholders, regarding what services they can purchase from their auditor.

Under state law, the board of directors, or its delegate, such as the audit committee, is deemed the appropriate locus of authority for determining what services, and from what source, a corporation purchases. No ex ante restrictions are imposed on the board's authority to act regarding accountants' services; it is instead subject to liability for wrongful decisions under fiduciary standards, which are enforced ex post.

In 2000, the SEC required registrants to disclose the amounts paid to auditors for audit and non-audit related services, and some non-audit services were identified as compromising the auditor's independence and therefore prohibited (as the securities laws require issuers' financials

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adjustment in the expertise requirement. The SEC's implementation of SOX in which it defined audit committee expertise presumably will preempt that flexible component of the exchange rule. Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Rel. No. 33-8177, 68 Fed. Reg. 5110 (2003) (codified at 17 C.F.R. parts 228, 229 and 249).

[83] Codified as §10A(g) of the Securities Exchange Act.

to be certified by independent auditors).[84] This outcome was the best that then SEC chairman, Arthur Levitt, could obtain, after a multi-year effort in which he failed to generate sufficient political support for a total ban on the provision of non-audit services by auditing firms. A further factor in Levitt's settling for a more limited ban than he originally sought was that the Administration was about to turn over and his term as chairman would therefore soon end (the compromise was reached and the rule issued in November 2000).[85] The compromise was not due to Levitt's being a political novice or inept: he skillfully used the media in the debate over the auditor independence rule to undermine the private sector entities he had established to study and regulate auditor independence (the Independence Standards Board and the Panel on Audit Effectiveness), when it became evident that they would not recommend restricting non-auditing services.[86]

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[84] Auditor Independence Rule, supra note 5. Two services that the SEC had proposed to ban but had been unable to include in the final rule because of significant opposition (financial information system design and implementation and internal audit outsourcing) were included in the SOX prohibition. Of the nine services prohibited in the rule, seven were already restricted under professional rules of conduct promulgated by the American Institute of Certified Public Accountants (AICPA) and SEC guidelines.

[85] See Sandra Sugawara, Accounting Firms, SEC Agree on Audit Rule, Washington Post, Nov. 15, 2000, p.E01 (reporting compromise reached over "controversial" rule that Levitt "has been pushing to get enacted before the end of the Clinton Administration.")

[86] See Zoe-Vonna Palmrose and Ralph S. Saul, The Push for Auditor Independence, Regulation, Winter 2001, 18, 22 (members of the Panel on Audit Effectiveness recount how Levitt used the press to generate public support for his position and to counter findings by the Panel and the Independence Standards Board that there was a lack of evidence of a problem regarding non-audit services). The Panel on Audit Effectiveness (also referred to as the O'Malley Panel after its chairman) was appointed to review the audit process by the Public Oversight Board for accountants at the request of SEC Chairman Arthur Levitt, in his effort to prohibit non-audit services, at the same time that he requested the stock exchanges to appoint a Blue Ribbon Committee to undertake a similar review. The Public Oversight Board is an independent self-regulatory organization, that was created by the accounting profession to oversee the auditing

Levitt was able to advance once again his agenda of a total ban on the provision of non-audit services by auditors when the accounting profession landed in Congress's cross hairs with the apparent involvement in Enron's financial statement fraud of its auditor, Arthur Andersen. Levitt and his former chief accountant, Lynn Turner, displayed the skills of expert legislative-agenda-setting entrepreneurs: through testimony during the legislative hearings on Enron (and additional off-stage communication, including considerable media exposure), they were able to link the scandal with Levitt's position on auditors' provision of consulting services and with the accounting profession's successful opposition to his agenda to ban such services while SEC Chairman. Members of Congress who had supported the accounting industry against Levitt's efforts to ban non-audit services in the rule-making process less than two years earlier, hastily abandoned that position in the aftermath of Enron.[87] Levitt is widely credited as the driving force behind the enactment of the non-audit services provision.[88]

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process. See, e.g., Senate Hearings, supra note 40, at 71 (prepared statement of David S. Ruder).

[87] E.g., Senate Hearings, supra note 40, at 1061 (Mar. 21, 2002) (Sen. Bunning) ("I was one of those who urged [SEC Chairman Levitt] to slow down a little on the auditor independence issue. I thought he was trying to ram a major rule through and taking side in an industry fight without the proper vetting. Though I still think that we were moving just a little too fast at the time, I think that we must have a true auditor independence. Although the firms have split off their consulting arms, we should codify that split into law. If you audit someone, you should not be able to do their business consulting.")

[88] E.g., Michael Schroeder, Arthur Levitt Finds Himself on the Outs, Wall St. J., Nov. 29, 2002, A4 (noting Levitt's "strong role in formulating" the accounting provisions, and that his former staff helped Democrats draft their bills); The Enron Collapse: Implications to Investors and the Capital Markets, Hearings before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the House Comm. on Financial Services, 107th Cong., 2nd Sess. 19 (Serial No. 107-51 Pt. 2) (Feb. 4, 2002) (hereafter Enron Hearings II) (Rep. LaFalce) (urging consideration of Levitt's recommendations); H.R. 3763-The Corporate and Auditing, Accountability, Responsibility and Transparency Act of 2002, Hearings before the House Comm. on Fin. Services, 107th Cong. 2d Sess. 163 (Serial No. 107-60) (Apr.9, 2002) (hereafter House

2. Studies of the Provision of Non-audit Services

Because the provision of non-audit services by auditors had been subject to persistent effort at elimination by the SEC prior to SOX's prohibition, numerous studies have sought to gauge whether the use of consulting services by the external auditor compromises audit quality (the rationale advanced for banning the practice). The most frequent variables used to measure the importance of non-audit services to the auditing firm are the fee ratio (the ratio of non-audit to total fees or to audit fees paid to the external auditor) and total fees (the sum of non-audit and audit fees paid to the external auditor); other measures investigated are the absolute dollar amount of non-audit and audit fees, varieties of the fee measures that adjust the amounts by client to construct a proxy for the client's importance to the auditor, and percentile ranks, by auditor, of a firm's non-audit and audit fees.[89] Higher values of these variables are considered to represent a non-independent auditor (that is, the potential for auditor compromise is expected to depend directly on the fees received for non-audit services). Several variables are used to measure audit quality, paralleling the literature on independent audit committees, including abnormal accruals, restatements, and a qualified audit opinion.

The findings of the studies on non-audit services are collected in Table 3. The

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CARTA Hearings) (Rep. LaFalce) (chief accountant under Levitt discussed and approved his bill's provisions).

[89] Because the SEC only recently began requiring disclosure of auditor fees, see Auditor Independence Rule, supra note 5, 65 Fed. Reg. at 76008 (disclosures required in proxies filed after the rule's effective date, Feb. 5, 2001), many of the studies are relatively recent and the data are limited (the earliest available data are expenditures from fiscal year 2000). The SEC required information on auditing and non-auditing fees to be disclosed from 1978-82, and some other countries have required such disclosure for many years. A few studies make use of those alternative data sources.

overwhelming majority (19 of 25) of the studies suggest that SOX's prohibition of the purchase of non-audit services from an auditor is an exercise in legislating away a non-problem. Namely, the overwhelming majority of studies (15) find no connection between the provision of non-audit services and audit quality, one finds no connection when the auditors are the big 5 accounting firms (the firms of concern to Congress in enacting SOX as they audit nearly all large public companies), three even find non-audit services improve audit quality (and two of the 15 finding no relation find audit quality improves in at least one model specification), while five find audit quality is compromised and one finds audit quality is compromised in one of several model specifications. But as will be discussed, the results of two of the studies finding audit quality is compromised are not robust.

The absence of a systematic inverse relation between non-audit services and audit quality in the literature is consistent with the Panel on Audit Effectiveness's failure to identify a single instance of a compromised audit by auditors providing non-audit services in its field study of auditor independence.[90] That finding no doubt contributed to the Panel's conclusion, as well as

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[90] The Panel conducted in-depth reviews of the quality of 126 audits of public firms conducted by 28 offices of the eight largest audit firms; in 37 of these engagements (29 percent) the auditor also provided a non-audit service other than tax work. Public Oversight Board, Report and Recommendations of the Panel on Audit Effectiveness 3, 113 (2000). The reviewers identified no case of a negative impact on the audit's quality and concluded that in one-quarter of the cases the non-auditing services had a positive impact on the effectiveness of the audit. Id. at 113. While the report of the Panel on Audit Effectiveness therefore found no evidence that non-audit services impaired independence in fact, it noted that "many people" perceived that such services impaired independence. Id. The studies discussed in this section examine whether independence is impaired in fact. A few studies have been directed at the issue of perception: working from the premise that a high ratio of non-audit fees creates an appearance of non-independence, such studies examine the hypothesis that firms will alter their behavior to mitigate the perception of non-independence. In support of that hypothesis, studies have found that firms that are more likely to have agency problems (measured by insider ownership) had lower fee ratios for non-audit services. Mohinder Parkash and Carol F. Venable, Auditee Incentives for

that of the Independence Standards Board, to not recommend banning the provision of non-audit services and to opt instead for bolstering the audit committee function by proposing that audit committees be composed of independent, and financially literate, directors.

a. Studies of Discretionary Accruals

One of the first studies on non-audit services to use the newly disclosed auditor fee data in 2000 was by Richard Frankel, Marilyn Johnson and Karen Nelson.[91] Frankel and colleagues examined the impact of non-audit services on two measures for biased financial reporting or earnings management, the magnitude of discretionary accruals (nondirectional and directional accruals) and the likelihood of meeting earnings benchmarks (analyst forecasts), as measured by

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Auditor Independence: The Case of Nonaudit Services, 69 Accounting Rev. 113 (1993); Michael Firth, The Provision of Nonaudit Services by Accounting Firms to their Audit Clients, 14 Contemporary Accounting Res. 1 (Summer 1997). The idea is that such firms have to provide more credible assurance of independent audits; the authors interpret the data as showing that managers voluntarily manage the purchase of non-audit services because they recognize the potential for a perception of independence impairment. Another study hypothesizes that managers and auditors of firms with high fee ratios will be more conservative in applying generally accepted accounting principles to avoid litigation and regulation costs. Stacie O. Kelley, D. Shores and Yen H. Tong, Independence in Appearance, Earnings Conservatism and Prediction of Future Cash Flows (manuscript 2003). The authors derive that hypothesis from two claims, that litigation and regulation are more likely when earnings are overstated, and that high fee ratios are likely to increase investors' and regulators' scrutiny of the auditor-client relationship (although they recognize that scrutiny need not result in costly litigation or regulation). In contrast with the other two studies, the idea is that firms engage in adaptive behavior other than adjusting the fee ratio downwards to deal with the perception problem because there are economic benefits from the auditor's joint provision of the services. Consistent with their hypothesis, Kelley and colleagues find, for most years in their sample, that firms with higher fee ratios do follow more conservative accounting practices for reported earnings.

[91] Richard M. Frankel, Marilyn F. Johnson and Karen K. Nelson, The Relation between Auditors' Fees for Nonaudit Services and Earnings Management, 77 Accounting Review 71 (Supp. 2002). The study's sample is composed of 3,074 firms; for the earnings test the sample is reduced to 2012 firms. The mean fee ratio is .49.

earnings surprises and small earnings increases.[92] The analysis includes controls that could affect the incentives or opportunity to engage in earnings management, such as institutional ownership, acquisition activity, and previous poor performance.

Frankel and colleagues found that the fee ratio and percentile ranking of non-audit client fees by auditor were positively related to the magnitude of discretionary accruals (nondirectional and directional)[93] and the presence of small positive earnings surprises but not small earnings increases. In contrast to the results for the fee ratio and non-audit fee ranking, the ranking of total fees was insignificant, while the ranking variable for audit fees was negatively related, to the earnings management variables.[94] Frankel and colleagues concluded that the composition, and

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[92] Frankel and colleagues use the absolute value of the accruals to measure the combined effect of income-increasing and decreasing accruals; these are referred to as nondirectional accruals, that is, the accruals are not distinguished by their sign. They also analyze the data separately for firms with income-increasing and income-decreasing accruals; these are referred to as directional accruals, as they are distinguished according to the accruals' sign. Discretionary accruals are what Klein termed abnormal accruals. Small positive earnings surprises are defined as earnings announcements in which the firm just meets or beats analyst forecasts, that is, annual earnings of zero or one cent higher than the consensus forecast. Small earnings increases are defined as an increase of two cents over the consensus forecast. Frankel and colleagues examine these earnings measures because managers place a premium on making (or just beating) analyst forecasts (they fear a negative stock price reaction if an earnings forecast is missed), and thus firms with such earnings results may have engaged in accounting manipulations to achieve them.

[93] To be precise, the positive discretionary accruals are positively related to the fee measures, and the negative ones are negatively related (which is equivalent).

[94] William Kinney and Robert Libby contend that these results are inconsistent with Frankel et al.'s theory of the relation between an auditor's economic dependence on a client and audit impairment (because their theory provides no justification for considering only higher non-audit fees, as opposed to higher audit fees, as creating the economic bond diminishing auditor independence, nor does their theory suggest the economic loss resulting from client departure would not be measured by total fees), and consequently they consider interpretation of the study's results problematic. William R. Kinney, Jr. and Robert Libby, Discussion of The Relation between Auditors' Fees for Nonaudit Services and Earnings Management, 77 Accounting Review 107, 110, 113 (Supp. 2003).

not the total amount, of compensation paid to auditors affects audit quality, and in particular that higher fees paid for non-audit services compromises audit quality. This is the only study even mentioned by any member of Congress in the congressional debates over, and seventeen hearings leading up to, SOX.[95]

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[95] See House CARTA Hearings, supra note 88, at 90 (Mar. 20, 2002) (Rep. Maloney) (entering in the record an "MIT, Michigan State and Stanford study" "cited in Business Week" that "showed that companies that use their auditors as consultants tend to manage earnings, including moving debt of (sic) the books into partnerships" and "cites that steps need to be taken statutorily.") Rep. Maloney made those remarks in response to testimony of SEC Chairman Harvey Pitt that studies showed that most frauds occur in the first two years of an audit-client relationship, in response to her question whether he supported mandatory rotation of accounting firms. Although the gist of her reference is correct as to audit fees and earnings management, she mis-spoke: Frankel et al.'s study does not examine the use of partnerships to remove debt from the balance sheet. Of 63 witnesses in the 17 hearings held by the House and the Senate committees, only five witnesses referred to any data on the relation between non-audit services and audit quality: one witness, Lynn Turner, the SEC's chief accountant while Levitt was chairman, submitted the Frankel et al. study to the Senate a few days after his testimony to refute what he had noted in his written testimony, that there were those who "have suggested" that there is "no smoking gun that provides a basis for changes in regulation and laws," Senate Hearings, supra note 40, at 302 (submission dated Mar. 1, 2002); another witness, James Copeland, CEO of the big 5 accounting firm Deloitte & Touche, testifying for the AICPA, noted that "several recent studies" had "demonstrated that there is no correlation between the provision of nonaudit services and audit failures" which was referring, as indicated in his submitted written statement, to the findings in the report of the Panel on Audit Effectiveness and the DeFond et al. study, note 152 infra, id. at 822, 864 (Mar. 14, 2002); the third witness, who testified to the House, James Glassman, a fellow at the American Enterprise Institute, cited the article by Palmrose and Saul, supra note 86, who were members of the Panel on Audit Effectiveness, as indicating that "the issue of auditor independence had been extensively studied with almost no empirical evidence of abuse," House CARTA Hearings, supra note 88, at 12 (Mar. 13, 2002). In addition, the chairman of the Panel testified in the Senate and summarized its findings (no instances of non-audit services affecting audits or impairing audit performance but survey indicated there was a perception that it did so). Senate Hearings, supra note 40, at 683 (Mar. 6, 2002) (statement of Shaun F. O'Malley, Chairman, Panel on Audit Effectiveness and former Chairman, Price Waterhouse). Finally, the fifth witness testified that his opinion in support of a prohibition was not "based on empirical evidence." Id. at 687 (Lee J. Seidler, deputy chairman 1978 AICPA Commission on Auditors' Responsibilities). He referred in his written statement to the fact that for both the Panel report and his commission's study, "theory was not supported by empirical evidence," but contended that those entities improperly viewed the issue by considering consulting work and not consulting fees as the source of the problem. Id. at 733-34. That is a

Two other studies report similar results to Frankel and colleagues. A study by Carol Dee, Ayalew Lulseged and Tanya Nowlin found a positive relation between discretionary accruals (using the level, rather than magnitude, of the accruals as the dependent variable) and the fee ratio, and no relation with total fees.[96] So does a study by Michael Ferguson, Gim Seow and Danqing Young, using current working, rather than total, accruals, for the discretionary accrual calculation.[97] Ferguson and colleagues investigate, in addition to the fee ratio, non-audit service fees and the decile ranking of non-audit service fees by the accounting firms' regional office (they do not examine total fees). The other measures of non-audit services are also positively associated with discretionary accruals. Ferguson and colleagues also examine two other measures of audit quality, a dummy variable for news reports indicating analysts' criticism of a

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rather puzzling objection. If there was no instance in which an auditor provided consulting services that resulted in a compromised audit quality, then the distinction is without a difference: regardless of fee size, auditors providing consulting services did not compromise their audits. The testimony at the hearings is discussed in part III.C, infra.

[96] Carol Callaway Dee, Ayalew Lulseget and Tanya Nowlin, Earnings Quality and Auditor Independence: An Examination Using Non-Audit Fee Data (manuscript 2002). The sample consists of 203 firms from the S&P 500. The average fee ratio of the study is a higher .66 than that of other studies, presumably because the sample firms are large. In contrast to Frankel and colleagues, Dee and colleagues focus on directional (level), rather than absolute value, accruals, on the view that the earnings management concern is directed at income-increasing, rather than income-decreasing, activities. Because the specification of the model is similar to that of Frankel and colleagues, the refinements of the Frankel et al. model in the studies discussed in the text that find no relation between accruals and non-audit services fees, raise similar concerns regarding the Dee et al. study.

[97] Michael J. Ferguson, Gim Seow and Danqing Young, The Effect of Nonaudit Services on Earnings Management: Evidence from the U.K. (manuscript 2003). The sample consists of 610 U.K. firms. The study uses data for the firms averaged over three years, 1996-98. Ferguson and colleagues use working capital accruals on the view that they are more likely to be used to manage earnings than other components of discretionary accruals. Id. at 13. They average the data over several years on the view that use of mean non-audit services fees "better captures the recurring level" of such fees, which "presents the greatest threat to audit quality." Id. at 4.

firm's accounting practices as improper or aggressive or a regulatory investigation into a firm's accounting practices; and a dummy variable indicating that in 1999 the firm restated prior earnings or adjusted current earnings to conform with a change in U.K. accounting rules for contingent liabilities, intended to eliminate what were considered abuses of provisioning for the purpose of earnings management.[98] These variables are also positively associated with the non-audit service fee measures, with the exception that the decile ranking is not significantly related to the news report dummy.

The Frankel et al. study, as it was the initial study on the issue of non-audit services after the SEC rule change, was the subject of substantial scholarly attention and refinement, and that research suggests that its findings are not robust. In particular, Hollis Ashbaugh, Ryan LaFond and Brain Mayhew redid the analysis in the Frankel et al. study by adding controls for firm performance in the estimation of the earnings management measure.[99] The adjustment for performance was undertaken out of the concern generated by more recent research indicating that estimating discretionary accruals without controlling for performance biases results (because prior performance affects total accruals, failure to take performance into account results in statistical tests rejecting too frequently the null hypothesis of no earnings management).[100] When

[98] The rule change sought to prevent " the practice [that] has grown up of aggregating liabilities with expected liabilities of future years, . . . the effect of [which] . . . has been not only to report excessive liabilities at the outset but also to boost profitability during the subsequent years." Id. at 22 (quoting from the release relating to the rule change).

[99] Hollis Ashbaugh, Ryan LaFond and Brain W. Mayhew, Do Nonaudit Services Compromise Auditor Independence? Further Evidence, 78 Accounting Review 611 (2003). The study sample consists of 3,170 firms and the mean fee ratio is .47.

[100] Id. at 612.

the estimate of discretionary accruals is adjusted for performance, Ashbaugh and colleagues find that there is no longer a significant positive relation between the fee ratio (or any other metric of auditor fees, including total fees) and positive (that is, income-increasing) discretionary accruals. Ashbaugh and colleagues conclude that measurement error in the Frankel et al. study explains the difference in results.[101] As the only evidence of a significant association between the fee ratio and discretionary accruals is for the subset of income-decreasing ones, they conclude that it is those accruals that drives the unsigned accrual results in the Frankel et al. study (which they replicate). Because income-decreasing accruals may indicate conservative accounting practices, rather than biased reporting from opportunistic manipulation of accounting principles, the authors do not consider the data as providing evidence of low quality audits of the sort of concern to regulators and legislators.[102]

In keeping with the Frankel et al. study, Ashbaugh and colleagues find no relation between total fees and meeting the earnings benchmark, and a negative relation between total fees and reporting small increases. They also find no relation between fee ratios and firms' meeting analyst forecasts or the likelihood of reporting small earnings increases. They are unable to provide an explanation for the disparate result across the two studies regarding a relation between non-audit fees and earnings surprises.[103] Accordingly, they conclude, in contrast to

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[101] Id. at 612. The reason for this interpretation is that a further analyses of the results show that the measurement error in the estimate of the income-increasing accruals that is "caused by not controlling for firm performance" is correlated with the fee ratio.

[102] Id. at 613.

[103] The only difference in the model is that Ashbaugh and his colleagues eliminate the control variables that Frankel and his colleagues reported were insignificant, and they controlled for discretionary accruals. But if they exclude the control for discretionary accruals, their result

Frankel and colleagues, that there is little evidence that the provision of non-audit services compromises auditor independence.

The findings of another recent study, by Hyeesoo Chung and Sanjay Kallapur, are also at odds with the Frankel et al. study.[104] Chung and Kallapur examine whether auditor independence is compromised by non-audit services, using discretionary accruals as the measure of audit quality. But their measure of auditor independence differs from the other studies, in that they measure the client's importance to the auditor by calculating the ratio of non-audit service fees, and of total fees, to the auditor's total U.S. revenue. Chung and Kallapur find no significant relation between abnormal accruals and either measure of client importance. They also develop estimates of client importance at the local practice office, and those measures are, as well, not related to abnormal accruals.[105] The result of no effect further holds up when they control for clients' incentives to manipulate earnings (proxied by high leverage and high market to book ratios, among other variables), for their opportunities to manage earnings (proxied by business and geographical segment diversification data), and for the quality of their corporate governance (measured by board independence and separation of the CEO and board chairman and outside blockholders). Finally, they provide an analysis of the power of the statistical tests, which

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that the fee ratio does not explain earnings surprises, is unchanged. Id. at 631.

[104] Hyeeso Chung and Sanjay Kallapur, Client Importance, Non-Audit Services, and Abnormal Accruals, 78 Accounting Review 931 (2003). The sample consists of 1,871 clients of big 5 accounting firms.

[105] For these measures, they assume clients are audited by the audit practice office closest to the client's headquarters, and allocate audit firm revenues to practice offices in proportion to the sum of log(sales) of each office's clients. Id. at 932. The sample for local office influence estimates consists of 1,778 firms.

indicates that the failure to find a significant relation between abnormal accruals and the client importance measures is not due to a low power of the tests.

Chung and Kallapur prefer their measure of client importance as a measure of auditor independence to a fee ratio because using a ratio as a measure of independence implies that an auditor's independence is equally impaired by a company paying an audit fee of $100,000 and non-audit fees of $200,000 and a company paying an audit fee of $1,000,000 and non-audit fees of $2,000,000.[106] They rightly consider that scenario implausible. But they also estimate the impact on discretionary accruals of the fee ratio for the firms in their sample. Chung and Kallapur can replicate the finding of a positive relation between independence, as measured by the fee ratio, and abnormal accruals in the Frankel et al. study if they eliminate the industry effects from the model. When they control for industry, the relation is no longer significant.[107] Further analysis partitioning the sample firms by size indicates that the statistical significance is driven by the smallest group of firms. There is no relation between the fee ratio as calculated by Frankel and colleagues and abnormal accruals for the groups of large and medium sized firms. Chung and Kallapur view this as convincing evidence that non-audit services do not compromise audit quality for, they contend, if independence impairment is a function of the ratio, then it

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[106] The numerical example is from their working paper version, Hyeesoo Chung and Sanjay Kallapur, Client, Importance, Non-Audit Services, and Abnormal Accruals 17-18 (manuscript 2001); that example was replaced by reference to actual audit and non-audit fees paid by Arthur Andersen clients in the published version, see Chung and Kallapur, supra note 104, at 948. I have retained the illustrative, rather than actual, fee example, for the sake of clarity.

[107] Further analysis shows that the result is driven by three industries (using two-digit SIC codes, two manufacturing sectors and business services including advertising, software and data equipment), which have both high abnormal accruals and high fee ratios; when firms in those industries are eliminated from the analysis, the relation between the fee ratio and abnormal accruals is insignificant, without including industry dummies. Id. at 950.

should be more likely to occur with the largest, rather than smallest firms (that is the point of the numerical example used to emphasize why it is preferable to use a client importance measure of independence).

A third recent study, by Jere Francis and Bin Ke, casts further doubt on the findings in the Frankel et al. study.[108] Francis and Ke also examine whether auditor independence is compromised by non-audit services, using the earnings benchmark (analyst forecast) measure of audit quality. They contend, however, that the Frankel et al. study, as well as the Ashbaugh et al. study, have not properly specified the dependent variable, the earnings surprises benchmark that is used as one of the proxies for audit quality, because those studies include large negative earnings surprises in their zero coding category. Francis and Ke note that the research motivating the formulation of earnings management with respect to earnings surprises used by the Frankel et al. study was based on the distributional anomalies for forecast errors for firms with zero and small positive earnings surprises, or small negative and large positive earnings surprises, but not large negative surprises. Thus, they maintain, inclusion of firms with large negative earnings surprises in the sample coding for earnings mismanagement may introduce unknown biases into the analysis.[109]

In addition to recoding earnings surprises, Francis and Ke also increase the sample size, and hence the power of the statistical tests, by using quarterly, rather than annual earnings.[110]

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[108] Jere Francis and Bin Ke, Do Fees Paid to Auditors Increase a Company's Likelihood of Meeting Analysts' Earnings Forecasts? (manuscript May 2003).

[109] Id. at 3-4.

[110] Their sample consists of 1,588 unique firms with 5,208 firm-quarter observations, in comparison to 2,012 unique firms in the Frankel et al. study and 1,666 unique firms in the

Finally, Francis and Ke test several measures of auditor independence besides the fee ratio emphasized by the Frankel et al. study, to take into account the magnitude of the non-audit service fee, including absolute amounts and percentile ranking of non-audit fees and total client fees in relation to all of the auditors' fees (similar to the client importance measure used in the Chung and Kallapur study). They consider independence measures that take scale into account to be preferable to the fee ratio, as do Chung and Kallapur, since it seems more plausible that economic bonds that would threaten an auditor's independence would arise from the magnitude of the fee received rather than the mix of audit to non-audit fees.

Francis and Ke first examine whether use of quarterly data would alter the analysis of Frankel and colleagues, and find it does not.[111] However, when the earnings benchmark used by Frankel and colleagues is corrected to exclude large negative earnings surprises, then they find no significant relation between the fee ratio and the benchmark. In fact, they suggest that the

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Ashbaugh et al. study, in those studies' analyst benchmark tests. Although only annual earnings are audited, the sum of quarterly earnings filed in interim statements must equal the annual audited earnings. This means that fourth quarter earnings have to be adjusted for misestimations in the prior quarters. Francis and Ke contend that this requirement would constrain managers from flagrantly managing earnings in the interim quarters if auditors are independent: that is, managers will not assume the risk of substantial fourth-quarter earnings adjustments when they know the auditor is an uncompromisingly independent auditor and will insist on adjustments. Francis and Ke therefore consider quarterly earnings data a prime means of testing the auditor independence hypothesis: if fees compromise auditor independence, then firms may more aggressively manage their earnings because they perceive the risk of fourth-quarter adjustment to be small.

[111] They determine that if they use the fee-ratio as defined in the Frankel et al. study as the measure of independence and Frankel and colleagues' definition of the earnings surprise variable, then they obtain the same result with the quarterly data as do Frankel and colleagues with annual data: the fee ratio is positively significantly related to the earnings benchmark, and auditor independence appears to be compromised by provision of non-audit services.

Frankel et al. results are due solely to the inclusion of such firms.[112] Moreover, the result of no relation continues to hold when other measures of auditor independence are used.[113] Their data indicate that the finding in the Frankel et al. study -that nonaudit services may impair auditor independence -- is not robust but rather, is highly sensitive to changes in research design choices. The more robust conclusion from the permutations that they analyze is that there is no systematic evidence that audit quality (measured by clients' ability to manage earnings) and accordingly auditor independence, is compromised by higher fees.

A study by Kenneth Reynolds and Jere Francis, which also reports results inconsistent with the Frankel et al. study but was not formulated as a refinement of that study's analysis, investigates client dependence at the local office level.[114] Reynolds and Francis explore whether

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[112] They run the regressions on their data using several variants of the surprise benchmark and only the series coding large negative earnings surprises as zero results in a significantly positive fee ratio.

[113] They find no relation with a properly coded earnings surprise benchmark with all but one of their alternative measures of auditor independence that take magnitude into effect, and with all six of the measures when they use the Frankel et al. earnings surprise benchmark rather than their preferred benchmark that excludes large negative earnings surprises.

[114] J. Kenneth Reynolds and Jere R. Francis, Does Size Matter? The Influence of Large Clients on Office-Level Auditor Reporting Decisions, 30 J. Accounting & Econ. 375 (2001). The sample consists of 6,747 (4,952 for the test using accruals) firms in 1996 at 499 local offices of big 5 accounting firms. Descriptive statistics provided for the full sample indicate that the local offices had an average of 13.5 clients, and a range of 1-139 clients. Client influence is measured as the log of the sales of the client divided by the sum of the log sales of all of the clients of the office. Client size is used as a proxy for fees because size is known to be highly correlated with audit fees. (The sample time period is prior to the date when the SEC mandated fee disclosure.) In contrast to Chung and Kallapur, who match audit office and client using an office distance algorithm, they collect the actual data that identifies which office audits which firms. (Chung and Kallapur note that when they obtained actual data on offices for a small random sample of 25 firms, 75 percent of their distance matches were correct; Chung and Kallapur, supra note 104, at 936, indicating, in my view, a substantial weakness with their method compared to Reynolds and Francis). Reynolds and Francis also calculate client influence using total sales of the national

a big 5 accounting firm's local office's dependence on a client (its relative size compared to all of the office's clients, which they call the client's "influence") results in lower quality audits measured by increased client discretion as indicated by the amount of discretionary and total accruals.[115] They focus on the local office because they maintain that is the appropriate organizational level to measure auditor independence, since the big accounting firms are decentralized (local offices contract for the audits) and have such immense revenue streams that the loss of one client, no matter how large, would not have any discernible effect on the national firm's cash flow but could have a tremendous effect on the livelihood of the individuals in a local office.

Reynolds and Francis find that relatively larger clients in offices of big 5 firms have lower levels of accruals, which is at odds with the client dependence hypothesis, and indicates that auditors in fact report more conservatively for the larger clients on which they depend more for income (that is, larger clients appear to have less discretion in reporting accruals than smaller ones).[116] They interpret that data as consistent with the hypothesis that accounting firms are more

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firm, rather than of the office, in the denominator; that measure is statistically insignificant in all of the accrual and going concern regressions. This is not surprising from an influence perspective: the individual clients average less than 2/10 of 1 percent of firm-wide audited sales.

[115] They also examine the issuance of going concern reports, as discussed at text and accompanying note 157, infra.

[116] The variance in the accruals is also lower for the larger clients, which is also inconsistent with the hypothesis of more favorable treatment for large clients (client dependence), because firms that make greater use of accounting accruals to manage earnings should, on average, have greater volatility in their accruals (as they are more actively managing earnings up or down to meet annual targets, the variance of accruals should be greater than that for companies less aggressively managing earnings). Reynolds and Francis, supra note 114, at 381.

concerned about reputation loss and litigation costs, which are at greater risk from an audit failure of a large client, than about retaining such a client. In other words, the data suggest that reputation and litigation costs trump fee dependence in auditor decision-making.

Because Reynolds and Francis do not have actual fee data, their study is not a clean test of the SOX independence hypothesis regarding the effect of non-audit services on audit quality. But as fee data indicate that audit and non-audit fees are positively correlated, the study is, in my view, probative on the legislation's premise, and it suggests that its premise is mistaken: financial dependence on clients does not compromise auditor decision-making. In any event, the findings are consistent with those in studies using actual fee data that auditor independence is not affected by receipt of substantial payments for non-audit services, including the Chung and Kallapur study that estimated client importance at the local office as well as the national level.

Another recent study, by Pelham Gore, Peter Pope and Ashni Singh, examines whether controlling for the size of the auditor will identify whether non-audit services threatens audit independence (leads to higher discretionary accruals).[117] Gore and colleagues hypothesize that concerns about audit independence relate to small-sized audit firms, who have more at stake regarding any particular client than large firms. They predict that, especially when fees for non-audit services are high, there will be a lower level of discretionary accruals when there is a big 5

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[117] Pelham Gore, Peter Pope and Ashni Singh, Non-Audit Services, Auditor Independence and Earnings Management, Lancaster University Management School Working Paper 2001/014 (Jan. 2001). The sample consists of 4,779 firm years of U.K. data from 1992-98. Although the SEC required disclosure of audit and non-audit fees only as of 2000, these data have been disclosed in the United Kingdom for over a decade. The dependent variable used by Gore and colleagues is only current accruals, and they include only firms with positive surprises (that is, firms whose nondiscretionary earnings are below basic targets, so that there is only one direction for the sample firms' earnings management, that of overstatement.

auditor than a non-big 5 auditor (that is, there should be a "lower likelihood that auditor independence will be compromised when auditors are larger").[118] The distinction is of interest because U.S. regulators are concerned primarily with the incentives of the big 5 accounting firms, as they audit the vast majority of U.S. public companies, the firms to which the SOX restrictions apply.[119] In fact, many non-big 5 accounting firms have not registered with the new oversight agency created by SOX, which is required to audit a public company.[120]

Gore and colleagues, studying U.K. data, test the hypothesis that auditor size is a factor in audit independence. They produce confirming evidence, that there is a positive relation between abnormal accruals and fees, for small (non-big 5) auditors but not for big 5 auditors. They further find that the extent to which big 5 auditors constrain earnings management more effectively than non-big 5 auditors increases as non-audit services fees increase.[121] That is, there is a negative relation between abnormal accruals and non-audit fees for the clients of the large

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[118] Id. at 7.

[119] In 1999, for example, the big 5 firms audited 76 percent of U.S. public registrants. Appendix B, Public Oversight Board, supra note 90, at 182.

[120] See, e.g., Auditing: The New Untouchable, Business Line, Sept. 4, 2003 (reports by Washington Post and General Accounting Office indicate that many accounting firms are giving up auditing of public companies because of new rules); Carrie Johnson, U.S. Accountants in 2nd Tier Drop Some Audit Work, Wall St. J. Europe, Sept. 2, 2003, M5 (discussing implications of exodus of small firms from auditing public companies due to new rules).

[121] The results regarding the differences for big 5 and non-big 5 auditors are replicated when they examine earnings changes as well as levels. There is no significant difference when they examine earnings surprises; they suggest one possible explanation for the difference is that the sample may be "unrepresentative and lacking in variation" because there are fewer forecasts for firms audited by non-big 5 firms (since analysts typically follow large firms), and, as a consequence, the proportion of non-big 5 firm years in the surprise sample is "unusually low." Gore et al., supra note 117, at 25.

international accounting firms. The implication is that large auditors who provide substantial non-audit services improve, rather than decrease, audit quality.[122] Because large firms audit the vast majority of U.S. public companies, the firms to which the SOX restrictions apply, the data in the Gore et al. study are at odds with the rationale for the SOX ban on non-audit services.

A study by Rick Antle and colleagues further questions the results of the Frankel et al. study relating auditor independence to audit quality, by noting that there is an endogeneity problem with the work of Frankel and colleagues, as well as the studies with contrary findings, in that the studies estimate fees and abnormal accruals separately but theory would suggest that fees and abnormal accruals are jointly determined.[123] Namely, as Antle and colleagues point out, under the maintained hypothesis of the Frankel et al. study (or the SEC's statement of the problem with the provision of non-auditing services by accounting firms), corporations pay their auditors large non-audit fees in order to obtain favorable audit treatment -- larger accruals. Antle and colleagues address the endogeneity problem by simultaneously estimating audit fees, non-audit fees, and abnormal accruals.

Antle and colleagues estimate the equations for fees and accruals using U.K. data, as well as U.S. data.[124] They find, for the U.K. sample, that audit fees are positively related to abnormal

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[122] The Gore et al. study results are consistent with the Chung and Kallapur analysis indicating that the Frankel et al. study results are driven by small firms, as those firms would be more likely to have a non-big 5 auditor, see text after note 104, supra.

[123] Rick Antle, Elizabeth A. Gordon, Ganapathi Narayanamoorthy and Ling Zhou, The Joint Determination of Audit Fees, Non-Audit Fees, and Abnormal Accruals, Yale University School of Management Working Paper No. AC-15 (June 2002).

[124] Using U.K. data from 1994-2000, the sample consists of 2,443 U.K. firm years. They also run preliminarily tests of the relations for a sample of 1,430 U.S. firms for the one year of available data.

accruals and non-audit fees are negatively related (in the U.S. sample the signs are the same but they are statistically insignificant). Thus, non-audit fees do not influence auditors and impair the quality of the audit; rather, non-audit services appear to decrease, not increase abnormal accruals. These data are consistent with the alternative hypothesis, noted by Antle and colleagues, that non-audit services can have a productive (beneficial) effect (that is, they can lower accruals).[125]

Antle and colleagues also find that audit and non-audit fees positively influence one another, which is consistent with the presence of knowledge spillovers or economies of scope in the provision of auditing and consulting services.[126] That interpretation of the data is consistent with the contention, found persuasive by the Independence Standards Board, against prohibiting auditors' provision of non-auditing services, that the joint provision of these services benefits customers. This important finding is the precise opposite of the premise of the SOX prohibition on permissible auditor services: if firms benefit from the simultaneous purchase of auditing and non-auditing services, then it is not in shareholders' interest to prohibit that practice.

For comparative purposes, Antle and colleagues also run an estimation that does not take into account the endogeneity of the system. In that model, neither type of fee is significantly related to abnormal accruals. They also run the non-simultaneous estimation of abnormal accruals using the ratio of nonaudit fees to audit fees instead of the absolute values of the fees; in

[125] The example that Antle and colleagues give of such a theoretical effect is a client hires the auditor to install an inventory control system and, if the system is effective, those non-audit fees would lead to lower abnormal accruals. Antle et al., supra note 123, at 9.

[126] Another study that simultaneously models audit and non-audit fees, but not abnormal accruals, does not find evidence of spillovers. Scott Whisenant, Srinivasan Sankaraguruswamy and K. Raghundandan, Evidence on the Joint Determination of Audit and Non-Audit Fees, 41 J. Accounting Res. 721 (2003). As that study notes, many studies using single equation models suggest that knowledge spillovers exist. Id. at 721.

this estimation, the fee ratio is only marginally significantly related to abnormal accruals (significant at 10 percent). These data indicate that the results on auditor independence found by other researchers, such as the results in the Frankel et al. study, can change dramatically when the endogeneity of the relation between fees and earnings management is modeled.

Nicole Jenkins considers a different model misspecification issue which could affect the identification of a relation between auditor independence and audit quality, omission of a variable measuring the effectiveness of the audit committee, on the view that the audit committee and external auditor are not likely to "operate independently as deterrents to earnings management."[127] She investigates the joint effect of the two monitoring mechanisms on earnings management; the issue is how they interact, do they complement or substitute for each other with respect to constraining earnings management. Because Jenkins calculates the auditor independence measure (the fee ratio) differently from the previously-reviewed studies, her findings are interpreted differently from those studies: namely, a negative, rather than a positive, relation between the fee ratio and abnormal accruals indicates a compromised audit.[128]

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[127] Nicole Thorne Jenkins, Auditor Independence, Audit Committee Effectiveness, and Earnings Management 1 (2003). The sample consists of 303 Fortune 1000 firms, for the years 2000-01. As a consequence, the sample firms are larger and in fewer industries than those of other studies. Id. at 17. The mean audit fee ratio of .38 implies a high mean nonaudit fee ratio of .62, similar to the Dee et al. study that also consisted only of large firms. Audit committee effectiveness is measured by a dummy variable constructed from a combination of four audit committee characteristics: size, the proportion independent, the proportion who have financial expertise, and the number of meetings during a year. Jenkins applies a type of factor analysis to these four characteristics, that uses a weighted average of the first principal component to estimate a composite measure of audit committee effectiveness (the first principal component explains 62 percent of the variance of the four factors). Id. at 14 n.21. The composite variable is then converted to an indicator variable, with a value of 1 if the composite variable is positive.

[128] In contrast to the convention in other studies, Jenkins constructs the fee ratio with audit fees, rather than non-audit fees, in the numerator. This is done to facilitate consistent

As in the Frankel et al. study, Jenkins calculates both nondirectional and directional abnormal accruals. When abnormal accruals are measured by absolute value, there is a significant positive relation between audit fees and accruals (that is, firms with more independent auditors engage in more, not less, earnings management).[129] This result is the opposite of the finding in the Frankel et al. study, which she takes as the benchmark for her study, and, of course, at odds with SOX's prohibition. However, the results differ significantly when abnormal accruals are signed. Here she finds that there is a significant negative relation between accruals and both the audit committee effectiveness and fee ratio variables (that is, they reduce accruals, improving audit quality), but a significant positive interaction. This interaction effect indicates that auditor independence and committee effectiveness are substitutes. A test of whether auditor independence still reduces accruals if the audit committee is effective is insignificant. This result implies that if an audit committee is effective, the independence of the auditor (as measured by non-audit services fees) has no relation to earnings management.[130]

Jenkins next applies a non-symmetric model to accruals that distinguishes between income-increasing and income-decreasing accruals. In this model, auditor independence is not significantly related to the income-increasing accruals but it is significantly negatively related to

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interpretation of results for her two monitoring mechanisms. With this computation of the ratio, for both the audit committee and auditor independence variables, a negative relation with abnormal accruals will indicate that the audit has been comprised (whereas in other studies using non-audit fees in the numerator, a positive relation between it and abnormal accruals indicates a compromised audit).

[129] Id. at 19 n. 25.

[130] Id. at 20.

income-decreasing accruals.[131] While this result suggests that more independent auditors exercise greater constraint on reported earnings, it is with regard to accruals of lesser concern: as earlier noted (as Jenkins and others have suggested), overstated earnings are typically of greater concern than understated earnings in the accounting literature as well as to investors, although the SEC is concerned about both.

Jenkins concludes her study with a series of robustness tests, some of which produce different results from the principal models. In the first test, she examines whether the results regarding auditor independence and audit committee effectiveness are driven by other control variables in the regression, that may be correlated with firms' incentives to manage earnings (such as poor performance in a prior year), but are necessary to include for the accurate estimation of abnormal accruals. The explanatory power of the regression drops substantially when the controls are omitted,[132] which raises the possibility that control variables may well be driving the results on audit fees and audit committees, but because the auditor independence and interaction variables are still significant when controls are excluded, Jenkins considers the concern unfounded. In the second test, performance is controlled in the accrual estimation

[131] The interaction effect between the audit committee and auditor independence variables is again significantly positive, and the audit committee effectiveness variable is significantly negative, for both income-increasing and income-decreasing accruals. Jenkins does not report a test of whether the fee variable remains significant if the audit committee is effective in the income-decreasing model.

[132] The decrease in adjusted R^2 (the goodness of fit) is over 70 percent; the decrease in the unadjusted R^2 is an even greater 80 percent. The fit was low to begin with (.07 and .10 respectively in the full models). A test of the hypothesis that all of the included regressors are insignificant indicates that the null can be rejected when the controls are excluded in the robustness test model, as well as when they are included in the full model (F-statistic significant of 2.57 significant at 5 percent, and of 3.5 significant at 1 percent, respectively), that is, the model is significant overall in the test and full models).

equation, rather than in the model that explains accruals.[133] She finds in this formulation that the auditor independence variable is now significantly negatively related to income-increasing accruals.[134] This is the only model specification in her study that supports the view that the provision of non-audit services compromises audit quality. But because it is important to adjust the estimation of abnormal accruals for performance, it is a key specification. In the final test, Jenkins alters the measure of auditor independence, using percentile rankings measures, an alternative also examined in the Frankel et al. study. There is no significant relation between any of the fee variables and accruals, nor do any of the models have explanatory power.

In tallying the results of studies at the outset of this section, Jenkins' research was classified as lending support to SOX's premise that non-audit services should be banned,[135] as that is along the lines of how she interprets the data. But it must be noted that such a conclusion is far from straightforward, as the finding that fees compromise audit quality is not robust to the many specifications she undertakes. Indeed, Jenkins emphasizes the substitution effect of audit committee effectiveness and external auditor independence, rather than any potential connection between non-audit service fees and poor audit quality, suggesting that contracting for non-audit

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[133] This is similar to the approach used to control for performance in the Ashbaugh et al. study, supra note 99. She does not report a test for this model of whether auditor independence still matters if the audit committee is independent. This is unfortunate, for evaluating the robustness of her results, because the Ashbaugh et al. study indicates that this is a key model specification.

[134] The results for the relation between the adjusted abnormal accruals and the audit committee effectiveness and interaction variables are the same as before, significantly negative and significantly positive, respectively.

[135] See text following note 89, supra.

services is not a problem when the audit committee is structured effectively.[136]

A final study examining the relation between abnormal accruals and fees for non-audit services raises a different challenge to the literature than that of Antle and colleagues, or Jenkins, although it shares her perspective that firms have other mechanisms for monitoring against earnings management besides the external auditor. David Larcker and Scott Richardson contend that if the relation between discretionary accruals and non-audit services varies for different classes of firms, then the results of studies that pool all observations will be misleading (that is, opposing -- positive versus negative --effects for different subsamples might wash out such that no effect would be identified in the full sample).[137] They further plausibly contend that a reason for variation in the relationship between abnormal accruals and non-audit service fees could be differences in firms' corporate governance characteristics, because the external auditor is only one of a number of managerial monitoring devices.

The conventional approach, as Larcker and Richardson note, to this problem, would be to pool the data and then extend the model by incorporating (and interacting) the variables of interest (that is, corporate governance characteristics). They use instead a latent class model, a statistical technique that groups observations by the empirical relation between the variables

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[136] Jenkins, supra note 127, at 27. It should be noted that, to the extent that having the auditor provide non-audit services benefits the client (as suggested by some evidence), then an effective audit committee might wish to use more of such services than an ineffective audit committee (high quality committees and auditors might be complements not substitutes); if the relation between committee and auditor varies across firms by some other unspecified characteristic, this might explain why Jenkins' finding of a substitution effect is not robust.

[137] Larcker and Richardson, supra note 48. Larcker and Richardson's sample consists of 3,424 firms audited by the big 5 accounting firms over two years of fee data, 2000 and 2001 (5,103 firm-years). The mean fee ratio for the sample firms is .48.

(here between accruals and fees for non-audit services), and thereafter examine whether corporate governance characteristics vary across the groups. In contrast to the conventional approach of a pooled regression, the latent class model permits the identification of different structural relationships between accruals and fees, and further avoids potential technical statistical concerns (multicollinearity) that could arise if the pooled regression includes numerous interaction variables between corporate governance characteristics and fees.[138]

Larcker and Richardson employ five measures of auditor compensation: the fee ratio, two measures of client importance as computed in the Chung and Kallapur study, and abnormal client importance measures (an estimation of expected non-audit fees related to a number of firm characteristics, in which the regression residual represents the abnormal fee).[139] For bench-marking purposes with prior research, they first estimate a conventional pooled regression model. There is a marginally significantly positive relation (10 percent) between the fee ratio (the measure used in the Frankel et al. study finding a significantly positive relation) and nondirectional accruals (absolute values). When the fee variable is a client importance measure, however, they find a significant positive relation with directional (signed) accruals and a significant negative relation with the nondirectional ones. They view the conflicting results as due to the regressions' low explanatory power, and attribute this to the inappropriateness of the conventional approach, that is, its failure to permit the relation between fees and accruals to vary

[138] Id at 638, 640.

[139] The explanatory power of the model estimating non-audit fees is high: R^2s of .75 and .60 for the estimates of total and non-audit fees (scaled to measure client importance), respectively. Id. at 651.

according to firm characteristics.[140] This sets up the comparison of the conventional approach with a latent class model that will be able to identify any different structural relations between the variables in the data.

Larcker and Richardson next estimate the relation between accruals and each of the fee measures using the latent class model, which identifies three groups.[141] They find no significant relation between the fee ratio and directional accruals or accruals constrained to be positive, across all three clusters. But for accruals constrained to be negative or zero there is a significant negative relation, and for nondirectional accruals, a significant positive one, for one cluster (identified as the first cluster). These results are consistent with the Frankel et al. study, although the cluster (hence number of firms) for which their results hold is small: only 8.5% (nondirectional accruals model) and 14.5% (constrained negative or zero accruals model) of the sample.

However, for the client importance fee measures, there is no significant relation with directional accruals, a significant negative relation for nondirectional accruals for the first two clusters (insignificantly negative for the third grouping), a positive relation for accruals constrained to be negative or zero and a negative relation for accruals constrained to be positive (both significant for the first cluster and insignificant for the other two). Thus, for the client

[140] Id. at 641.

[141] In latent class models, a fit statistic is computed to determine the number of groups (clusters). Id. at 639. Thereafter, posterior probabilities using Bayes Theorem are computed to assign observations to clusters (the assignment principle is the group for which the observation has the largest relative posterior probability). The data can then be analyzed using standard ANOVA methods to ascertain differences across the clusters related to other variables (such as, in Larcker and Richardson's study, firms' corporate governance characteristics).

importance measures of non-audit fees, the abnormal accruals are smallest where the non-audit fees are largest, a result completely at odds with the fee ratio results (and of course, with the Frankel et al. study's findings and the rationale for prohibiting non-audit services). Larcker and Richardson conclude from these results that if the fee ratio is a valid measure of the relation between an auditor and client, then audit quality is only affected for a small subset of firms.[142]

To evaluate the finding of differences across the clusters, Larcker and Richardson test for differences in the clusters' corporate governance characteristics.[143] The governance variables are insider ownership, institutional ownership and the proportion of the board that is independent. They also include in the analysis two financial characteristics, book-to-market ratio, as a proxy for growth opportunities, and market capitalization. They find that the firms in the first cluster that exhibited the positive relation with the fee ratio had smaller book-to-market ratios (that is, higher growth prospects), smaller market capitalizations, and lower institutional and higher insider stock holdings than the other firms. These data are interpreted as suggesting that the first cluster firms are difficult to monitor and have insiders with effective control. The authors thereby conclude that weak corporate governance is "an important determinant of the relation between auditor independence and earnings quality," and that corporate governance is a "key factor" determining accrual choices (audit quality), rather than the size of the fees (auditor independence).[144]

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[142] Id. at 645.

[143] They classify the observations according to the posterior probability methodology described in note 141, supra.

[144] Id. at 645, 655.

When the clusters for the models using client importance measures and absolute accruals are examined, which had exhibited an opposite relation from that of the fee ratio results, they find that the cluster with the strongest negative relation (that is, the one with the largest statistically significant coefficient on the fee variables) consists of firms with low book-to-market ratios, low market capitalizations, low institutional and high insider ownership, and the fewest outsiders on the board. Thus, the relation between auditor independence and audit quality is precisely the reverse of that found when using the fee ratio. Namely, the relation between auditor compensation and earnings quality is the "most stringent" when firms have weak corporate governance. Larcker and Richardson plausibly interpret the results as most consistent with reputational concerns determining auditor behavior regarding constraining clients' "unusual accounting choices" and inconsistent with higher fees decreasing audit quality.[145]

Similar results obtain for the abnormal client importance fee measures as obtain for the standard client importance measures regarding the relation to discretionary accruals. The rationale for using these measures is that auditor behavior should differ depending on whether it is being paid more or less than a benchmark (as expressed by the estimation of an expected fee). The idea is that, if the abnormal fee is negative or zero, the auditor has "little to lose" from imposing stringent accounting rules on the client because in these cases if it loses the client, it can be assumed that there are "other more profitable uses" of the auditor's time than to service such a client.[146] Hence negative or zero abnormal fees should be associated with lower accruals. Conversely, if the abnormal fee is positive, this would be the instance where client pressure to

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[145] Id. at 650.

[146] Id. at 651.

permit earnings management should have the most impact, as the auditor has an incentive to retain such a client (to the extent reputational concerns are not important). Positive abnormal fees should therefore be associated with high levels of accruals. Larcker and Richardson find that there is no significant relation between the abnormal fee measures and directional accruals but that positive abnormal fees are associated with lower nondirectional accruals and smaller constrained (negative and positive) accruals (as are negative abnormal fees, adjusting the coefficients for the sign shift). Accordingly, there is no evidence that abnormally large fees cause a decline in audit quality. Larcker and Richardson conclude that the data are consistent with reputational concerns being the primary determinant of auditor behavior, and not fees.[147]

b. Studies of Earnings Conservatism

A variant of examining the relation between auditor independence and the quality of financial reports is to use measures of earnings conservatism, rather than earnings management, as the audit quality benchmark. Conservatism refers to a long-standing accounting principle of accelerating expenses and deferring revenues (attained in practice by requiring a higher level of verification for revenue recognition), which results in lower profits than would otherwise be reported; hence reported earnings are "conservative." The principle has been operationalized in empirical research by measuring whether bad news is incorporated in financial reports (and hence in stock prices) more rapidly than good news. Two studies by Caitlin Ruddock, Sarah Taylor and Stephen Taylor and by Gopal Krishnan use this accounting principle to study the auditor independence issue: they investigate the relation between non-audit services and earnings conservatism, or the timeliness of the recognition of bad news in financial statements (within

[147] Id. at 655.

earnings).[148] The idea is that firms whose auditor's independence is comprised by fees received for non-audit services, should report less conservatively (there would be delayed recognition of bad news).

Ruddock and colleagues, studying Australian firms, find, for a variety of measures of earnings conservatism, that there is no relation between the provision of non-audit services (measured by the fee ratio) and the quality of the reporting (that is, higher fees do not result in less conservatism). Krishnan finds, in a U.S. firm sample, contrary to what would be the result if the SOX concern about auditor independence were correct, that the earnings of the higher fee clients are more sensitive to bad news (that is, they are more conservative) than those of the lower fee clients.[149] When the sample is divided by auditor type, the data indicate that the effect -- higher fee clients' earnings are more sensitive to bad news than those of low fee clients -- is for

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[148] Gopal V. Krishnan, Are Audit and Nonaudit Services Associated with the Delayed Recognition of Bad News? (manuscript 2003); Caitlin Ruddock, Sarah Taylor and Stephen Taylor, Non-Audit Services and Earnings Conservatism: Is Auditor Independence Impaired? (manuscript 2003). The Krishnan sample consists of 5430 firm-years (2000-01 data); the Ruddock et al. sample consists of 4708 Australian firm-years (1993-2000 data).

[149] The finding of greater conservatism holds for total fees, audit fees and non-audit fees; the sign remains positive, but is insignificant, for the fee ratio and client importance measured by the ratio of total fees to the auditor's total revenues. The finding of greater conservatism for high-fee clients also holds up when the model is run using unexpected total and audit fees (estimated for the positive residuals of the fee regressions, as they indicate "excess" profitability, whereas negative residuals would be cases where the audit was unprofitable - auditor effort exceeded revenues earned). In addition, the analysis of total fees is undertaken for an alternative measure of earnings conservatism, and separately for the two sample years, 2000 and 2001 (1030 firms are in both sample years); the result is the same for the alternative measure of earnings conservativeness, and the data indicate that earnings conservatism increased for high total-fee clients during 2001 relative to 2000. Krishnan speculates that the increase reflects an effort "to mitigate investor concerns about auditor independence given the higher non-audit services fees. Krishnan, supra note 148, at 19.

the clients of big 5 auditors, and not non-big 5 firms.[150] Consistent with the Gore et al. study, the data suggest that stronger "brand name" auditors have incentives to protect their reputations, as their clients' earnings are more conservatively reported when there is a question of the auditor's appearance of independence (high fees). In sum, neither study of earnings conservatism offers support for the view that auditor independence is compromised by the provision of non-audit services.

c. Studies of Going Concern Opinions

Most of the U.S. studies investigating the impact of non-audit services on auditor independence have focused on measures of earnings management to proxy for the quality of the audit. A few U.S. and several non-U.S. studies have, however, investigated whether there is a relation between non-audit services and more extreme measures of compromised audits, such as the failure to issue qualified (going concern) opinions and the issuance of accounting restatements. None of the U.S. studies using those measures of audit quality have uncovered a significant relation indicating that audit quality is compromised by non-audit services, as is true of most of the non-U.S. studies.[151]

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[150] It should be noted that the vast majority of sample firms are audited by a big 5 firm (4867 firm-years for big 5 firms, compared to 563 firm-years for non-big 5 firms).

[151] Two additional studies examining the issuance of qualified opinions are not discussed and excluded from Table 3, one finding a negative association (fewer qualified opinions the higher the non-audit fees) and one finding no association, because those studies did not control for any characteristics of firms that could affect the likelihood of the issuance of a qualified opinion, such as the firm's financial condition, nor did they include only financially distressed firms (the two techniques used in the other studies that are discussed), and as a consequence, the results are not reliable (since not all firms are equally likely to be potential subjects of a qualified opinion). Those studies are: Graeme Wines, Auditor Independence, Audit Qualifications and the Provision of Non-Audit Services: A Note, 34 Accounting and Fin. 75 (1994) (76 of 1980 Top 100 Australian firms, data years 1980-89; negative effect) and Lynn Barkess and Roger Simnett,

Mark Defond and colleagues investigate whether non-audit service fees affect auditors' issuance of going concern opinions for firms in financial distress.[152] They contend that going concern opinions provide a better test of auditor independence than earnings management because auditors have less direct influence on clients' earnings characteristics, which affect the ability to engage in earnings management, than they have on the audit opinion (the auditor clearly influences the opinion). In addition, there are empirical problems measuring discretionary accruals whereas there is no measurement question regarding the audit opinion. The model estimation includes several control variables for what accounting guidance identifies as "contrary" or "mitigating" factors in the issuance of a going concern opinion when a firm is in financial distress. None of the formulations of the fee variable are significant predictors of a

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The Provision of Other Services by Auditors: Independence and Pricing Issues, 24 Accounting and Business Research 99 (1994) (from Top 500 Australian firms, 371 in 1986, 403 in 1987, 466 in 1988, 463 in 1989 and 391 in 1990; no effect). The Barkess and Simnett study has a better research design than the Wines study in that, the authors construct a model of the provision of non-audit services, and include in the model the type of audit opinion (as one of several factors creating the demand for non-audit services). But as Allen Craswell notes in discussing the study, there is no basis for assuming that "the factors affecting the demand for non-audit services [are] adequate controls for the likelihood of qualified opinions." Allen T. Craswell, Does the Provision of Non-audit Services Impair Auditor Independence?, 3 Int'l J. of Auditing 29, 32 (1999).

[152] Mark L. Defond, K. Raghunandan and K.R. Subramanyam, Do Non-Audit Service Fees Impair Auditor Independence? Evidence from Going Concern Audit Opinions, 40 Journal of Accounting Research 1247 (2002). The sample includes 1,158 distressed firms, 96 of which received first-time going concern audit reports. In addition to the fee ratio, they also use log transformations of the absolute value of non-audit, audit and total fees, to measure the effect of non-audit services. The fee ratio of .49 for the sample is comparable to that in the Frankel et al. study, although the average total fees are smaller; this is not surprising given that their sample consists solely of distressed firms (and it highlights the scale concern in measuring independence by the ratio rather than the magnitude of the fees received).

going concern opinion.[153]

Defond and colleagues undertake several further formulations to test the robustness of the results of no association between the fee variables and the issuance of a going concern opinion. They reestimate the model using unexpected fee ratios and unexpected fees (that is, they control for that portion of audit and non-audit fees that can be expected, on the theory that it is unusually high or low fees that influence auditors' independence), and none of those variables are significant. They also control for endogeneity -- the objection to the Frankel et al. study raised by Antle and colleagues -- by undertaking a simultaneous regression estimation of non-audit fees, audit fees, and the going concern opinions. The fee variables remain insignificant in the going concern opinion estimation. They further test for robustness by using client importance measures of non-audit and audit fees following the approach in Chung and Kallapur's study. These measures are also insignificant. Finally, they consider the ex post error in the auditor opinions.[154] None of the fee variables are significantly related to the ex post auditor opinion dependent variable. Thus, using a variety of research design choices, they find no support for the hypothesis that non-audit services or fees impair auditor independence.

Allen Craswell, Donald Stokes and Janet Laughton also examine whether fees are related

[153] Several of the control variables are significant and the models have decent explanatory power (pseudo R^2 of .41), suggesting that the insignificance of the fee variables is not because the model is not well-specified.

[154] Ex-post error is measured by computing a variable that equals the going concern indicator variable minus one if the firm filed for bankruptcy within 12 months (the variable value is -1 for an erroneous clean opinion, 0 for a correct opinion and +1 for an erroneous going concern opinion).

to the issuance of qualified opinions for Australian firms.[155] Again, the idea is that if "fee dependence affects auditors' independent judgment, then auditors (will be) less likely to issue qualified audit opinions."[156] Craswell and colleagues investigate the ratio of client audit fees to total (audit and non-audit) fees, as well as the ratio of client non-audit fees to total fees, at both the national and local office level of accounting firms, for clients receiving qualified and unqualified opinions. They find that dependence on fees, at either the national or local office level, does not affect auditors' propensity to qualify audit opinions.

Craswell and colleagues undertake numerous robustness checks, such as using only the most severely qualified opinions, eliminating larger accounting firms or clients in larger cities to increase the likelihood that the auditor is dependent on a specific client's fee, and using only the firms with the longest delay in the signing of the opinion to identify "problem" firms. But in all of those variants, the fee variables measuring client dependence at either the national or local office level have no statistically significant impact on the formulation of the audit opinion. One can conclude from the study that Australian auditors are willing to issue modified or qualified opinions regardless of the economic importance of the client. Although it is possible that the behavior of Australian auditors differs dramatically from U.S. auditors, there is no self-evident explanation concerning why that would be so, and these results parallel the result of the DeFond

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[155] Allen Craswell, Donald J. Stokes, Janet Laughton, Auditor Independence and Fee Dependence, 33 J. Accounting & Econ. 253 (2002). The sample consists of 1,062 Australian firms in 1994 and 1,045 Australian firms in 1996. Approximately 15 (13) percent of companies had qualified accounts in 1994 (1996). The model controls for a number of firm characteristics likely to affect the propensity to qualify or modify an audit opinion (such as variables measuring the financial riskiness of the firm that would bear on the exercise of independent judgment to issue a qualified opinion).

[156] Id. at 255.

et al. study of U.S. auditors.

The previously discussed Reynolds and Francis study also investigates the relation between client dependence at the local office level, for U.S. big 5 firms, and audit quality as measured by the issuance of a going concern audit report. As with the Defond et al. and Craswell et al. studies, they find no evidence of client dependence compromising audit quality. Paralleling their results for the relation between client dependence and discretionary accruals, they find that the larger clients appear to have a higher rate of going concern opinions (statistically significant at 6 percent).[157]

The findings of six other studies examining the issuance of qualified opinions can be briefly summarized, as the majority are consistent with the findings already reported and none of these studies undertake as many sensitivity tests as the Defond et al. and Craswell et al. studies, which found no effect. In brief, four studies (using Australian, U.K., New Zealand, and 1979-82 U.S. data) find no relation or a significant positive relation between non-audit fees and qualified opinions, that is, that the provision of non-audit services increased audit quality, the opposite of

[157] Reynolds and Francis, supra note 114. For this analysis, the full sample is reduced to include only 2,439 potentially financially distressed firms, audited by 402 offices of big 5 firms. A going concern report was issued for 9.2 percent of those firms, compared to 3.8 percent of the full sample. Id. at 390. The model controls for firm-level factors known to be associated with the issuance of going concern reports. Note that the average company size is smaller for this subsample than the full sample, and of course, the risk of litigation and reputation loss is much higher for these firms, which will weaken the power of the test to uncover a significant impact from economic dependence for this measure of audit quality, compared to the test using accounting accruals. In some of the robustness tests of the going concern opinion regression results, the client influence variable is statistically significantly positive (indicating that auditors do not treat larger clients more favorably.)

the SOX presumption,[158] while two studies (using U.K. and Australian data) find a significant negative effect.[159] However, as Michael Firth, the author of one of the two studies finding a negative effect notes, the data do not distinguish whether the auditor's independence was impaired by large fees or whether a substantial amount of non-audit services (indicated by large fees) helps to resolve problems that a customer is facing, the resolution of which enables a clean opinion.[160] This is an important qualification of his study's results.

The other study, by Sharma and Sidhu, is not subject to that concern because its sample consists of firms that filed for bankruptcy. There is, however, a concern regarding that study's research design. In the Sharma and Sidhu study, 63 percent of the sample firms had received qualified opinions prior to the bankruptcy filing, but 20 percent of those firms are placed in the "non-qualified" opinion category, because they did not receive the most severely qualified going-concern opinion. That reclassification increased the non-qualified firms by one-third, so that for

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158 Craswell, supra note 151, at 32 (885 Australian firms for 1984, 1477 firms for 1987, and 1079 firms for 1994) ; Clive S. Lennox, Non-audit fees, Disclosure and Audit Quality, 8 European Accounting Rev. 239, 249 (1999) (837 U.K. firms, data years 1988-94; one model specification significantly positive); Vivian Li, David Hay and Robert Knechel, Non-audit Services and Auditor Independence: New Zealand Evidence (manuscript 2003) (177 New Zealand firms for 1999, 224 firms for 2000, and 243 firms for 2001; one model specification significantly positive); Lynn M. Pringle and Thomas A. Buchman, An Examination of Independence in Fact when Auditors Perform Nonaudit Services for Audit Clients, 6 Accounting Enquiries 91 (1996) (47 bankrupt U.S. firms, filing between 1979-82).

159 Michael Firth, Auditor-Provided Consultancy Services and their Associations with Audit Fees and Audit Opinions, 29 J. Bus. Fin. & Accounting 661, 685 (2002) (1112 U.K. firms, 1996); Divesh S. Sharma and Jagdish Sidhu, Professionalism vs. Commercialism: The Association between Non-Audit Services and Audit Independence, 28 J. Bus. Fin. & Accounting 595, 608 (2001) (49 bankrupt Australian companies, filing between 1989-96).

160 Firth, supra note 159, at 687. Firth's measure of non-audit service fees is also calculated differently from other studies, as he standardizes the amount by the client's total assets.

the statistical tests, the sample firms are equally divided between the qualified and non-qualified categories. It is quite possible that the negative relation the study finds would hold up were those firms not reclassified, but the reliability of the finding would be more credible had the tests been run with alternative classifications of those firms. It is, in any event, the only study of nine studies examining the issuance of qualified opinions, that clearly identifies a relation between audit quality and provision of non-audit services of the sort that motivated the SOX restrictions.

d. Studies of Financial Restatements

K. Raghunandan, William Reid and Scott Whisenant investigate whether fees for non-audit services are associated with the issuance of financial restatements.[161] After constructing measures of unexpected audit and non-audit fees,[162] they examine whether the unexplained portion of the non-audit fees, total fees or fee ratios differ across the restatement and control firms. They find no significant difference in any of the unexpected fee variables across restaters and non-restaters.[163] The restatement firms did not have unexpectedly higher fees from the

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[161] K. Raghunandan, William J. Reid and Scott Whisenant, Are Non-Audit Fees Associated with Restated Financial Statements? Initial Empirical Evidence (manuscript April 2003). The sample consists of 110 firms that restated their financial statements in 2000-01 and 3,481 firms that did not. None of the restatements involved technical restatements and all of the control firms had positive non-audit fees.

[162] This is done by estimating a model of expected fees, following prior studies, such as the Defond et al. study, supra note 152, to select fee determinants, such as size, institutional ownership and various accounting measures that affect auditor demand, such as mergers or special items.

[163] In addition to using the full sample of restatement and control firms, they also run the comparisons using a matched sample, in which the matches are made by auditor, industry, size and time period (which reduces the comparison to either 78 or 84 pairs, with the larger group constructed by using more leeway to match on size - by quartile rather than sales within 20 percent - and by eliminating the time period constraint). The results are the same, for both comparison groups, as for the full sample.

provision of non-audit services, which implies that restatements are not more likely to occur in firms that pay higher than normal non-audit fees (or total fees) to their auditors.[164]

These results are replicated by Agrawal and Chadha. In their previously noted study of firms issuing earnings restatements, in addition to examining the impact of the independence of the audit committee, they also examined the effect of the independence of the auditor, as measured by the fee ratio as well as a measure of very high non-audit fees, on the likelihood of restatement.[165] They find no relation between the restatement of earnings and either measure of the level of non-audit services. One cannot conclude from these studies that accounting misconduct will be significantly increased by auditors' provision of non-auditing services to their clients.

Mukesh Bajaj, Katherine Gunny and Atulya Sarin examine auditor compensation in the context of firms subject to securities litigation alleging accounting improprieties, about half of which cases involved financial restatements.[166] They find that the lawsuit firms did not have significantly higher fee ratios, non-audit fees, audit fees or total fees, compared to a matched

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[164] The restatement firms are larger than the control firms, and have higher total fees as well; but the fee ratios are the same across the two sets of firms. This finding is consistent with the concerns of commentators that use of a ratio to measure independence may omit important scale information.

[165] They consider very high fees to be fees over $1 million. Agrawal and Chadha, supra note 48.

[166] Mukesh Bajaj, Katherine Gunny and Atulya Sarin, Auditor Compensation and Audit Failure: An Empirical Analysis (manuscript 2003). The sample consists of 100 firms that experienced a securities class action suit in 2001-02, matched by size and industry to a control sample. Of the 100 sued firms, 54 had either restated their earnings or planned to restate earnings in the sample period.

sample of firms that were not sued.[167] Because these are only allegations of accounting misconduct (the lawsuits were either dismissed or settled), their study is not as effective a measure of an accounting failure as the studies examining solely firms that restated earnings. However, the results are consistent with data compiled by a reporter for the Dows Jones News Service, that indicate that the non-audit fees paid by firms sued by the SEC for accounting issues (a set of cases likely to consist of a higher proportion of legitimate allegations of impropriety compared to the Bajaj et al. study sample), are no higher, and indeed slightly below, the fees paid by companies without such problems.[168] These results are inconsistent with the belief that quality is compromised by high fees for non-audit or audit services.

Bajaj and colleagues then examine the data for only the bottom third of the sample, as ranked by the size of the stock price decline from the highest stock price during the class period and the price at the end of the class period. For this subsample of firms, the fee ratio and non-audit fees are significantly higher for the sued firms, while audit and total fees are not.[169] In

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[167] They also find no difference in the fee measures between sued firms and their matches for subsamples of sued firms that went bankrupt (16 firms) and that restated earnings (54 firms).

[168] Michael Rapoport, In the Money: Scandal Can't Be Foreseen from Auditor Fees, Dow Jones News Service (Jan. 1, 2003). Rapoport identified 64 firms sued by the SEC (or announcing an SEC investigation) over accounting issues in 2002, and compared their fee practices to those reported by the Investor Responsibility Research Center for its universe of 1,240 public companies. For the sued firms, 71 percent of total fees paid to the auditor were for non-audit services, compared to 72 percent of total fees paid by the IRRC firms, translating into an average of $2.50 paid to the auditor for non-audit services for every $1 paid in audit fees, for both samples; or, making the comparison in another way, 66 percent of the sued firms paid more to their auditors for non-audit fees than for the audit, compared to 69 percent of the IRRC firms.

[169] These findings raise similar interpretive difficulties to those that Kinney and Libby raise regarding the Frankel et al. study; see note 94, supra. The bottom third of the sample (33 firms), as ranked by size of stock price decline, lost an average 81 percent of market value compared to the top third's average 25 percent decline. None of the fee measures are significant

contrast to the full sample results, these data suggest that auditor independence may be compromised by non-audit services.

The significance of the finding regarding auditor independence for the bottom third of the sample is not, however, straightforward:[170] the stock price declines used to identify this sample were apparently not adjusted for market movements, which is a conventional adjustment used for calculating litigation damages, and hence this subsample may not, as the authors intend, be equivalent to the potential severity of an accounting failure (as opposed, for instance, to the subsample of firms for which earnings had to be restated). Moreover, firm size is insignificant for explaining the fee ratios in the regressions for this subsample, although it is significant in all the other models in the paper (and in the models in other studies of auditor compensation); the instability of the other regression coefficients in that model raises concern over the proper inference to draw regarding the fee ratios (that is, whether this is a spurious effect). But even if, for argument's sake, we were to accept the finding at face value, the result is very much an outlier in a large and sophisticated literature, and hence a very thin reed on which to rationalize a prohibition of auditor provision of non-audit services.

A final study of earnings restatements, by William Kinney, Zoe-Vanna Palmrose and Susan Scholz, uses a unique dataset for computing audit and non-audit fees, which contains

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for the middle third and top (least severe) third of the sample.

[170] The authors note that the small sample sizes prevents them from making "a conclusive argument" regarding the auditor independence hypothesis. Bajaj, Gunny and Sarin, supra note 166, at 19. Whether the result would hold using a different cutoff for the bottom of the sample, such as 10, 20 or 25 percent, would be of interest, as there is no theoretical justification for restricting the examination to the bottom third of the sample, as opposed to any other fraction, such as an association with the specific magnitude of a stock price drop and the validity of fraud allegations.

detailed fee information obtained from seven large auditing firms.[171] This enabled them to subdivide the fee data into five non-audit service fee categories following SEC definitions, the two categories of non-audit services explicitly prohibited by SOX (financial information system design and implementation and internal auditing), the two categories of non-audit services explicitly allowed (tax and audit-related services), a miscellaneous category of "unspecified services," as well as the sixth category of fees, those paid for auditing services. Their data set is therefore unique, as it separately identifies four categories of non-audit service fees that the SEC proxy disclosures – the data source for all of the other studies – combine into one category. Very few of the firms in their sample purchased the SOX-prohibited non-audit services while most firms purchased the permitted non-audit services.[172]

Kinney and colleagues find, after controlling for involvement in an acquisition, as such activity is likely to cause a restatement, that the fees of the SOX-prohibited services (financial information system design and implementation and internal auditing) are not significantly related to the issuance of a restatement, the fees for the permitted non-audit tax services are significantly negatively related to restatement issuance, and the fees for auditing and for the unspecified non-

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[171] William R. Kinney, Zoe-Vonna Palmrose and Susan Scholz, Auditor Independence, Non-Audit Services, and Restatements: Was the U.S. Government Right?, 42 J. Accounting Res. 561 (2004). They identified 713 companies that restated quarterly or annual earnings from 1995-2000; from this universe, they requested information from the auditing firms on a set of 617 restating firms or 979 restating fee-years (since some restatements have multiple year effects), and on 1070 non-restating firms matched to the restaters by auditor, industry and size. The sample obtained consisted of 432 restating company-fee-years and 512 matched non-restating fee-years, or a set of 289 matched pairs of fee-years, of which 187 matches are for first-year restatements.

[172] Five percent or less purchased the prohibited services; almost 80 percent purchased the permitted (tax and audit-related) non-audit services.

audit services are significantly positively related to restatement issuance.[173] To check the robustness of the results, they subdivide the data in several ways. The authors reestimate the model using only material misstatements (corrections equal to at least 5 percent of the absolute value of the originally reported net income or loss); the results are unchanged. They further estimate a model limited to firms paying what they consider lucrative fees (total fees to the auditor of over $1 million). Again the key results are unchanged –the prohibited non-audit services are still insignificant and the permitted (tax) service is significantly negative –although there is one different result, the unspecified non-audit services variable is now only marginally significantly positive (significant at 10 percent).

However, if the sample is split into large and small firms (using $200 million in assets as the cutoff), it becomes apparent that the non-audit service results are due to the large firms in the sample.[174] For the large firm sample, fees for tax services are significantly negatively related to material misstatements; the relation is only of marginal significance (6 percent) in the full restatement sample. Also for large firms, the fees for unspecified non-audit services are significantly positively related to restatements (the significance level for this variable in the

[173] None of the fee variables were significant in the regression using the smaller matched sample of first year restatements, however. In addition, if the fees for the four non-audit services aggregated under the SEC proxy disclosure rules are summed together into one variable, that variable is insignificant, consistent with the findings in the literature using SEC disclosures. This result suggests that the opposing effect of tax and unspecified services are offsetting.

[174] The positive significance of the audit fee variable is due entirely to the small firms in the sample (that variable is significant in the small firm, but not in the large firm, regressions; none of the non-audit service variables is significant in the small firm regressions). Kinney and colleagues interpret this result –that higher the fee paid for auditing services, the more likely a restatement in the context of small firms– as an indication that audit firms either identify or price ex ante misstatement risk, or they expend increased audit effort on smaller, riskier clients. Id. at 584.

estimation limited to material misstatements is 5.2 percent). Thus for large firms, tax services provided by the auditor appear to enhance audit quality (there are fewer misstatements), although it is also possible that high quality firms select their auditor to obtain tax advice.[175] In either interpretation, the data imply that the absence of a SOX restriction on auditor provision of tax services - which has been a topic of continued debate[176] - should not be a source of concern. The positive association between unspecified non-audit service fees and restatements for large firms is a concern, but such services (the nature of which are unknown) are not the subject of SOX's prescriptions. The data, and hence the appropriate conclusion, are clear cut regarding the statute's prescriptions: in all model specifications, regardless of firm sizes, there is no significant relation between audit quality (restatements) and the prohibited non-audited services fees, and accordingly, the ban, with no basis in fact, was solving a non-problem and unnecessary.

The similar results obtained in the Kinney et al. study, which uses data from a period before fees were disclosed, to those in studies of disclosed fee data, suggests that the disclosure mandate did not alter substantially firms' behavior[177] and bolsters the conclusion that the purchase of non-audit services does not result in more financial restatements. Given the absence of a finding of a systematic relation between the purchase of non-audit services and compromised

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[175] Id. at 585.

[176] See, e.g., Auditor Independence: Investors, Auditors Face Off on Tax Services at PCAOB Session on Auditor Independence, 36 BNA Sec. Reg. & L. Rep. 1320 (July 19, 2004).

[177] An absence of an impact on firm behavior from the disclosure requirement is consistent with the finding by James Scheiner that the imposition of the SEC's non-audit service disclosure requirement in 1978-82 did not affect the quantity of such services provided to clients. James H. Scheiner, An Empirical Assessment of the Impact of SEC Nonaudit Service Disclosure Requirements on Independent Auditors and Their Clients, 22 J. of Accounting Res. 789 (1984).

audit quality, with studies using different proxies for audit quality and auditor independence,[178] the best inference to draw for policy-making from the extensive literature is that SOX's prohibition of non-audit services by auditors is a policy that makes little sense.

C. Executive Loans

1. Statutory mandate

Section 402(a) of SOX prohibits corporations from arranging or extending credit to executive officers or directors (unless the corporation is a financial institution offering credit in the ordinary course of business and the terms of the credit are the same as those offered to the public).[179] Loans became a focus of congressional attention in the wake of disclosures that executives at Enron, WorldCom, Tyco International, and Adelphia Communications had obtained extremely large loans (in some cases in the hundreds of millions of dollars). The ban was introduced at the end of the legislative process in the Senate, as a floor amendment substitute for a provision that was drafted and reported out of the Senate committee as a disclosure

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[178] The studies discussed in the paper answer the question whether the form of auditor compensation affects audit quality, because that is the rationale for SOX's prohibition on auditors' provision of non-audit services. One recent study sought to examine the economic impact of auditor compensation by investigating the relation between non-audit and audit fees and stock market liquidity and disclosure quality (measured in terms of abnormal trading volume), on the theory that if non-audit fees reduce audit quality, that should result in lower disclosure quality and decreased liquidity. Asli Ascioglu, Shantaram P. Hegde and John B. McDermott, Does Auditor Compensation Lower Market Liquidity? (manuscript 2004). Because of concern that the disclosure of information regarding fees could affect market liquidity, the study measures market liquidity and disclosure quality prior to the fee disclosure. The results provide little support for the prohibition as a significant relation was found between auditor compensation and only some of the liquidity measures in only some model specifications; fees were unrelated to the disclosure quality measure. One explanation the authors offer for the results is that litigation risk and reputational concerns constrain auditors.

[179] Codified in §13(k) of the Securities Exchange Act.

provision.[180]

In contrast to other SOX corporate governance provisions, this initiative had not been a component of recent policy discussions; the permissibility of such transactions has been settled law for decades without generating scholarly controversy. Even critics of the 20th century trend to enabling provisions on executive loans did not advocate a return to an absolute prohibition of such transactions, but rather, they argued for disclosure and limits on loans in specific contexts (to insiders in close corporations).[181]

While all states permit lending excess funds to directors or officers,[182] the statutory schemes vary as to the permissiveness of the approach. Delaware has one of the most permissive statutes, allowing loans to officers and other employees as long as the directors "reasonably expect" that the loan would "benefit" the corporation, and the loan may carry no interest and be

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[180] Sean A. Power, Sarbanes-Oxley Ends Corporate Lending to Insiders: Some Interpretive Issues for Executive Compensation Surrounding the Section 402 Loan Prohibition, 71 UMKC L. Rev. 911, 917-18 (2003). It should be noted that SOX's blanket prohibition has engendered much debate and concern among practitioners, as it appears to prohibit standard compensation practices thought to be uncontroversial and beneficial, such as advancing indemnification expenses, the purchase of split-life insurance policies (the company pays the premiums and is repaid out of the policy's payout to the officer upon its expiration at the officer's retirement or death) and arranging with brokers or other financial institutions for employees' cashless exercise of stock options under incentive compensation plans. See, e.g., id.; John C. Coffee, Jr., A Brief Tour of the Major Reforms in the Sarbanes-Oxley Act (Foundation Press, Sept. 2002).

[181] See Jayne W. Barnard, Corporate Loans to Directors and Officers: Every Business Now a Bank?, 1988 Wis. L. Rev. 237 (1988).

[182] Although it is technically not a prohibition on loans, the District of Columbia corporation code holds directors who vote to make a loan liable for the loan until its repayment. See D.C. Code § 29-101.42 (2003).

unsecured, or secured by the corporation's stock.[183] California's statute is procedurally more restrictive, requiring loans to executives to be approved by a majority vote of the shareholders, or by the disinterested directors of the board if a bylaw, approved by the shareholders, permits the board to approve such loans.[184] But California excludes from the more stringent approval requirements, transactions that are extensions of credit falling within the SOX ban, the payment of life insurance premiums and transactions under employee stock purchase or stock option plans.[185]

Thus, SOX is once again in conflict with the state law approach: while state codes vary with respect to the ease with which corporations can extend credit to top management in general and for specific transactions, no state forbids the practice absolutely as did Congress. In this regard, a practical reason for permitting executive loans should be noted: it is extremely difficult to regulate managerial compensation, for if one form of compensation is restricted, then managers can renegotiate their contracts to make up for the loss. As a result, regulation of

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[183] Del. tit.8, § 43. In 1989, revisions to the Model Business Corporation Act eliminated specific provisions on executive loans, taking the position that they are a subspecies of conflict of interest transactions that do not necessitate special treatment but should come under the procedural provisions governing all conflict transactions. See Committee on Corporate Laws, Changes in the Model Business Corporation Act - Amendments Pertaining to Directors' Conflicting Interest Transactions, 44 Bus. Law. 1307 (1989). The history of the Model Act's position on loans illustrates the state law trend, that moved from blanket prohibitions (the original 1950 Model Act treatment) to enabling policies, which were at times more restrictive than Delaware's approach (the 1969 Model Act, for instance, prohibited loans unless approved by a majority vote of the shareholders, with further revision in 1985, to permit loans when the board determines that the loan "is of benefit" to the corporation). See Douglas M. Branson, Corporate Governance 452 (1993).

[184] Cal. Corp. Code, §§ 315 (a) and (b) (Deering 2003).

[185] Cal. Corp. Code, §§ 315 (e) and (f) (Deering 2003).

compensation, such as the federal loan ban, can be expected to alter the form compensation takes, but is not likely to result in a reduction in total pay, and it will thereby raise the cost to shareholders of hiring managers. That is because investors have to increase another component of the manager's pay package to make up the loss in utility from the removal of the now-restricted compensation option. The dollar value of the component that is increasing will be higher than that of the one foregone, for if the manager valued an increase in the unrestricted component more highly than the lost compensation, the latter would not have been part of the original compensation package (and there would have been more of the unrestricted form of compensation) in the first place.[186]

2. Study of Executive Loans

Given that the extension of credit to corporate officers at state corporate law has not been a topic of contention for decades, it is not surprising that there is an absence of empirical research on the practice. Motivated by the spotlight thrown on executive loans in the scandals leading to SOX, and its ban on the practice, a recent study by Kuldeep Shastri and Kathleen Kahle seek to measure the efficacy of the use of executive loans.[187] The bulk of the sample loans were made to assist in stock and stock option purchases, with a much smaller set consisting of relocation

[186] See note 12, supra, citing studies detailing firms' adoption of compensation practices in response to federal regulation of specific forms of management compensation.

[187] Kuldeep Shastri and Kathleen M. Kahle, Executive Loans (manuscript Feb. 2003). Their sample consists of the executives of 70 corporations that loaned money to executives from 1996-2000, or 2,018 person-year observations, only 700 of which are observations of executives with an outstanding loan in the year (i.e., many executives never received a loan -- or a reported loan -- over the sample period). The corporations were identified from firm proxy statements or annual reports that reported offering personal loans.

loans.[188]

Shastri and Kahle analyze loan characteristics and whether the loans accomplish their purpose, which Shastri and Kahle consider is to increase managerial stock ownership, thereby aligning managerial incentives with shareholder interests. The results are summarized in Table 4. The majority of loans are secured by the asset being financed (stock in stock and option purchase loans, and real property in relocation loans). The average interest rates are favorable to the executives (below market rates), but the discount is greater for relocation loans than for loans for stock and stock option purchases.

More important, Shastri and Kahle find that loans for stock purchases are made to executives with low stock ownership and low option exercises, and such loans are especially made when the stock price is not performing well. Those officers' stock ownership increases after the loan. These data are consistent with the loans' purpose as being one of incentive alignment (increasing management equity ownership). In contrast, loans for stock option purchases tend to be made to executives with high[189] stock ownership, suggesting that these loans do not serve a similar incentive-alignment function. In both situations, loans for stock purchases and loans for stock option purchases, there is, in fact, an increase in the executives' equity

[188] Two-thirds of the sample loans were for stock or stock option purchases and 11 percent were for relocation loans. The remainder had no stated purpose.

[189] Shastri and Kahle do not identify the cutoff for "high" and "low" ownership, but note that 56 percent of the sample falls into the high ownership category. Shastri and Kahle, supra note 187, at 18. The average stock ownership in the sample was slightly higher than 1 percent (the range was from close to 0 to 18 percent).

ownership after the extension of credit, for both high and low stock-holding managers.[190] The increase is, however, small with respect to loan value. On average, a loan enabling a manager to buy 100 shares of stock increases the manager's ownership by eight shares.

Executives who receive loans receive a greater fraction of stock-based compensation than executives without loans, and they own a significantly smaller number of shares. In addition, executives with loans increase their ownership over time while those without loans decrease their ownership. These data similarly suggest that loans are used in a targeted effort to increase executive ownership. But as a fraction of share ownership, the difference across the two groups of executives is insignificant, and measuring ownership changes on a yearly basis, there is no significant difference as well. It should also be noted that it is possible that the executives for whom no loans were reported, had received loans in earlier periods, which might explain their higher ownership as well as the insignificant results.

Relocation loans go to executives with short tenure. They appear to be made to assist newly hired executives in relocating, consistent with the apparent objective of the loans. The loans are often interest-free (which accounts for the lower discount to market rate for this subset of loans), and the loan amounts are far less than loans given for stock or stock option purchases.

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[190] Shastri and Kahle find that a higher number of options are exercised in their sample than in a study of the effect of stock option plans on managerial stock ownership conducted by Eli Ofek and David Yermack, Taking stock: equity-based compensation and the evolution of managerial ownership, 55 J. Fin. 1367 (2000). They attribute the difference to the presence of the loans: the loans, in their view, permit the managers to hold onto more shares after exercise because they do not need to sell shares to pay taxes and the exercise price. That would again suggest that the loans are functioning as desired, increasing management stock ownership. But it should be noted that Shastri and Kahle do not evaluate the cost effectiveness of the loan program (that is, whether there is a cheaper mechanism to increase stock ownership than through a stock option or purchase loan program.)

Not surprisingly, such loans have no direct impact on managerial stock ownership. Shastri and Kahle do not attempt to measure whether the loans serve as an effective recruitment device.

As Shastri and Kahle suggest, executive loans in a large class of cases served their purpose well, of increasing managerial stock ownership, thereby aligning the manager's and shareholders' interest. The blanket prohibition of executive loans in SOX, from this perspective, is self-evidently a public policy error. The provision in the original Senate bill, which was consistent with the conventional federal regulatory approach, required disclosure of executive loans and did not prohibit them. Such an approach would have been far less problematic than the final legislative product from the perspective of shareholder welfare. It would have had the effect of facilitating the termination of loans most unlikely to benefit shareholders, by highlighting their presence to investors who could then place those loans' elimination onto a corporate governance agenda (in the many states where they would otherwise not be involved because shareholder approval of loans is not required). Instead, the legislation is a blunderbuss approach that prohibits all loans, whether or not they are useful in facilitating the shareholders' objective of providing a sought-after incentive effect.

D. Executive Certification of Financial Statements

1. Statutory mandate

Section 302 of SOX requires the CEO and CFO to certify that the company's periodic reports do not contain material misstatements or omissions and "fairly present" the firm's financial conditions and results of operations.[191] The certification requirement contains

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[191] Paralleling the audit committee mandate, this mandate directs the SEC to adopt rules to implement it. Section 404 contains a related filing requirement, a management report, attested to by the external auditor, assessing the internal controls.

substantive corporate governance mandates. It imposes on the signing officers the responsibility for establishing and maintaining internal controls and for evaluating the effectiveness of those controls, along with the duty to disclose to the audit committee any deficiencies in the internal control design or any fraud involving any officer or employee with a significant role in the company's internal controls. These obligations are imposed by way of the certification requirement: the officers' signature certifies that they have undertaken those tasks, as well as the veracity of the financial information. A second provision, section 906(a), is a new criminal statute, that enumerates criminal penalties for knowingly violating a similar certification requirement.[192]

The certification provision, in contrast to the other corporate governance provisions that have been discussed, is not a self-evident infringement on state corporate law: although it is a corporate governance mandate–it imposes duties on corporate officers--the required certification accompanies the filing of federally-mandated documents that are not part of the state corporate law regime.[193] Nor is this an entirely new federal requirement, although its specific form is of

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[192] The two sections differ in the certification language and covered reports. See, e.g. Lisa M. Fairfax, Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability under the Sarbanes-Oxley Act, 55 Rutgers L.Rev. 1 (2002).

[193] A few states require corporations to provide shareholders with annual reports and financial statements. E.g., Cal. Corp. Code §1501 (requiring provision of annual report and financial statements, and specifying certain disclosures for firms not subject to federal reporting requirements). Given the mandatory federal reporting and disclosure requirements, there was no room (or need) for state law to develop reporting requirements for publicly traded corporations. After SOX passed, California expanded its disclosure requirements to include, among others, SOX-related items, such as non-audit services and loans to directors. For a discussion of the statute's requirements see Roy J. Schmidt, Jennifer W. Chaloemtiarana, Gregory J. Conklin and Russell C. Hansen, Compliance with the New California Disclosures Act: Issues and Tips, Wall Street Lawyer 11 (Nov. 2002). Before the enactment of the federal securities regime in the 1930s, the New York Stock Exchange mandated financial disclosures; the federal disclosure

recent vintage. Prior to the enactment of SOX, the SEC imposed a certification requirement on the largest public firms in its regulatory response to the Enron scandal.[194] This requirement was one of the proposals advanced by President Bush in his response to the Enron fiasco, a Ten-Point Plan to make corporate executives more accountable to investors, that had been announced in March.[195] But even before the promulgation of that SEC rule, CEOs and CFOs had always been required to sign the annual report and were liable for knowingly filing fraudulent reports, as well as for inadequate internal controls.[196]

Despite the strictly federal character of the certification mandate, it does have important implications for state corporate law. That is because state courts consider directors and officers to have knowledge of federal obligations, and violations of those obligations may provide the

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regime displaced those listing requirements. See Paul G. Mahoney, The Exchange as Regulator, 83 Va. L. Rev. 1453 (1997).

[194] SEC, File No. 4-460, Order Requiring Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934 (June 27,2002), available at www.sec.gov/rules/other/4-460.htm.

[195] President Bush outlined his plan to improve corporate responsibility in a speech in Washington, D.C. on March 7, 2002. See "President Outlines Plan to Improve Corporate Responsibility," available at http://www.whitehouse.gov/news/releases/ 2002/03/20020307-3.html and the "President's Ten-Point Plan," available at http://www.whitehouse.gov/infocus/ corporateresponsibility/index2.html.

[196] See Fairfax, supra note 192 (discussing prior law regarding signatures on financial statements). Section 102 of The Foreign Corrupt Practices Act of 1977, Pub. L. 95-213, required public corporations to establish internal controls adequate to ensure that "transactions were recorded as necessary" to permit the preparation of financial statements in accordance with generally accepted accounting principles (codified at § 13(b)(2) of the Securities Exchange Act of 1934). Although the impetus for that legislation was to prohibit sensitive foreign payments, the language imposing obligations on firms is not limited to the accounting for bribe-related transactions.

basis for derivative litigation (as constituting a breach of fiduciary duty).[197] It could be contended that the formulation of the certification language regarding the officers' obligations concerning their evaluation and establishment of internal controls tracks what would conventionally be understood to be a component of fiduciary duties: the contention would be that it is probable that state courts would find senior management liable for fiduciary breach were they not to have had in place an appropriate system of internal controls.[198] But such a requirement could well represent the federal creation and expansion of what would otherwise be state-defined fiduciary duties. Whether it marks the emergence of new federally-mandated fiduciary duties (besides the action that is required to implement the actual document certifications) will depend upon how well the SEC's interpretation of the matters that Congress specified must be certified, such as what constitutes adequate internal controls, meshes with state law expectations of corporate conduct.

2. Studies of Executive Certification of Financials

Two studies, as indicated in Table 5, have sought to measure the efficacy of the SEC's rule requiring executive certification of the financials of the largest firms, as a means of evaluating SOX's expansion of the requirement to all firms, by examining stock price reactions to timely and untimely certifications.[199] The first study, by Utpal Bhattacharya, Peter Groznik

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[197] See In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996) (dicta) (noting relevance for fiduciary duty standard of federal sentencing guidelines on corporate crime that identify organizational procedures that mitigate sanctions).

[198] See id.

[199] The methodology, commonly referred to as event studies, which evaluates the impact of particular policies on the welfare of investors by examining changes in stock returns, is widely used and well accepted in financial economics. For an overview of the technique see, e.g., Sanjai

and Bruce Haslem, focuses on the price effect for the small number of firms that did not make the SEC's certification deadline.[200] Their research question is whether the SEC requirement of certification provided information to investors - was it "value-relevant" as they put it, and in particular, was failure to comply with the certification requirement value-relevant?

Bhattacharya and colleagues find that the certification requirement had no impact.[201] The non-certifiers experienced no abnormal returns, unusual trading volume or stock volatility,

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Bhagat and Roberta Romano, Event Studies and the Law: Part I: Technique and Corporate Litigation, 4 Amer. Law & Econ. Rev. 141 (2002).

[200] Utpal Bhattacharya, Peter Groznik and Bruce Haslem, Is CEO Certification of Earnings Numbers Value-Relevant? (2002). The filing deadline was August 14, 2002. Ninety-seven percent (664 of 688) of the firms required to file by that deadline did so, as did 74 of 252 firms whose certifications were due on a later date. Those were firms whose fiscal year did not coincide with the calendar year. Their certifications were not required until the date on which their annual reports were filed.

[201] Because most firms certified their financials in the last week before the deadline, the traditional event study methodology would suffer from a clustering problem, reducing the power of the tests. Bhattacharya and colleagues therefore employ two standard techniques to estimate prices that account for the clustering problem, a portfolio approach, that groups all the firms together into a single portfolio and calculates average portfolio returns, and estimation of a system of seemingly unrelated regressions, with one equation for each firm that includes a dummy variable for abnormal returns on the event date, which are summed for significance testing. A study by Paul Griffin and David Lont duplicates their result. Paul A. Griffin and David H. Lont, Taking the Oath: Investor Response to SEC Certification (manuscript 2003). The Griffin and Lont study, however, focuses on an unconventional measure of investor valuation, unsigned excess returns, measured around three certification event dates (the SEC announcement of the requirement, the enactment of SOX, and firms' release of financial reports that were certified) compared to the excess returns measured on the firms' financial report releases before SOX, and they find the variable significantly differs. It is difficult to interpret what such a variable measures, nor can one state with confidence what finding a difference in the magnitude of investor response to releases indicates, as it is not an indicia of investor welfare (as are signed returns) or information flows (as proxied by bid-ask spreads or the variance of returns), nor is there any content analysis of the releases over time to provide a rationale for expecting a difference and attributing it to SOX.

around the event date.[202] Nor did the certifiers. Abnormal returns are also insignificant when the certifiers are grouped into separate portfolios by certification date, and the earlier certifiers' returns are not systematically larger than those of the later certifiers. This suggests that investors did not obtain new information about firms from their responses, that is, that the earnings certification required by the SEC was a "non-event." In other words, the market could predict which firms would not be able to certify their earnings. Many of the non-certifiers were the well-known scandal firms - Enron and WorldCom - which were not expected to certify, and firms in financial distress that had restated their earnings in the past year.

Bhattacharya and colleagues then examine whether the size of the abnormal returns around the event can be explained by firm characteristics that would be expected to be predictive of timely certification, such as firm characteristics associated with good corporate governance and indicators of financial distress. They find, however, that such characteristics do not explain the abnormal returns. They interpret this result as evidence that the event was predictable but not value-relevant: if it was value relevant, they maintain, then the predictive features should be associated with returns. In this view, the SEC requirement made no difference to investors: the market had already distinguished between firms with good and bad earnings transparency, and the certification order did not enable the market to differentiate further between those two types of firms.

Two points should be made that caution against generalization from the study. First, the small number of firms that failed to certify in time limits the power of the test. Second, by the

[202] The event date used for firms that failed to certify is August 15, the day following the certification deadline.

time the SEC issued the earnings certification order, the market had, in all likelihood, adjusted stock prices for an "Enron" effect, reducing the value of firms with opaque financial statements and numerous off balance sheet transactions, as many firms reacted by voluntarily increasing their disclosure to provide more transparent reports.[203] It is therefore possible that in the future under different market circumstances (for example, in a time of less investor scrutiny of firms), a failure to certify earnings might provide new information about the firm.

A second study, by Beverly Hirtle, examines the stock market reaction to certifications by bank holding companies.[204] Hirtle suggests that examining those firms separately is of interest because financial institutions are more opaque than non-financial firms, due to banks' core activity, intermediation of credit to small firms, which may themselves be too opaque to obtain public debt financing, and due to greater liquidity of assets, which facilitates shifting the composition of the balance sheet.[205] Her idea is that given their opacity, there might have been greater uncertainty whether bank holding companies could meet the certification deadline, and hence that their certifications would be more informative than those of non-financial firms. All of these firms certified on time, but some filed their certifications earlier than others.

Hirtle finds that the bank holding companies experienced significant positive abnormal

[203] The SEC order was issued in June 2002. Firms that had obscure balance sheets like Enron experienced stock price declines in the Fall of 2001 upon the revelation of Enron's accounting problems. See Romano, supra note 18, at 58-59.

[204] Beverly Hirtle, Stock Market Reaction to Financial Statement Certification by Bank Holding Company CEOs, Federal Reserve Bank of New York Staff Report no. 170 (July 2003). Forty-two bank holding companies were subject to the SEC's certification order.

[205] Id. at 4. As Hirtle notes, however, the characterization of banks as more opaque than nonfinancial firms is not uniformly accepted in the banking literature.

returns (30-60 basis points) on the day of certification; there was no significant response to the SEC announcement of adoption of the requirement. The statistical significance is driven by the returns of the early certifiers: when the sample is divided into three temporal filing categories, only the abnormal return of the early certifiers is significant.[206] This is in further contrast to the Bhattacharya et al. study, which did not find significant abnormal returns when the sample was divided into firms according to the date of the certification. To control for whether the significant returns related to new information about earnings in the quarterly reports filed with the certification, Hirtle reran the regressions using solely bank holding companies that had announced their quarterly earnings prior to certification; she indicates that the results were similar to the results reported for the full sample (positive average abnormal returns driven primarily by early certifiers).

Hirtle also attempts to determine whether holding company opacity (the explanation offered for the difference in findings between her study and the Bhattacharya et al. study) influences the abnormal returns. She examines whether firm characteristics associated with the opaqueness of holding company activities (size and the extent of liquid assets and risky assets or non-traditional banking activities) explain the variation in return or the timing of certification. The question is whether more opaque holding companies experience larger abnormal returns, as that could indicate that those firms' certifications provided more information to investors. In addition, if more opaque holding companies had certified earlier, that would explain why the earlier certifiers have higher abnormal returns (being more opaque, more information was

[206] The three temporal filing categories are: twelve holding companies that certified before August 9 ("early certifiers"), eighteen holding companies that certified on either August 12 or August 13, and twelve holding companies that certified on the deadline date of August 14.

provided to investors from their certifications). Hirtle finds that several of her measures of opaqueness are positively correlated with the size of the abnormal return on the certification date, but they are not significantly related to the timing of the certification.

Another hypothesis that Hirtle considers to explain why bank holding companies experienced positive abnormal returns upon certification is a signaling explanation. The idea is that the first certifiers resolved general uncertainty about whether bank holding companies could comply with the certification requirement by providing a positive signal to investors about the probability that other bank holding companies would meet the deadline. That scenario implies that all of the sample firms should experience significant positive returns on the date of the first certifications, with little additional impact upon their actual certification dates. Hirtle finds that, depending on the specification, there is a positive abnormal return for the not-yet-certifying firms on the day the first two bank holding companies certified. But further examination indicates that one firm, which was the subject of takeover rumors at the time of the early certifications, is driving the result. When that firm is excluded, the returns of the late certifiers are positive but not significant on the early certification dates. Hirtle therefore concludes that the signaling explanation for the results has less support in the data than the explanation dependent on the firms' relative opacity.

Hirtle infers from her data that the SEC certification requirement did provide information of value to investors of bank holding companies. However, she notes that it is ambiguous whether this stock price reaction is a one-time effect, that is, whether certification in subsequent years will provide new information to investors about financial firms. The contrary findings of the two event studies of the certification requirement render it difficult to draw any definitive conclusion regarding the efficacy of the provision for improving the ability of investors to distinguish between high and low quality firms. There is a need for considerably greater research to draw strong inferences. But one inference that would reconcile the results is to characterize the preferable certification regime as an optional one, that would permit firms for which there is a benefit to engage in special certifications rather than the conventional financial statement signature -- opaque firms such as bank holding companies -- to do so. In addition, given the considerable compliance costs associated with certification that have been reported or anticipated,[207] it would be advisable to permit firms to select into the regime only when the burden of compliance is more likely to produce a positive payoff to their investors.

In addition to the difficulty of drawing definitive policy implications from the studies regarding the informative efficacy of the certification requirement, it should be noted that the studies do not address whether certification will alter management's behavior so as to reduce the occurrence of accounting misconduct in the first place (the evaluative strategy of the studies of independent audit committees and the provision of non-audit services); only studies with a longer window will afford such a test. Nor do the studies address whether the certification provision will increase plaintiffs' success rate or the size of the recovery obtained in private federal securities lawsuits.[208] Given the problematic efficacy of securities litigation,[209] however, whether

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[207] Patricia A. Vlahakis, Takeover Law and Practice 2003, 35th Annual Institute on Securities Regulation 673, 799-800 (Nov. 2003) (discussing costly impact of certification requirement on acquisitions of private and foreign corporations); Adrian Michaels, Costs rise as US businesses act to meet governance laws, Financial Times (US ed.), Apr. 25, 3002, p.15 (reporting survey indicated cost of being a public company doubled after SOX).

[208] Members of Congress and witnesses at congressional hearings contended that the restrictions on private securities actions from congressional action in 1995 caused the corporate scandals of 2001, see, e.g., Enron Hearings II, supra note 88, at 16 (Feb. 4, 2002) (Rep.

such a finding would indicate an improvement in social welfare is an open question, as it could as well indicate that the legislation increased the incentive to bring litigation and to settle frivolous suits, when it may well be socially desirable to reduce those incentives.

E. Event Studies of the Enactment of SOX

In addition to the two event studies of the SEC's adoption of the certification requirement that SOX codified and expanded, there have been two event studies of the adoption of the statute itself. Haidan Li, Morton Pincus and Sonja Olhoft Rego investigated the market reaction to key events during the legislative process, over an eleven month period beginning with then- SEC chairman Harvey Pitt's proposal of a new accounting oversight board in January, 2002, and concluding with Pitt's and William Webster's resignations in November 2002, in the midst of the flare-up over Webster's appointment as the first chairman of the Public Company Accounting Oversight Board (PCAOB) created under SOX.[210] Li and colleagues report negative stock

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Kanjorski). The debate over enhancing plaintiff lawsuits was directed at efforts to expand the statute of limitations for fraud (which succeeded) and to revive aider and abettor liability (which failed); it was not related to the adoption of the certification requirement.

[209] See, e.g., legislative history of the private securities litigation reform act of 1995.

[210] Haidan Li, Morton Pincus and Sonja Olhoft Rego, Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002: Overall and as a Function of Earnings Management and Audit Committee Effectiveness (manuscript Nov. 2003). The appointment of the PCAOB chairman, which SOX delegated to the SEC, was the subject of controversy between the then SEC Chairman, Harvey Pitt, and a Democratic commissioner Harvey Goldschmid, who had been SEC General Counsel under Pitt's predecessor as chairman, Arthur Levitt. Goldchmid and Levitt publicly championed John Biggs for the position. Biggs, the former CEO of TIAA-CREF, a retirement fund until recently serving solely university educators that has an active corporate governance agenda, was closely associated with Levitt and much of the accounting profession vigorously opposed his candidacy. William Webster was Pitt's candidate, with the support of the White House. Goldschmid, along with Levitt, skillfully involved the media and Democratic legislators in a public campaign for Biggs' appointment, and when it became apparent that Pitt would nominate Webster instead, Goldschmid accused Pitt of bowing to

returns over the legislative events (that is, investors perceived those actions to have a negative effect on firms' future cash firms), but the negative returns reverse after enactment, and returns are positive on events related to the act's implementation (the controversy over the Webster appointment and the Bush Administration's proposal of an SEC budget substantially lower than the increase authorized by SOX).[211] However, only WorldCom's bankruptcy filing resulted in significantly negative returns (the other legislative events, separately and in the aggregate, are marginally significantly negative at 10 percent, as are the positive returns on the post-enactment event dates).

Although not a legislative event, WorldCom's failure precipitated the resolution of the disagreement between the House and Senate: the Conference committee reported a bill that was virtually identical to the Senate version two days after WorldCom's bankruptcy filing. Whether the market reaction to WorldCom's collapse should be interpreted as a measure of investors' anticipation that the Senate (Democratic rather than Republican) bill would be enacted compared

political pressure by Republicans and insisted on a public vote on the nomination. At the public session he questioned Pitt's integrity and voted against Webster's nomination. See, e.g., Michael Schroeder, Accounting Board Rift Bodes Ill for SEC, Wall St. J., Oct. 28, 2002, A4; Schroeder, supra note 85. Shortly after Webster's selection, the news media reported that Pitt had not informed the other SEC commissioners before the vote that Webster had chaired the audit committee of a corporation being investigated for accounting fraud. That revelation resulted in Pitt's resignation and, a week later, in Webster's resignation as well. Michael Schroeder, Webster Makes It Official and Quits Accounting Board, Wall St. J., Nov. 13, 2002, A3.

[211] They identify a total of 20 events, comprising 71 trading days, of which 13 events and 49 days involved the legislative process. They do not adjust portfolio returns for the market return because their sample consists of most of the market; abnormal returns are measured in reference to the standard deviation of returns estimated over the non-event period (the 181 trading days in 2002 not included in the events). Li et al., supra note 210, at 15. As discussed in the text, they undertake additional analyses comparing firms likely to be differentially affected by SOX, which avoid the problem of confounding common events that make it difficult to identify a price effect of an event that affects the market as a whole.

to, for instance, other concerns such as, additional firms collapsing due to accounting scandals, is not at all self-evident. The authors' rationale for treating the reaction to the bankruptcy filing as a legislative event is the perception that the revelation of the accounting fraud at WorldCom, about a month before its bankruptcy filing, altered the political environment and increased the probability that legislation would be enacted.[212] While this is a plausible contention,[213] it is difficult, if not impossible, to disentangle an effect due to a changed perception regarding the likely legislative product from updating of beliefs concerning the extent of accounting problems, as yet undisclosed, that could lead to additional financial failures.

Li and colleagues interpret the data as indicating that investors had expected SOX to impose significant costs on public companies but that the implementation revealed that the legislation would not be as costly as had been expected. While such an interpretation is possible, the post-enactment events that they examine would not have provided unambiguous information regarding SOX's implementation. The resignations of Harvey Pitt as SEC chairman and William Webster as the PCAOB chairman suggest little about who the successors would be, except, perhaps, individuals perceived to be less politically or professionally identified with the accounting profession (the source of much of Pitt's political difficulties). Such a change in the regulatory environment, as suggested by the resignations, would not self-evidently reduce the

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[212] Id. at 14 (citing discussion with Lynn Turner, former SEC chief accountant, about the legislative process, and news reports upon the statute's enactment).

[213] Senator Jon Corzine, for instance, was described as having "said that the [Senate] bill would have lost momentum without WorldCom and the other scandals that followed Enron." Spencer S. Hsu and Kathleen Day, Senate Vote Spotlights Audit Reform and Sarbanes, Wash. Post, Jul. 15, 2002, at A01. The impact of WorldCom's bankruptcy filing on the legislative process is noted in part III, infra.

cost of compliance with SOX, nor provide any straightforward guidance concerning the direction the SEC would take toward implementation of SOX's non-accounting related provisions. Further complicating Li and colleagues gloss on events is that the event whose characterization is less ambiguous in relation to their interpretation, the reduced budget proposal (which implicated the SEC's ability to enforce SOX and detect corporate misconduct), was not an event date on which even a marginally significant positive return was found.

There is a further interpretative difficulty with an event study of SOX: because the legislation covered all publicly traded firms, its enactment is a systematic market effect, and it therefore is impossible to distinguish its impact from any other market effect occurring on the event dates. That difficulty is avoided in two other analyses undertaken in the Li et al. study. The study further examined whether the stock reaction differed for firms that managed earnings compared to firms that did not and for firms with fully independent audit committees and those without such committees. These comparisons are of interest because the firms are likely to be differentially affected by SOX. Finding a difference in returns across those firms should lessen concern about the potential confounding influence of other common factors on the SOX event dates.

Li and colleagues offer two hypotheses regarding why firms managing earnings should experience differing returns compared to firms not engaged in such behavior: positive abnormal returns because investors anticipate SOX will constrain earnings management, enhance accuracy and reliability of reporting, and thus reduce uncertainty regarding the earnings of those firms; or negative abnormal returns because firms managing earnings would find it more costly to comply with SOX, as they would have to change accounting and reporting strategies, which could entail opportunity costs from changes in decisions made under prior policies, above the out-of-pocket costs for compliance. They suggest that a similar analysis applies to the composition of the audit committee, and, in particular, hypothesize that firms with non-fully independent audit committees might have higher compliance costs. They find that there are no significant differences in the stock returns across either comparison, firms managing earnings compared to firms not doing so, and firms with fully independent audit committees compared to those without such committees. They interpret the results as evidence that the market did not expect the net effect of SOX to differ across firms that managed earnings and those that did not, or across firms that had fully independent audit committees and those that did not.

Li and colleagues consequently conclude that the data are most consistent with the view that SOX was more "rhetoric than reform."[214] Their data are also in accord with the broad thrust of the empirical research on SOX's substantive corporate governance mandates, that the initiatives will not improve firm performance or reduce accounting improprieties.

Zabihollah Rezaee and Pankaj Jain also examined the effect of SOX on the return on the S&P 500 index and the Value-line index.[215] Rezaee and Jain use different and fewer events than Li and colleagues use. This is a matter of concern for interpreting their results and comparing them to the Li et al. study, because numerous events are missing from their paper. Rezaee and Jain exclude all of the legislative events in the House except the introduction of the Republican

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[214] Id. at 33.

[215] Zabihollah Rezaee and Pankaj K. Jain , The Sarbanes-Oxley Act of 2002 and Security Market Behavior: Early Evidence (manuscript 2003). Note that abnormal returns are calculated using a constant-mean return model (instead of a market model because the whole market was affected by the statute), and the estimation period includes Enron's restatement and bankruptcy filing dates, as well as September 11,2001 (142 -21 days before February 2,2002).

bill, and many of the legislative events in the Senate (all of those legislative event dates are included in the Li et al. study). As these dates had some bearing on the probability of enactment, and the interpretation of the events that are included, given differences in the House and Senate bills (a focus of the Li et al. study), their omission is unfortunate. In addition, Rezaee and Jain's first event date for the SEC's approach to the accounting oversight board is an agency announcement in June, whereas the SEC first announced its proposal for a new board in January, which is the date used in the Li et al. study. Because the initial legislative proposals (which are included in the study) were reactions to the SEC's initial proposal, it is disappointing that Rezaee and Jain did not include that event. Finally, a date that Rezaee and Jain identify as a legislative event (the meeting of the conference committee), July 19, is interpretively problematic, as it was also the date of WorldCom's announcement that it would file for bankruptcy (the identification of the date in the Li et al. study).

Rezaee and Jain report significant positive returns on event dates that they consider "favorable" to enactment, such as the date of the conference committee report, the vote on the conference bill's passage, and the President's signing the bill into law. It should be recalled that Li and colleagues do not, however, find significant positive returns on precisely the same dates. The difference between the studies' findings might be due to the fact that Rezaee and Jain's sample is a smaller portfolio, consisting of larger firms, than Li and colleagues' sample.[216]

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[216] Rezaee and Jain's study reports results for two portfolios, firms in the S&P and Value Line Indexes, 500 and 1,700 firms, respectively, whereas Li and colleagues use all industrial firms with available data for their earnings management analysis in the compustat industrial and research files, which is 3,648 firms. For the audit committee analysis, the sample in the Li et al. study is 1,280 firms obtained from the Investor Responsibility Research Center database, which includes the S&P 1500. The relation between that sample and the Value Line index is unknown; to the extent that the two are similar, then a difference in sample due to firm size would not

However, there is no obvious explanation for why the largest firms would be positively affected by SOX. For example, if the reason for such a perceived difference is that the cost of compliance with SOX was expected to be lower for larger firms (since they might have already met some of the corporate governance requirements), that would not be an explanation consistent with Rezaee and Jain's interpretation of their results as indicating the market had a favorable opinion of SOX.

An alternative technical explanation for the difference between the studies is a difference in the computation of abnormal returns. Rezaee and Jain calculate abnormal returns for separate events even though the event intervals overlap (that is, they compute returns using event intervals that consist of the day before and after an event date, for events that occur on consecutive days), whereas Li and colleagues group together events occurring on consecutive days, in their calculation of returns. Li et al.'s technique avoids measuring abnormal returns twice (in overlapping intervals of the events), which could confound, or exaggerate, the effect of the events.

But even assuming that the difference in significance is due to sample differences, rather than event interval construction, it is difficult to ascertain what to make of the result. As Rezaee and Jain note, given the systemic impact of the legislation, it is impossible to rule out the

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explain the difference across the studies' results. It should be noted that in an earlier version of the paper, Rezaee and Jain report that the price effect was greatest for the larger firms in their sample. Zabihollah Rezaee and Pankaj K. Jain, An Examination of Value Relevance of the Sarbanes-Oxley Act of 2002, at 26 (manuscript 2003). That finding is consistent with a size explanation for the difference in the studies' findings. The text notes that size could be related to lower compliance costs because governance requirements are more likely to have already been met by large firms, as Rezaee and Jain find that those firm characteristics are related to the price reaction. If compliance costs are fixed, then that would be another reason why large firms' returns would be more positively associated with the statute than small firms (it would be less costly for them to comply, even if they were not yet in compliance).

possibility that other common factors affected the market at the time. In addition, even assuming there were no confounding events, SOX contained numerous provisions, and it is impossible to identify whether the market's positive assessment involved specific provisions, such as the accounting profession regulation, the expansion of criminal penalties or the corporate governance mandates. Of course, a positive reaction to the statute can also be cast in a different light from affirmative benefits for investors. Senator Phil Gramm's remarks concerning how investors should view the conference committee's action (that they could "rightly feel that [the] bill could have been much worse"[217]) suggests an alternative explanation of the market upturn: the market was relieved that the statute was not as bad as expected, rather than that it believed the statute was welfare-improving. Whether or not Senator Gramm's gloss on the legislation is more plausible than the converse, the market's failure to sustain the higher price level a few months later raises doubt concerning the persuasiveness of Rezaee and Jain's interpretation, since if SOX benefitted investors the effect should have been permanent.

Rezaee and Jain also identify legislative events as "unfavorable" to the enactment of SOX,[218] and predict that such events should produce a negative stock market reaction. They find the prediction confirmed by the data. The events that they place in the "unfavorable" category are the approval in July of Senator Paul Sarbanes' bill, the approval of a criminal penalties bill in the House the following day, and the first meeting of the conference committee. This analysis is,

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[217] 148 Cong. Rec. S7354.

[218] They make no prediction for their set of initial legislative events, on the ground that there was uncertainty whether legislation would be enacted, and what the final form would be. Rezaee and Jain, supra note 215, at 9. Of these events, they report significant returns only for one, a negative reaction to the SEC's announcement on the proposed accounting oversight board's composition. Id. at 41.

however, problematic because the identification of those events as “unfavorable” is implausible. First, it is a mistake to interpret as “unfavorable” the Senate’s passage of Senator Sarbanes’ bill. The bill was unanimously adopted, a voting outcome that could not provide a stronger indication that legislation would be enacted. As will be elaborated, Senate Republicans who voted for the bill were hoping to obtain a compromise between the Senate and House bills in conference, and not to stop it. It stretches credulity to characterize that posture in conjunction with the passing of a bill, after the Senate sat on the House bill for three months without action given partisan disagreements, as an event that decreased the likelihood of enactment of legislation, rather than increased it.[219]

Rezaee and Jain’s prediction regarding the House’s enactment of a criminal penalties bill is also unsatisfactory. It might have been perceived, as Rezaee and Jain suggest, as making it less likely that Senator Sarbanes’ bill would be adopted, but it also might have made it more likely that a compromise would be reached, since the House now had a bill (although not the one in conference) that included criminal penalties, a subject included in the Senate bill.[220]

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[219] In defining favorable and unfavorable events, Rezaee and Jain do not specify that the forthcoming legislation had to be the Senate bill rather than the House bill, although they note the public perception that the House bill was too favorable to business and the accounting profession. Such a definition would exacerbate, rather than mitigate, the classification problem, because the “unfavorable” event was enactment of Senator Sarbanes’ bill.

[220] On July 17, the day after the criminal penalties bill passed the House, upon the motion to appoint the members of the conference committee to reconcile the Senate and House bills, House Democrats sought unsuccessfully to instruct the conferees to accept certain provisions in the Senate bill, including the extension of the statute-of-limitations for fraud for civil suits, which were not in the House bill. The House Republicans, who opposed the motion, emphasized that their new bill was preferable to the Senate provisions because it had tougher criminal penalties, and they objected to the extension of the statute-of-limitations. See 148 Cong. Rec. H4838-H4846 (July 17, 2002). The categorization of the vote as an unfavorable or favorable event is not obvious, because the result was not a specific instruction to the conferees to insist on their bill. In

Moreover, it would be difficult to disentangle a negative market response to the bill's impact on the enactment of the House judiciary committee's bill from a negative response on the bill's merits (that is, the market might have had a negative reaction because its penalties were more substantial than the penalties attached to Senator Sarbanes' bill on the Senate floor, and might have been considered excessive and likely to chill the recruitment of higher quality individuals for positions as directors and officers). In any event, the returns were not significant on this event date, supporting the view that it was not properly included in an "unfavorable" event category.

Finally, and most important, the conference committee meeting date, the third unfavorable legislative event, and the date on which there are consistently significantly negative returns, as noted, is the same date that WorldCom announced it would file for bankruptcy, a critical fact that Rezaee and Jain fail to mention. It is consequently difficult to attribute the negative market reaction on that date to Rezaee and Jain's interpretation that the market was concerned that the conference committee meeting signalled legislation would not be enacted. Li and colleagues, who also report a negative price effect on that date, offered, in fact, the opposite interpretation of that event: they view the bankruptcy filing as signifying an increase in the probability that the Senate bill would be adopted (that is why, in their view, the market reaction was negative). Of course, the market's decline could also be unrelated to an evaluation of the likely progress of legislation, and be instead an expression of concern that there might be more "WorldComs" forthcoming.[221] Because of these serious interpretational concerns, it is difficult to

any event, Rezaee and Jain do not include that vote as an event date.

[221] This issue is discussed in the text after note 227, infra.

consider the findings of negative reactions to the events classified as unfavorable as providing information with respect to the market's perception of SOX.

Rezaee and Jain further undertake a cross-sectional analysis of the market reaction to the favorable legislative events, based on firms' corporate governance, disclosure and auditing practices. As in the Li et al. study, this investigation is of greater interest than the market portfolio abnormal return analysis, in that, by analyzing relative reactions of firms expected to be differentially affected by the legislation, it mitigates the problem of confounding common events. They hypothesize that the stock price of the firms with the best corporate governance, disclosure and auditing practices prior to SOX will increase the most upon the events they consider to have increased the probability of enactment. (These practices are identified by Standard & Poor's scores for firms' governance and disclosure practices, and the ratio of non-audit fees to total auditor fees.) Rezaee and Jain do not compare the significance of the abnormal returns for firms grouped by such practices (which would parallel the approach of Li and colleagues), but rather, they run a regression in which they seek to explain the size of a firm's abnormal return by those practices. They report that the data are consistent with their hypothesis: there is a significant positive correlation between two of three measures of corporate governance (the scores for board and management structures, and for financial transparency and disclosure practices), and a significant negative correlation between the fee ratio, and the size of the abnormal return.[222]

The hypothesis that firms with better practices should benefit the most from SOX, however, in my judgment, makes little sense. This is because, if the legislation were to achieve

[222] To get a better understanding of the cross-sectional results, it would be of interest to know what the results would be if, following Li and colleagues' approach, Rezaee and Jain had compared returns for the firms with the lowest and highest S&P scores and fee ratios.

its objective of improving the quality of firms' reporting, then it should have the greatest positive effect on firms whose corporate governance, disclosure and auditing practices, were of the lowest quality beforehand, as those firms would be the ones in whose reporting investors would have the least confidence. To the extent that the higher scoring firms have fully independent audit committees and those for whom the mandates had bite have lower scores, then it would be difficult to interpret this result as evidence that the statute was favorably received, for the result would bizarrely be suggesting that firms that would have to improve their corporate governance practices in order to come into compliance with SOX experienced the least benefit from its enactment.

Rezaee and Jain do not offer a precise explanation for why they expect firms with the best practices to benefit most from the legislation. One possibility they suggest is that such firms would have lower costs to comply with SOX's mandates. But that suggestion does not explain why firms would benefit to be covered by legislation with which they have already conformed. It is, moreover, not obvious that such an explanation is consistent with the market having a favorable view of the legislation: if a mandate was necessary (because the reason firms did not conform with the desired governance practices is that the managers were exploiting shareholders, and not that they had chosen the optimal form), then the higher compliance costs should be outweighed by benefits and the firms most in need of change should experience the largest, not the smallest, positive reaction.

In addition, there is another explanation besides compliance costs for the result, not emphasized by the authors, that the market reaction was lower for firms with a higher proportion of fees for non-audit services. Investors could have perceived a prohibition of non-audit services would adversely effect the firms for which it would have bite on the substantive merits, that is, they believed there would be a negative wealth effect from no longer being able to obtain those services from their auditors. That equally plausible interpretation would imply that, at minimum, the non-audit services mandate of the SOX was perceived unfavorably by investors, an interpretation that is at odds with Rezaee and Jain's conclusion regarding the market's positive assessment of the legislation.

III. The Political Economy of the SOX Corporate Governance Mandates

A review of the empirical literature indicates that a case does not exist for the principal corporate governance mandates in SOX. The decisive balance of research suggests that those mandates will not benefit investors. This section addresses a puzzle implicated by the literature review: what were the political dynamics that produced legislation in which Congress enacted a set of mandates that will in all likelihood not achieve the professed goal of the legislation, an improvement in investor welfare?

Although much of the research reviewed in this paper was not available to Congress during its deliberations, there were, at the time, sufficient findings on independent audit committees and non-audit services to give at least pause, if not caution against, the legislation's approach.[223] That this literature was not even cursorily addressed is indicative of the poor quality of decisionmaking that characterized the enactment of the SOX corporate governance mandates. The corporate governance mandates stemmed from the intricate interaction of the Senate banking committee chairman's response to suggestions of policy entrepreneurs and party politics in an

[223] It should be noted that some of the citations in this paper with publication dates after 2002 were circulating in manuscript form before 2002, including the one paper noted by a legislator, mentioned in note 95, supra.

election cycle coinciding with spectacular corporate scandals, a sharp stock market decline, and the consequent political collapse of the interest groups (the accounting profession and the business community) whose policy position was most consistent with the findings of the empirical literature.

Legislators' lack of awareness or disregard of the empirical literature which results in low quality decisionmaking, has to be realistically evaluated, however. Even with a committee system permitting specialization, legislators cannot be expected to have extensive technical expertise: there are numerous demands on their time and they must rely on staff and the information provided by interested parties. Without doubt, therefore, some of the shortcomings with regard to the SOX corporate governance mandates should be assigned to the legislative staff. Whether that failure was due to staff members' ideological commitments, an absence of the technical skill necessary to evaluate the literature, or a combination of the two, is unknown. But members of Congress select their staff, and in that regard, they bear responsibility for the performance of those individuals.

A. Background

SOX was adopted in July 2002, slightly less than a year after the Enron scandal broke. A flurry of congressional hearings were held on the company's collapse, its causes and potential legislative solutions, commencing in December 2001 and continuing after the enactment of the legislation.[224] The House passed a bill in April 2002, after the financial services committee had held seven hearings on Enron and proposed legislation. But that bill was not considered by the

[224] The online service, the Law Library of Congress, identifies over forty Enron-related hearings held by ten different committees in the House and Senate from December 2001 to February 2003.

Senate until shortly after WorldCom's collapse in July 2002. Only one of the corporate governance mandates adopted in SOX appeared in the House bill, a more limited restriction on the provision of non-audit services by auditors than what was enacted.[225] The other mandates along with a more stringent prohibition on non-audit services were introduced in the Senate.

Some important institutional detail should be noted before examining the legislative process in the Senate. First, it should be recalled that in 2002, the Republicans controlled the House and the Democrats controlled the Senate. The House bill was a Republican bill, although many Democrats voted for it.[226] The Senate Democrats substituted their bill for the House bill when the legislation was brought up on the Senate floor. Second, the Enron scandal was followed by revelations of accounting fraud and insider self-dealing at several large corporations,

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[225] See The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002, H.R. 3763, 107th Cong. 2d sess., which was introduced and referred to committee on February 14, 2002, ordered reported on April 16, 2002, reported to the House on April 22, 2002 and passed on April 24, 2002. One of the mandates, the executive certification requirement, was rejected by the House committee (by a vote of 29:30 on the ranking Democrat's motion to amend the Republican bill). That requirement, as well as a more expansive prohibition on non-audit services, were included in the House Democrats' bill. See Comprehensive Investor Protection Act of 2002, H.R. 3818, 107th Cong. 2d sess., and 148 Cong. Rec. H 1574 and ff. (Apr. 24, 2002) (amendment no. 5, offered by ranking Democrat Rep. LaFalce in the nature of a substitute to the Republican bill). Finally, the House bill required disclosure of executive loans, as opposed to the prohibition adopted on the Senate floor. Id. at section 6(a)(2).

[226] The vote on the bill's adoption was 334 ayes to 90 noes (roll no. 110), 148 Cong. Rec. H 1592 (Apr. 24, 2002). There were three votes on amendments, two of which were much closer votes following party lines, see id. at H1574 (roll no. 107, 39 ayes to318 noes, on creating government agency to conduct audits of public companies), H1588-89 (roll no. 108, 202 ayes to 219 noes, on the Democrats' substitute bill, which included a certification requirement), and H1591-92 (roll no. 109, 205 ayes to 222 noes on the Democrats' amendment containing provisions endorsed by President Bush not in the bill of the Republicans, who were likely to view the items as within the SEC's authority), as was the one vote sponsored by the Democrats regarding instructions to be provided to the members of the conference committee, 148 Cong. Rec. H4846 (roll no. 313, 207 yeas to 218 nays, on the Democrats' motion to require House conferees to accept certain provisions of Senate bill not in House bill) (July 17, 2002).

nearly all of which were thereafter pushed into bankruptcy: Global Crossing, Adelphia Communications, Tyco International, and WorldCom. Third and coincident with the revelation of other corporate scandals, the stock market declined sharply throughout the time frame in which Congress was considering the SOX legislation. The economy had come out of a recession several months earlier, but employment continued to decline through July 2002, from its pre-recession peak in February 2001.[227]

The daily closing prices of the S&P 500 composite index (S&P) from two months before Enron's revelation of its earnings restatement through two months after the enactment of SOX are plotted in Figure 1; the other major indices exhibit a similar pattern. As the figure indicates, after declining from July 2001 through shortly before Enron's financial restatements and collapse in the fall of that year, the market went into a downward spiral from April 2002, with the S&P reaching a bottom in July 2002. The low point in July 2002, which represented over a 1/3 loss in value of the index over the preceding year, occurred on the day before the conference committee reported out a bill (July 23), which was also the second trading day after the bankruptcy filing of WorldCom (it filed on a weekend). Congress was therefore operating in an environment in which investor losses were staggering. A subsequent study by the General Accounting Office indicated that a well-known measure of investor sentiment was at its lowest recorded level in

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[227] The National Bureau for Economic Research's (NBER), a nonprofit research organization that is the official arbiter of the U.S. business cycle, identified the start of a recession in March 2001 (the end of the peak of the prior expansion that began in March 1991) and its end in November 2001 (the trough in economic activity). See Business Cycle Dating Committee, National Bureau of Economic Research, The NBER's Recession Dating Procedure (Oct. 21, 2003), available at http://www.nber.org/cycles/recessions.html. Note that employment rose slightly from July through November 2002, and then, with the exception of January, declined until September 2003. Id.

June and July 2002.[228] Members of Congress, not surprisingly, were attentive to the situation: Senators explicitly referred to the steep stock market decline in July as a rationale for the need for legislative action.[229] That response was certainly not out of the ordinary: as Stuart Banner has shown, most new major securities regulations in the United States, as well as the United Kingdom, have followed stock market crashes.[230]

It should be noted that the downward spiral in the stock market ceased after the conference committee reported its bill, but the upward drift was only temporary: by October 2002

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[228] General Accounting Office, Report to the Chairman, Senate Comm. on Banking, Housing, and Urban Affairs, Financial Statement Restatements Trends, Market Impacts, Regulatory Responses, and Remaining Challenges 32-34 (Oct. 2002) (UBS/Gallup Index of Investor Optimism, a suvey-based index of investor sentiment that has been conducted since 1996). Id. The GAO attributed the loss of investor confidence to accounting scandals (the large number of financial statement restatements). The investor confidence indices of the International Center for Finance at the Yale School of Management did not, however, register a consistent decline over that period (the "one-year" and "crash" confidence indices increased over the period and the "buy on dip" confidence index remained unchanged for institutional investors but declined for individual investors). Id. at 37.

[229] E.g., 148 Cong. Rec. S6558 (Jul. 10, 2002) (Sen. Reid) ("the stock market dropped again today almost 300 points. We need to do something to reestablish credibility and reestablish confidence... .This legislation goes a long way toward that end");id. at 6622 (Jul. 11, 2002) (Sen. Nelson) ("commenting on "timeliness" of Leahy amendment to Sarbanes bill to increase criminal penalties, among other provisions, in conjunction with "yesterday when the market dropped almost 300 points . . . being a reflection ... that confidence is sinking"); id. at S6744 (Jul. 15, 2002) (Sen. Allen) ("in today's climate, with the stock market dropping again today, ...it is axiomatic that there is a pressing need for accounting reform... the bill, as it is presented, is a very good bill").

[230] Stuart Banner, What Causes New Securities Regulation? 300 Years of Evidence, 75 Wash. U.L.Q. 849, 850 (1997). The SOX governance mandates and Banner's observation are consistent with the results of an interesting model of news media bias by David Baron, in which issues receiving media attention produce increased regulation. David P. Baron, Persistent Media Bias, Stanford Graduate School of Business Research Paper No. 1845 (Feb. 2004). The model depends on a median voter model of politics and the assumption, which is supported by empirical evidence, that the news media is biased toward the left, a bias Baron translates into the regulatory context as in favor of more stringent regulation.

the S&P was back to about where it had been in July. It is, consequently difficult to attribute the change in market direction upon the conference report to the market's positive assessment of the substantive provisions of SOX: if that had been the case, the upturn following the conference report should not have been temporary. The same difficulty is presented with Senator Gramm's more jaded take on the legislation: in supporting the conference report, he noted that investors should be reassured that the bill being enacted was not worse.[231] (That is the interpretation advanced in the Li et al. event study of the legislation as well.) But whether one considers the reconciliation across chambers as stemming a negative market assessment of previously introduced legislation as too lenient (the Democrats' view of the market decline after the House action in April) or too strict (Senator Gramm's view of the market decline during the Senate deliberations), in either scenario, the upturn should not have faltered. This leads me to conclude that the declining stock price pattern pre-enactment is best explained as a reflection of investors' assessment of market fundamentals, and not of the legislation moving through Congress.

A possible interpretation of the resumption of the market decline soon after SOX's enactment is that the market's initial positive evaluation of the legislation changed to a negative assessment. Insofar as public opinion poll data are informative on such matters, as they are not polls of investors, they are at best murky: in polls taken during and after the Senate's deliberations but before the conference report, a majority of respondents indicated that they

[231] 148 Cong. Rec. S7354 (Sen. Gramm) (July 25, 2002) (remarks justifying his support of the bill reported out of conference) ("If people on Wall Street are listening to the debate and trying to figure out whether they should be concerned about this bill, I think they can rightly feel that this bill could have been much worse. I think that if people had wanted to be irresponsible, this is a bill on which they could have been irresponsible and almost anything would have passed on the floor of the Senate.")

thought the Senate's bill would have a minor or no effect on reducing corporate wrongdoing, but that position changed to a minority shortly after the legislation was enacted; yet one month later, a much smaller percentage (a bare majority) opined that the legislation would make a difference than the proportion who thought that it was not enough and "more [had] to be done."[232] The inconclusiveness of the polling data bolsters the view, already noted, that the market trend during the legislation's consideration and after its enactment is best understood as evincing random fluctuations in line with market fundamentals, rather than investors' reactions to SOX.[233] Of

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[232] The "Polling the Nations" database, which consists of over 14,000 surveys, conducted using scientifically selected random samples, by over 700 polling organizations in the United States and other countries from 1986 to the present, contained five questions asking respondents' views on the effect of the proposed/enacted legislation on corporate misconduct or corporate corruption as follow:

Poll	Field dates (sample size)	Major effect	Minor (no) effect
Newsweek	July 11-12 (1000)	26%	48% (14%)
Newsweek	July 17-19 (1004)	27%	48% (14%)
CNA/USA Today/Gallup	July 29-31 (1003)	66%	30%
NBC News/WSJ*	Sep. 3-5 (1011)	50%	44%

*The NBC News/Wall Street Journal poll asked (of one-half of respondents) whether the respondent felt the legislation will make a "real difference" or "not make a real difference," in contrast to whether they thought it would have a "major effect," the wording of the other three polls. This poll also asked (of the other one-half of respondents) whether they thought "enough will have been done" or "more should be done," than the legislation, which question received responses of 24 percent and 71 percent, respectively.

[233] Peter Wallison has advanced another plausible explanation of the stock market movement, also unrelated to SOX, the market's reaction to an anticipated war in Iraq, by expanding the window of analysis to June 2003. Peter J. Wallison, Introduction, Sarbanes-Oxley: A Review (May 5, 2004), available at http://www.aei.org/docLib/20040506_WaillisonIntroduction.pdf. He notes that post-9/11, the market began to rise after the United States attacked Afghanistan on October 19,2001, and that trend continued well beyond the Enron collapse. Rather, the market decline began in March 2002, and continued into September 2002, for a 3000 point drop in the Dow Jones Index, a period in which the market reaction to the events of WorldCom and SOX are "not even a blip on the chart." Id. at 2. He then notes that the market picked up at the end of September through November 2002, but then declined again until March 2003 when it began a long and significant

course, the members of Congress did not have the benefit of hindsight and, rightly or wrongly, with an upcoming election looming, they interpreted the market decline from April through July 2002 as requiring legislative action.

B. The Legislative Debate

The corporate governance mandates, which interposed federal regulation on what had previously been within the states' jurisdiction, were neither a principal nor subsidiary focus of legislative consideration. With the exception of the restriction on non-audit services by auditors, for all practical purposes, they were not even discussed. The legislation in both houses was considered within a narrow time frame: only one day, for instance, was allocated for the House's consideration of the financial services committee's bill. The Senate debate, which lasted a week, was conducted under a Republican press for a cloture motion that succeeded, which restricted the time for legislative consideration as well as permissible amendments.[234] Hence, the usually key role of committees in the formulation of legislation was virtually absolute, and in the committees, the Democrats' drafting was heavily informed by the views of former SEC chairman Arthur

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recovery, continuing into 2004 (a 2000 point increase in the Dow). Wallison therefore associates the decline beginning in March 2002 with investors' uncertainty concerning an anticipated war with Iraq (for example, the Prime Minister of the United Kingdom, Tony Blair, announced that he would support United States action against Iraq on March 8, 2002), and the upturn in the market a year later with investors' uncertainty being resolved when the United States and United Kingdom invaded Iraq on March 19, 2003. Id. He fills in the details of his explanation by contending that the rise in the stock market in September 2002 coincided with the Bush Administration's request for United Nations support against Iraq on the anniversary of 9/11.

[234] After cloture is invoked, debate on a bill is limited to "a maximum of 30 additional hours . . . before a vote must be taken." Samuel Kernell and Gary C. Jacobson, The Logic of American Politics 228 (2d ed. 2003). This procedure is described in detail in the discussion of the debate in the Senate in part III.B.2, infra.

Levitt and his former SEC chief accountant Lynn Turner.[235] In a remarkable turn of events, Levitt was able to revive his agenda for accounting regulation (particularly the prohibition on non-audit services) that had failed less than two years earlier when confronted with bipartisan Congressional support for the accounting profession's position against Levitt's proposals.[236] No doubt, Levitt's having ready-made solutions for perceived problems with the accounting profession, in conjunction with his long-time support of and affiliation with the Democratic party,[237] and his background in the securities industry and as a regulator who took on the accounting profession, made him a natural and trusted source for advice and guidance among Democrats.

1. The Debate in the House

The majority party exercises strict control over the legislative process in the House, and the adoption of Representative Michael Oxley's committee's bill was no exception: the

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[235] For example, in introducing the bill and summarizing its content, the floor manager, Senator Sarbanes, referred to Arthur Levitt's testimony regarding the kind of regulatory board that was needed. 148 Cong. Rec. S6331 (Jul. 8, 2002) (Sen. Sarbanes). In introducing and describing his committee's bill, the floor amendment to SOX containing the criminal provisions discussed in part III.B.2, infra, Senator Patrick Leahy referred to Arthur Levitt, along with his predecessor SEC chairman, as supporting the provision expanding the statute of limitations for private securities actions. Id. at S6440 (Jul. 9, 2002) (Sen. Leahy). See also id at S6525 (Jul. 10, 2002) (Sen. Wellstone) (discussing his support in 2000 of Levitt's failed effort in restricting non-audit services and characterizing Sen. Sarbanes' bill as largely implementing that agenda: "[Levitt's] solution looked a lot like what is in this bill"); and note 88, supra (indicating Levitt's influence on the Democrats' bill in the House).

[236] See text and accompanying notes 84-86, supra.

[237] See Arthur Levitt, Take on the Street 3-4,7, 10 (2002) (describing his political background, including his father's elected position, as a Democrat, as New York State Comptroller, his fund-raising effort for Bill Clinton's 1992 Presidential campaign, and his lobbying activities for the American Stock Exchange).

Republican party shepherded the bill through the floor with one day of debate. In that debate, Democrats objected to the absence of provisions that subsequently appeared in the Senate bill (two of these were substantive corporate governance mandates, the expansion of prohibited non-audit services and the certification requirement, and both provisions appeared in a House Democratic bill that was offered as a substitute amendment and defeated on the floor). But the bill passed with broad bipartisan support. For most Democrats, the easy calculation was that in their upcoming reelection campaigns, a vote against the Republican legislation, on the ground that the bill was not tough enough and that they had voted for a tougher bill that had been defeated, could be difficult to explain.[238]

No one mentioned at any point in the House debate, the independence of the audit committee or executive loans, the subjects of the SOX corporate governance mandates most intrusive on state law jurisdiction, nor did those mandates appear in the House Democrats' bills, whose consideration the Republicans suppressed.[239] In fact, few Representatives participated in

[238] As will be discussed in part III.B.2, a similar dynamic eventually operated in the Senate, as the same calculation was obviously made by Senate Republicans who voted for the Democratic bill and who, it should be noted, did not have the opportunity for an up-down vote on their own bill as a substitute, as did the House Democrats.

[239] The House bill contained a provision requiring disclosure of executive loans, as noted in part III.C.2, infra. The minority views included in the report accompanying the House bill in April did, however, object to the bill not having any provision restricting the definition of directors' independence to exclude their acting as "consultants," citing in support, the views of Lynn Turner, the SEC chief accountant when Arthur Levitt was Chairman. Minority Views, House Comm. on Financial Services Report, Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, Rep. No. 107-414, 107th Cong., 2d sess. 49 (Apr. 22, 2002) (hereafter House Report). The substitute bill that was offered by the financial services committee's ranking Democrat, Representative John J. LaFalce, had a provision that instructed the SEC to adopt rules requiring independent directors to be nominated by nominating committees consisting solely of independent directors, with the definition to follow the definition used by the stock exchanges in their rules on audit committees. See House Committee of Rules,

the debate at all; of those who did, virtually all were members of the financial services committee that had produced the bill.

As Table 6 indicates, the issue that attracted the most attention during the House debate was the creation of an accounting industry regulator. Given the absence of corporate governance provisions in the House committee's draft legislation, this is unexceptional, as creation of a new regulator, which was advocated by Harvey Pitt, was the bill's most significant alteration of the status quo. The Table shows a related pattern, however, when action in the Senate three months later triggered further activity on the legislation in the House: none of the governance provisions that had been introduced in the Senate bill were even mentioned in the House debate over the Senate bill.[240]

Political scientists have characterized House floor debate as for "public consumption"

Providing for Consideration of H.R. 3763, Corporate and Auditing, Accountability, Responsibility, and Transparency Act of 2002, Rep. No. 107-418, 107th Cong., 2d Sess. 35 (Apr. 23, 2002).

[240] Over two days of consideration, House members raised issues similar to those then being discussed in the Senate, and not the Senate's additions of the governance provisions regarding audit committees and loans, nor the differences in the Senate and House bill on the matters earlier debated in the House, regarding restrictions on non-audit services and the new overseer of the accounting profession. The floor debate summarized in panel C of Table 6 (July 16) concerned a judiciary committee bill, drafted by the Republicans in response both to the House Democrats' bill that had similar provisions to the Democratically-controlled Senate judiciary committee's bill being enacted in the Senate at the time, and to remarks by President Bush calling for harsher criminal sanctions for securities fraud. Much of the debate on that day consisted of Democrats objecting to what they considered to be improper political maneuvering by the Republicans to rush their bill to the floor and prevent a vote on the Democrats' alternative. The floor debate in panel D of Table 6 (July 17) was over a motion by the Democrats to instruct the House members of the conference committee to support the Senate version over that of the House, with respect to extending the statute of limitations for private securities actions and certain other criminal and civil provisions; that motion was defeated on a party-line vote of 207:218. 148 Cong. Rec. H4846 (Jul. 17, 2002) (roll no. 313).

rather than persuasion of members on the other side of an issue.[241] Even from that perspective, the absence of reference to the corporate governance reforms that were included in the final bill is notable, because it indicates that members of Congress did not consider them to be matters that would serve either to justify their vote or to demonstrate to constituents how legislation was solving the "Enron" problem. The governance provisions therefore would appear to have been of principal interest to corporate governance policy entrepreneurs, individuals "inside the beltway," at least as far as House members were concerned.

2. The Debate in the Senate

While committee deliberations are conventionally considered key to the making of legislation, floor action is often important for shaping legislation in the Senate, compared to the House.[242] This is because Senate rules permitting nongermane amendments and filibusters provide individual Senators with considerable ability to affect – and delay – legislation. To obtain an orderly and timely consideration of a bill, the party leadership therefore "routinely negotiate unanimous consent agreements" that determine what amendments will be allowed and other procedures to be followed.[243]

That routine changes with a successful cloture motion, since once cloture is invoked, debate and amendments are severely restricted.[244] Because under the Senate rules a cloture

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[241] Kernell and Jacobson, supra note 234, at 229.

[242] See, e.g., Kernell and Jacobson, supra note 234, at 229.

[243] Id. at 228.

[244] Only amendments that are germane to the bill are permissible once cloture is invoked. This contrasts with the ordinary Senate procedures, by which any amendment can be added to a bill, compared to the House rules, which require amendments to be germane, when they are

motion requires the vote of 3/5 of the Senate, with the restrictions on debate thereafter, the leadership of both parties have to agree on the content of a bill (and line up support of sufficient party members) to be able to sustain a successful cloture motion. In the absence of the successful cloture motion on SOX, a more extensive unanimous consent agreement would have been necessary instead, and that might have been difficult to achieve, given the many members seeking to attach their issues to the legislation.[245] The successful cloture motion's limitations on the Senate debate over SOX accordingly meant that matters unresolved in committee would

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permitted under the rule adopted for considering a bill. Id. at 227, 229.

[245] For a sense of the problem, see, e.g., 148 Cong. Rec. S6535 (Sen. Gramm) (July 10, 2002) ("we are going to have a literal blizzard of amendments not directly related to this bill . I continue to believe that at some point, in order to finish the bill, we are going to have to file cloture"); id. at S 6558 (Sen. Levin) ("What my great fear is -which is being reinforced tonight- is that the time is going to be filled not by relevant amendments but in other ways which would preclude the consideration of relevant amendments in the event cloture is adopted. . . I don't know if other people waiting in line with amendments that are relevant have the same concern"); id. at S6632 (Jul. 11, 2002) (Sen. Sarbanes) (criticizing a Senator for trying "to jump ahead of other people" to get a vote on his amendment: "we have these people lined up here who want to do amendments... We have been trying to process those amendments, and we have not been able to do it. As one who is down here trying to work overtime to get these amendments processed, I want to very strongly register that point"); id. at 6633 (Sen. Gramm) (responding to a Senator proposing to debate all amendments for a half-hour each: "we have 36 Republicans who want to offer an amendment. My amendment is next on the list. I am the ranking member of this committee and it appears I am not going to get an opportunity to offer an amendment....There are 58 Democrat amendments. .. If we sat here and tried to do [all of them]-and some of them having to do with things such as the Ninth Circuit Court of Appeals or bankruptcy law - we would literally spend 3 or 4 months"); id. at S6684 (July 12, 2002) (Sen. Sarbanes) ("I urge my colleagues to vote for the cloture motion. I know there are a lot of amendments pending, but we have now been on this legislation a full week. . . ..There are a number of amendments that are relevant to the bill but not germane. Once cloture is invoked, they will fall. I know that is a matter of some concern to those who are proposing those amendments, but I do not know how we can handle this differently and move along towards a resolution.. . . In addition . . . there are also amendments that are not even relevant. . .. I am frank to say to my colleagues, I do not see how we can progress and move towards a final vote and resolution on this issue without invoking cloture this morning. . . .We have to move forward on this legislation").

never reach the floor, and that compromises in committee could not be recrafted, unless there was unanimous agreement.

Although the Senate bill was drafted by the Democrats, the Republicans had some input because their support was needed to move the legislation. Because the Democrats had a bare floor majority of one vote, major legislation such as SOX required some degree of bipartisan support in committee to have any possibility of success on the floor (let alone for legislation to proceed to an expedited vote with the Senate operating under cloture). The authorization for up to two members of the new accounting regulator's board to be (or have been) certified public accountants is the most prominent instance of the Republicans' ability to affect the legislation.

The inclusion of practicing accountants on the new regulator's board was of particular concern to Senator Michael Enzi, a Republican who was the only certified public accountant in the Senate and a member of the banking committee; his support of the Democratic bill, which was crucial to its reaching the floor, depended upon that provision's inclusion. Legislation had been stalled in the Senate committee because the Democrats who controlled the Senate favored greater regulation than the Republicans, but a Democratic bill that passed on a party line vote in committee was not considered likely to succeed on the floor. Accounts of the Senate committee deliberations indicate that it took until the end of May for the committee chairman, Senator Sarbanes to draft a bill acceptable to all of the Democrats on the committee, and another month to reach his agreement with Senator Enzi.[246] Their compromise ended the committee stalemate, as Senator Enzi had been sponsoring the alternative Republican bill, and his shift in support

[246] See David S. Hilzenrath, Jonathan Weisman and Jim VandeHei, How Congress Rode a 'Storm' to Corporate Reform, Wash. Post (Jul. 28,2002), p. A01.

brought over other members of his party, so that Senator Sarbanes could achieve a bipartisan, albeit non-unanimous, committee vote in favor of his bill and bring it to the Senate floor.[247]

Still, the Republicans' input into the committee draft was peripheral. Republican committee members submitted over 100 proposed amendments to Senator Sarbanes' bill, stalling the bill's progress, and the compromise with Senator Enzi released the bill without including the substance of those proposals.[248] The dispute between the parties over the regulatory sweep of the bill (with the Republicans favoring a narrower bill similar to that passed by the House) was the reason why Senate action was protracted compared to the House, whose rules enable the majority party to implement its will.[249] During the course of the legislative process, however, the Republicans' strategy changed from what the press characterized as delaying tactics and efforts to kill the bill, to seeking expedited action: the Republican leadership sought a cloture motion after the bill reached the floor (and thereby supported the bill's adoption), although it had opposed the bill throughout the committee process. The Republicans' explanation for the shift was that they expected to be better positioned to influence the legislation in the conference

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[247] The committee vote was 17 to 4 (six of the ten Republicans on the committee voted for Senator Sarbanes' bill). Id. Senator Enzi recognized Senator Sarbanes' compromise on the accounting board composition provision that he deemed so important. See 148 Cong. Rec. S6338 (Jul. 8, 2002) (Sen. Enzi) (thanking Sen. Sarbanes for changing the language of the legislation so that two board members will be accountants).

[248] Senate Democrats Forced to Lower Expectations on Accounting Reform Bill, Securities Week, May 27, 2002, at 1. Most of the amendments were offered by the ranking minority member, Senator Gramm, who was opposed to Senator Sarbanes' bill. See Douglas Turner, SEC Chief to Impose 'Stringent' Rules on Accountants, Buffalo News, May 24, 2002, at A9 (Sen. Gramm, who "opposes increased regulation of the accounting business," introduced 77 of 123 amendments to the bill at the "last minute").

[249] The Republicans had a larger margin of control in the House than the Democrats did in the Senate (although it was still a narrow one).

committee, which would have to reconcile the Senate bill with the House bill that they preferred.[250]

But the calculation of a better outcome in conference does not explain why they sought to expedite the legislative process (after all, the bill would end up in conference whether it took a week or a month on the Senate floor). The learning in the political science literature suggests an answer: emergency legislation is more likely to be considered under restrictive rules such as a cloture motion, than other legislation; political scientists attribute this finding to legislators' having high discount rates in such a context, that is, in a situation calling for emergency action, legislators have strong preferences for "earlier rather than later passage."[251] This hypothesis – that SOX was emergency legislation – has plausibility in accounting for the switch that led to the agreement on cloture.

Initially, Enron's collapse in the fall of 2001 generated a crisis situation and a media

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[250] See, e.g., 148 Cong. Rec. S 6684 (Jul. 12, 2002) (Sen. Gramm) ("We need to pass a bill. We are going to conference with a House bill that is substantially different from this bill.. . The amendments being offered now are largely nongermane. . . It is very important that we get on with our business and that we pass this bill. I intend to vote for it today. I do not think it is the bill we need in the end, but it gets us to conference where we can get the bill we need in the end. I urge my Republican colleagues to vote for it, not because in the end they are for this version but because they want to do something We need to bring this debate to a close.. . . So I urge my colleagues to vote to end the debate."). The agreement on the expanded statute-of-limitations provision producing the cloture vote, see note 266, infra, further illustrates this description of the Republican's position. The first person to mention the possibility of a cloture motion on the floor of the Senate was Senator Enzi, a Republican, in his initial remarks on the legislation on the first day of debate. See 148 Cong. Rec. S 6340 (Jul. 8, 2002) (Sen. Enzi) ("As we get into this bill, there are virtually no limits on what amendments can be put on –at least unless there is a cloture motion. I hope people will recognize the need to have something done, the need to get it done quickly, and not try and make this a vehicle for everything they ever thought needed to be done with corporations.")

[251]Keith Krehbiel, Legislative Organization, 18 J. Econ. Perspectives 113, 125 (Winter 2004).

frenzy, as every congressional committee that could find some jurisdictional basis held a hearing on the scandal. But by April, the sense of an emergency had lessened, such that the members of the Senate banking committee did not feel any urgency to agree on a bill in response to the House action. Indeed, even after Senator Sarbanes took several months to craft a bill that met bipartisan committee approval, it appeared that the bill would not progress: the best the majority leader could do was to try to schedule a vote on the bill for sometime after the August recess, and legislators opposed to the bill expressed the view that "Enron's moment as a galvanizing issue ha[d] passed."[252] But when the WorldCom scandal broke on June 26, the political environment changed dramatically once again, as the Senate majority leader, now predicting 80 votes in support of the bill, was able to move it up on the calendar for a July vote; Senator Phil Gramm, the ranking member on the Committee who opposed the bill and had earlier thought the "feeding frenzy" was over and the movement for legislation stopped, did not even attempt to stem the progress to a vote.[253] This chain of events suggests that circumstances had altered Senators' perception of the situation, to be one calling for emergency action, and the Senate thereupon moved on the legislation rapidly, agreeing to cloture, after having taken no action on the House bill for months.

A further and related impetus for the Republicans' desire to expedite the legislative process was that the issue of corporate accountability which was implicated by the accounting scandals was considered a Democratic issue, and the concern was that Democrats would gain in

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[252] Stephen Labaton and Richard A. Oppel Jr., Enthusiasm Waning in Congress for Tougher Post-Enron Controls, N.Y. Times, June 10.2002, at A1.

[253] Hilzenrath et al., supra note 246.

the mid-term elections if no legislation was enacted and Republicans could be portrayed as "soft" on corporate crime.[254] Indeed, there was an effort to widen the accounting scandals into a broader political scandal for the Republican Administration because Enron had been a major contributor to George Bush's presidential campaign.[255] Other legislators picked up on press reports pointing out that President Bush had received loans as a corporate officer in the 1980s, in an attempt to tie him to the scandals.[256] Although the scandal-stoking strategy failed, as the news

[254] E.g., Borrus and McNamee, supra note 9. Democrats actively sought to associate Republicans, and especially the Bush Administration, with corporate crime. E.g., 148 Cong. Rec. 6749 (Jul. 15, 2002) (Sen. Grassley) ("I have heard during . . news conferences.. Democrats wishing to use Enron and WorldCom events very much as, I think, political issues. I think the Democrats are hoping for a "November storm" in which our economy is weak and no progress is made on accounting reforms....the distinguished majority leader on "Face the Nation" recently attributed the current crisis to the alleged "permissive" attitude in the Bush administration towards business.")

[255] E.g.,The Enron Collapse: Implications to Investors and the Capital Markets, Hearings before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the House Comm. on Financial Services, 107th Cong., 2nd Sess. 17 (Serial No. 107-51 Pt.1) (Dec. 1, 2001) (hereafter Enron Hearings I) (Rep. Sanders) ("The Chairman of Enron ...contributed $800,000 to the Republican party since 1988...During the 2000 presidential campaign, Enron made its [jets] available for candidate Bush...There is no question but Enron, through their political contributions and influence, has had an enormous impact on energy policy and the way this Government does business.") Without doubt, this allegation was a reason why campaign finance reform was enacted in the aftermath of Enron's collapse, as Enron also made substantial contributions to many members of Congress, as summarized in note 257, infra.

[256] E.g., 148 Cong. Rec. S6608 (Jul. 11, 2002) (Sen. Byrd) ("I ask ...to have printed in the Record an article from today's Washington Post titled 'Bush Took Oil Firm's Loans as Director' and an article from today's Washington Times titled 'Cheney named in fraud suit.'") The litigation against Vice President Cheney regarding accounting questions at his former corporation was brought by Judicial Watch, a conservative group that had also sued the Vice President to obtain information concerning private meetings of his energy task force, and whose request to obtain documents regarding President Clinton's last-minute pardons had been refused by the Bush Administration . Watchdog Group Is Suing Cheney and Halliburton, New York Times, Jul. 11, 2002, C2; National Briefing Washington: Hard Line on Records, New York Times, Aug. 3, 2002, A12; Elisabeth Bumiller, White House Withholding Documents on Pardons, New York Times, Aug. 28, 2002, A17.

reports did not have traction (no doubt because Bush's corporate loans were small, disclosed and legal, the Administration did nothing to save Enron from demise, there followed scandals involving firms that were major contributors to Democrats (WorldCom and Global Crossing),[257] and Congress enacted campaign finance reform legislation), it was nevertheless an ever-present concern for Republicans.

The controversy over the legislation in the Senate included only one of the corporate governance mandates (the restriction on non-audit services). In particular, the key provisions in the House bill that the Senate Democrats rejected were the provisions that left the organizational structure of the new accounting regulator as a matter for the SEC to determine and that

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[257] The Center for Responsive Politics, which tabulates Federal Election Commission filings on campaign contributions, shows the following summary data in special issue reports for these companies (available on their website, www.opensecrets.org):

Company	Election cycle	Total contributions+	Democrats	Republicans
Enron	2002	$353,959	6%	94%
Enron	1990-2002*	$5,951,570	26%	74%
WorldCom	2002	$1,016,614	50%	50%
WorldCom	1990-2002**	$7,554,291	46%	54%
Global Crossing	2002	$724,270	55%	45%
Global Crossing	1998-2002***	$3,573,665	55%	45%

+ Total contributions include contributions from individuals and political action committees, and soft money contributions (not reported before the 1992 election cycle), given to federal parties and candidates.
* From 1989-94 (election cycles 1990-94), 42 percent of Enron's contributions went to Democrats and 58 percent to Republicans; thereafter, the proportion given to Democrats ranged between 6 and 21 percent. Over the full period, it gave a total of $736,800 to George W. Bush (for gubernatorial and presidential campaigns, and recount and inauguration funds); $111,513 to 29 Democratic Senators, $415,730 to 41 Republican Senators, $257,090 to 69 Democratic Representatives and $345,748 to 117 Republican Representatives. (Based on FEC data as of 1/1/02.)
** From 1989-96 (election cycles 1990-96), WorldCom gave a higher percentage, ranging from 62 to 72 percent to Democrats than Republicans; thereafter the proportion given to Democrats ranged between 30 and 50 percent. Figures represent contributions from donors affiliated with MCI Telecommunications, WorldCom Inc. and MCI WorldCom, and include contributions to leadership PACs. (Based on FEC data as of 6/1/02.)
*** In the 1998 election cycle, the proportion Global Crossing gave to Democrats was only 22 percent, compared to 55 percent in the 2000 and 2002 cycles. (Based on FEC data as of 1/1/02).

maintained the language of the SEC's rule restricting non-audit services, while adding two more services to those enumerated.[258] Those provisions dovetailed with then SEC Chairman Harvey Pitt's proposals for regulatory reform (which had been vetted with the accounting profession), and accordingly, the accounting profession supported the House legislation. This created an additional barrier to reaching a compromise because Arthur Levitt's failed effort in accounting regulation a few years earlier was attributed to Pitt's successful efforts, as counsel to the accounting profession, in orchestrating political support for the industry against the SEC. No doubt, the Democrats' displeasure with Pitt and the Republicans' support for him, was a factor contributing to their differing positions on the organization of the entity regulating accounting.

In this regard, it should be noted that, although the debate in the House was, by contrast, circumscribed due to Republicans' ability to exercise strict control over the process, the antagonism toward the SEC Chairman was, in fact, so intense, that in the House committee hearings, Democrats insisted that he be sworn in as a witness, to the Republicans' irritation, because the convention, as they contended, was to do so only for witnesses representing

[258] The two services (internal audit and financial information systems) now proscribed by Congress had not been included in the rule the SEC adopted in 2000 because of opposition by the accounting profession, which, in the atmosphere of corporate scandals, had now acquiesced in their ban. The House Democrats objected that the Republican bill "includes no real limits on non-audit services" and it "references the existing SEC rules in a way that includes only the limited restrictions that the SEC currently places. . . codifying existing regulatory carve-outs... mak(ing) no change in existing law." Minority Views, House Report, supra note 239, at 48. The Senate bill enumerated all of the non-audit services restricted in the SEC rule along with those two services. It also relocated the rule-making authority regarding those services to the new accounting regulator. In addition, the Senate bill did not leave the details of the accounting regulator to the SEC, but established them itself, giving the SEC only the power to appoint the members of the new entity's board.

organizations under investigation.[259] In general, the Republicans sought to delegate as much authority as possible to the SEC to organize the regulation of the accounting profession, while the Democrats' objective was to create an entity with greater independent authority and to provide it with instructions on its role.[260] It is possible that the parties' positions might have been otherwise had there been a different SEC chairman (or if the positions were reversed and Democrats had controlled the executive branch).

There was a near total absence of discussion on the Senate floor of the three corporate governance mandates – the independent audit committee provisions, executive loan ban and certification requirement – that were included in the Senate, but not the House, bill. Table 6 makes graphic how unproblematic those provisions were viewed by legislators. Only a minority of Senators (28) referred to those provisions on the floor (and nearly all references were included in laundry lists, in which Senators expressed support for the legislation by enumerating specific provisions in the bill).[261]

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[259] See Enron Hearings II, supra note 88, at 2-9.

[260] The position of the Senate Republicans was somewhat different concerning the organization of the new accounting regulator. Senator Gramm stated that he and Senator Enzi had proposed in committee, instead of the Democrats' grant to the SEC the authority to appoint the board of the new regulator, that the SEC, CFTC, Federal Reserve Board and the President, each appoint two board members (with a requirement that half have accounting expertise). 148 Cong. Rec. S6335 (July 8, 2002) (Sen. Gramm). They also opposed any specification in the statute regarding non-audit services, contending that the issue should be left to the new regulator, which would have the time and expertise to do a "reasoned analysis" of what should be proscribed, along with the ability to adapt any such rule to changing circumstances or perceptions of the problem, in contrast to a federal statute (noting that it took 60 years to change the Glass-Steagall legislation). Id.

[261] The count of 28 eliminates double-counting of Senators who referred to more than one of the governance provisions in their remarks; no Senator referred to all four mandates but five Senators referred to three of them. It should be noted that two of the six references to executive

As Table 6 indicates, floor time was most commonly expended on references to the bill's proposed oversight board for the accounting industry and the restrictions on non-audit services (besides these matters' inclusion in Senators' laundry lists in support of the bill, Republicans expressed a preference for the form those provisions took in the House bill). Most of the other topics in Table 6 were raised either in conjunction with consideration of a Senate judiciary committee amendment to the bill, or individual Senators' attempts to propose amendments to the bill that the leadership would not permit.

The judiciary committee bill (the Leahy amendment), consisted of provisions involving criminal penalties (as this was not within the banking committee's jurisdiction), protection for whistle-blowers, and a provision extending the statute of limitations for private securities fraud actions.[262] That provision overruled a Supreme Court decision setting the statute of limitations that had been left unchanged by Congress' 1995 private securities litigation reform legislation, despite lobbying at the time by the SEC and plaintiff's bar to have the decision overruled. The Democratic majority bundled the statute of limitations provision with the bill's broadly-

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loans included in the tally in Table 6 were references to the original disclosure requirement, bearing no relation to the subsequent amendment of a prohibition. When the Senate adopted the conference report on July 25 (remarks not tabulated), four of the 14 Senators who made any remarks at the time referred to the loan provision. Two of those Senators had referred to the loan provision in the debate on the bill. The only other provisions mentioned by more than two Senators in the deliberation on the conference report were: enhanced criminal sanctions (eight); accounting profession regulator (six); and restriction of non-audit services (five). Senator Sarbanes was the sole Senator to refer to the audit committee provision; he also covered the most items - six - in his review of the key provisions of the legislation. Senator Gramm highlighted the second highest number of items - four - only one of which was a governance mandate, the non-audit services restriction.

[262] The criminal certification requirement was added by another judiciary committee proposal, referred to as the Biden-Hatch amendment.

supported extensions of criminal penalties for securities fraud; in contrast to the penalty provisions, this provision was controversial, and had a partisan tinge given Republicans' general support for litigation reform restricting liability and Democrats' opposition, paralleling the perspective of key constituencies, the business community for the Republicans and the plaintiff's bar for the Democrats. [263] It was, understandably, not in the Republican-controlled House's version of a criminal penalty bill. The 1995 securities reform legislation was bipartisan legislation (it withstood a veto by then President Clinton), although it had been vigorously opposed by the plaintiff's bar, which was said to have had great influence on the President's action.[264] After the Republicans gained the White House in 2001, litigation reform initiatives

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[263] The Senate judiciary committee voted against a Republican amendment to exclude the provision expanding the statute of limitations by a party-line vote (with one Republican cross-over) of 7:11, and then approved, by voice vote, an amendment lowering the bill's expansion of the statute of limitations from the earlier of three years from the date of the discovery of the fraud or five years from the date of the fraud, to the earlier of two years from the date of the discovery of the fraud or five years from the date of the fraud. The Corporate and Criminal Fraud Accountability Act of 2002, Rep. No. 107-146, Sen. Judiciary Comm., 107th Cong. 2d Sess. 22 (May 6, 2002) (hereafter Judiciary Report). The 1995 securities litigation reform act, and Supreme Court decisions cutting back on liability, were mentioned by witnesses during the hearings as factors contributing to the accounting scandals. E.g., Senate Hearings, supra note 40, at 1008 (Mar. 20, 2002) (opening statement of Sen. Howard Metzenbaum, Chairman, Consumer Federation of America); id. at 1018-19 (opening statement of Damon A. Silvers, Assoc. Gen. Counsel, AFL-CIO). A related proposal promoted by the same witnesses, reestablishing aiding and abetting liability under the federal securities laws, which would have similarly overturned a Supreme Court decision that was left intact by the1995 act and was of interest to the plaintiff's bar, was not included in the bill. E.g., id. at 1008 (Sen. Metzenbaum); id. at 1018-19 (Damon A. Silvers). Given the omission of the one and not the other from the bill, it is most plausible to conclude that there was not sufficient support among Senators of either party for such an expansion of liability, and that it was excluded to ensure the legislation would move forward.

[264] The President's veto was unexpected, and William Lerach, one of the leading securities class action plaintiffs' lawyers, met with President Clinton at a political dinner the weekend before he vetoed the legislation, although White House officials stated that the two did not discuss the legislation. See Neil A. Lewis, Securities Bill Becomes Law as the Senate Overrides Veto, N.Y. Times (Dec. 23, 1995), p. 39.

were blocked by Senate Democrats,[265] and the effort to "repeal" the 1995 limitations on securities litigation (the only litigation reform that had been adopted at the federal level) was viewed with considerable ire by many Republican legislators and the business community.

The statute-of-limitations provision's inclusion provided an opening for a key legislative maneuver. Senator Gramm moved to separate the statute-of-limitations provision from the other provisions in the Leahy amendment, which he was able to do as a matter of right under the Senate rules. This move jeopardized the bill's progress. Shortly thereafter, the two sides reached an agreement to clarify the language regarding the extension of the statute of limitations and to file a cloture motion on the bill (an action, as earlier discussed, that the Republican leadership desired in order to get to conference), and the division of the Leahy amendment was withdrawn.[266]

An issue generating debate, the accounting for stock options, was sought to be included

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[265] President Clinton had vetoed other tort reform legislation as well passed by the Republican Congress, see Dan Van Natta Jr. with Richard A. Oppel Jr., The 2000 Campaign: The Contributions: Memo Linking Political Donation and Veto Spurs Federal Inquiry, New York Times, Sep. 14, 2000, A1, and President Bush ran on tort reform among other issues, Leslie Wayne, Trial Lawyers Pour Money into Democrats' Chests, New York Times, Mar. 23, 2000, A1. When the Democrats took control of the Senate in 2001, tort reform was "written off as dead" by lobbyists. Leslie Wayne, Senate Shifts, So Lobbyists Who Seek to Influence Its Legislation Scramble to Shift, Too, New York Times, June 9, 2001, A16.

[266] See 148 Cong. Rec. S6534 (Jul. 10, 2002) (motion dividing the Leahy amendment); id. at S6538 (Sen. Gramm) (describing agreement). Before the agreement was reached, there was a floor colloquy in which Senator Sarbanes sought Senator Gramm's agreement to adopt the parts into which he had divided the Leahy amendment that did not include the statute-of-limitations provision and then they could discuss on the floor the statute-of-limitations provision (which Senator Sarbanes commented was the only part of the amendment to which Senator Gramm had indicated an objection), but Senator Gramm refused, referring to his and other members' desire to offer additional amendments to the bill, and mentioning his support for a cloture motion. Id. at S6535.

as an amendment to the bill by Senators John McCain and Carl Levin.[267] The leadership of both parties had agreed to not include the accounting for stock options in the bill (given a lack of consensus on that issue, which could threaten adoption of legislation).[268] Their agreement to consider the legislation under the cloture motion that expedited passage by prohibiting non-germane amendments (of which the stock option provision was one), as well as limited the duration of debate, ensured that the amendment would not make any progress.[269] It should be

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[267] Senator Mitch McConnell was allowed to offer an amendment to apply certification and audit requirements to labor unions before the cloture motion came into effect; eight senators spoke on his amendment (not reported in Table 6), and it was tabled by a vote of 55 yeas to 43 nays, 148 Cong. Rec. S6534 (Jul. 10, 2002) (roll call no. 168). Thereafter, many instances of floor remarks, also not reported in the table, consisted of individual senators seeking to offer amendments, or objecting to the cloture motion that prohibited their ability to offer amendments.

[268] Almost a decade earlier, when the FASB proposed the expensing of stock options, the high technology industry mounted a successful lobbying campaign in Congress that resulted in FASB's withdrawal of the proposal. The SEC at the time advised the FASB to retreat in the face of the political controversy. See Levitt, supra note 237, at 11. For a sense of the Senate debate over the FASB proposal, see 140 Cong. Rec. S5030-46 (May 3, 1994) (debate over Senator Joseph Lieberman's amendment no. 1668, a resolution providing the "sense of the Senate" that the "status quo" in the accounting for stock options should be retained, which was adopted by a vote of 88:9 in roll call vote no. 98 Leg.) An amendment to the bill that would have required the FASB to do in 2002 what the Senate had in 1994 instructed it not to do was controversial on the merits, as many members still opposed the policy, e.g., 148 Cong. Rec. S6744 (Jul. 15, 2002) (Sen. Allen); id. at S6636-40 (Sen. Enzi), and controversial procedurally, as some members were against the further politicization of the accounting rule-making process and considered the bill's new funding arrangement for FASB to render a provision on stock options unnecessary because it eliminated concern over the independence of FASB's rule-making, e.g., id. at S6697 (Sen Sarbanes); id. at S6698 (Sen. Santorum). Independent of his view on the merits, Senator Sarbanes' opposition undoubtedly was pragmatic as well: as noted in the text, he had gained support in committee for his bill from key Democratic Senators by agreeing to eliminate a provision requiring the expensing of options, and he therefore could not support its introduction on the floor without jeopardizing the coalition he had put together for his bill.

[269] One reason the leadership opted to limit debate is that, as everyone recognized a bill had to be enacted because the public wanted action, a large number of Senators filed amendments, seeking to add extraneous provisions to the bill, which would prolong the legislative process unless cloture was invoked. See, e.g., 148 Cong. Rec. S6559 (Jul. 10, 2002)

noted that this was not simply a cross-party issue. To obtain support for his bill in committee from members of his own party before negotiating the compromise with Senator Enzi, Senator Sarbanes had agreed to eliminate a provision in his bill that would have required option expensing.[270]

A few amendments agreed to by both parties were added to the bill on the floor without debate, one of which was the prohibition of loans to executives. There was no discussion of that amendment when it was offered by Senator Schumer: it was simply immediately unanimously agreed to without a roll call vote.[271] President Bush had called on corporate boards to prevent officers from receiving company loans in a speech a few days before on Wall Street.[272] Senator Schumer referred to the President's remarks when introducing the amendment, and noted that he had "spoken to people in the White House who were supportive of [the] amendment."[273] The President's unexpected remarks appear to have been a decisive factor in the inclusion of this

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(Sen. Gramm) (referring to the many amendments filed, which he considered to have "nothing to do with the bill," such as amendments on bankruptcy, the Ninth Circuit Court of Appeals, pensions, tax policy and stock options).

[270] Hilzenrath et al., supra note 246.

[271] 148 Cong. Rec. S6690 (Jul. 12, 2002). Because they were operating under the cloture time limits, this was essentially the only way that new amendments could be made to the bill.

[272] See "Summary: A New Ethic of Corporate Responsibility" (Jul. 9, 2002), available at http://www.whitehouse.gov/news/releases/2002/07/20020709.html. In contrast, the certification requirement was part of the specific corporate governance proposals promoted by the President in March 2002. See note 195, supra. The President's July 9 press release on the issue did not seem to indicate that he was seeking a statutory, rather than voluntary, termination of loans to executives, as his "call" to cease the practice was addressed to corporate compensation committees. The part of the President's release that was addressed to Congress was a request for action on a proposal of additional funds for the SEC.

[273] 148 Cong. Rec. S6690 (Jul. 12, 2002) (Sen. Schumer).

provision, because Senator Sarbanes, the manager (and drafter) of the legislation, stated, when introducing the bill on the Senate floor, that the banking committee did not "go [as] far" as prohibiting loans to executives, as some had argued, but instead opted for a disclosure requirement, because "some testified there are some good reasons" for providing loans to officers "on occasion."[274]

The near total absence of considered discourse on SOX's governance provisions is consistent with characterization of the corporate governance issues as being below the radar screen and "inside the beltway." In the limited time frame available for legislative debate, Senators did not focus any attention on the corporate governance provisions. Thus, as in the House, legislators who could not possibly be informed on technical issues and who felt that they had to act under the pressure of mounting corporate accounting scandals, accepted the bill that was presented, which in this case consisted of policies advocated by trusted former government officials acting as policy-entrepreneurs, as filtered by the banking committee chairman who relied heavily on their advice. Those individuals, in turn, sometimes advanced proposals that they had previously advocated and that they believed would improve the quality of financial reporting, despite a lack of evidence supporting their beliefs. With little attention accorded the proposals in the committee hearings, and even less attention on the floor,[275] the disjuncture

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[274] 148 Cong. Rec. S6332-33 (Jul. 8, 2002) (Sen. Sarbanes).

[275] The committee hearings are discussed in section III.C, infra. Corporate governance proposals were often suggested in witnesses' written statements but not emphasized in their oral testimony, and consequently they were not a focus of much attention by the legislators participating in the hearings. The Chamber of Commerce lobbied against several provisions of the bill, see, e.g., U.S. Chamber of Commerce Letter to the Senate on Public Company Accounting Reform and Investor Protection Act of 2002 (July 15, 2002), available at http://www.uschamber.com/government/letters/020715s2673.htm (hereafter Chamber Senate

between the recommended policies and the scholarly literature was never even acknowledged, as might have been possible if the legislative process had not been operating in a crisis atmosphere.

One corporate governance provision generated some attention on the floor and in the committee hearings, the prohibition on the provision of non-audit services. But the debate over this issue was, in large part, a replay of a battle over the regulation of the accounting industry fought two years earlier when Arthur Levitt chaired the SEC. The environment this time was, however, markedly different. There was a media frenzy, which was heightened by a sharply declining stock market and high-profile accounting frauds and business failures, in the middle of an election year. For example, the major network evening news coverage over January-July 2002 contained 613 stories on business of which 471 or 77 percent were about corporate scandals, and of those stories, 195 connected corporations to Congress (individual members or the institution itself), while 188 connected corporations to the Bush Administration; this compared to a total of 489 business stories (of which 52 were about scandals) in the same period the prior year.[276] Moreover, more than 80 percent of the news stories looked to government action to address the problem.[277] In this charged atmosphere, the earlier proposals of the Democrats' source of

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Letter) but when WorldCom collapsed the lobbying process shut down and the Republicans, who had up to then taken the business community's objections seriously, reversed course and accepted the Democrats' bill. See Top of Their Game: Lobby Leaders in 2002, Legal Times, Dec. 16, 2002 at 14. As one commentator put it, "the Chamber [of Commerce] called on Congress to be 'cautious' in its final considerations of the measure. Congress' answer: fat chance in an election year." Peter Mayberry and Jessica Franken, Legislation targets stock scandals, Nonwovens Industry, vol. 33, no. 9, p. 20 (Sep. 1, 2002).

[276] Remarks of Karlyn H. Bowman, American Enterprise Institute for Public Policy Research, Sarbanes-Oxley: A Review (May 5, 2004) (discussing data compiled by the Media Research Center), available at http://www.aei.org/events/eventID.809,filter.all/event_detail.asp#.

[277] Id.

expertise (former SEC chairman Levitt and chief accountant Turner, for instance) now seemed prescient, and the accounting industry had lost its public credibility with the audit failures.[278]

Democrats' reliance on Levitt for expertise on accounting regulation in the context of the highly publicized and time-restricted deliberation over SOX is critical for understanding why Congress enacted a series of provisions that are ill-matched to meet the stated objectives. During Levitt's term as SEC chairman, empirical research was of no import for the setting of regulation. This fact is made plain by the agency's response to the Panel on Audit Effectiveness' failure to find that audit quality was compromised in connection with the provision of non-audit services. In the release on the proposed auditor independence rules restricting non-audit services, the SEC summarily dismissed the concern raised by the accounting profession in light of the Panel's report, that there was no evidence of a connection between the provision of non-audit services and accounting fraud or audit compromise; it stated: "Studies cannot always confirm what common sense makes clear."[279] The Panel, it should be recalled, was created at the request of the SEC chairman. Not surprisingly, a statute informed by Levitt's perspective would give short shrift to a literature that did not fit with his preconceptions.

The difficult political environment provides the context for why the Republicans voted

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[278] See Top of Their Game, supra note 275 (accounting industry's "lobbying effectively stopped the day WorldCom hit.") The impact of media pressure on the congressional bandwagon for the Levitt-Turner approach is apparent in Senator Gramm's floor remarks. While criticizing the bill's prohibition of an enumerated set of nine non-audit services, instead of his proposal that would have left the decision to the new accounting regulator, he referred to having "read editorials" that said the provision "makes the bill tougher, but I don't think it makes it better," 148 Cong. Rec. S6335 (Jul. 8, 2002), and he "lament[ed]... that the media has decided that the tougher bill is the bill with more mandates," id at 6333.

[279] SEC, Revision of the Commission's Auditor Independence Requirements, Release Nos. 33-7870; 34-42994; 35-27193, 65 Fed. Reg. 43148, 43155 (July 12, 2000).

for a bill influenced by Democratic policy advisors whose views were at odds with their own political viewpoint. As previously noted, they publicly stated that they were seeking quick adoption of the Democratic bill in order to get to conference, with the expectation of reaching a compromise there on a more favorable bill (that is, a bill closer to the bill adopted by the House, which Republicans controlled).[280] An added benefit generated by this strategy was that it would provide one less reason for the public to have a negative view of Congress: political scientists have found that public opinion is least approving of Congress when it engages in open partisan debate and conflict over legislation (that is, attitudes to Congress are influenced not simply by the policies produced but by the processes that make those policies).[281] Limited consideration and quick floor passage of the bill curtailed partisan debate and shifted discussion of the issues out of

[280] See, e.g., 148 Cong. Rec. S6540 (July 10, 2002) (Sen. Gramm, ranking member on the banking committee) ("I want to reiterate that when cloture is filed in a few minutes, I will be supportive. . . .I think the agreement we worked out has guaranteed we are going to pass this bill either this week or very early next week. The net result is that we can go to conference with the House, and we will have an opportunity, I believe, to come back with a strong bipartisan bill"); id at S6769 (July 15, 2002) (Sen. Gramm) (noting that rights to add amendments were limited to only those that were agreed to, excluding some people who are unhappy about the process, but emphasizing that the conference committee will produce a stronger and more flexible bill that will have bipartisan support, and "the sooner we get to conference, the sooner we can write a bill and see the bill signed into law.") Even before cloture was invoked, Senator Gramm held out the hope that a more acceptable bill would emerge from the conference. Id. at S6337 (Jul. 8, 2002) (Sen. Gramm) (referring to financial services modernization bill, which he supported and Sen. Sarbanes did not, that passed the Senate by a narrow margin but came out of conference supported by both Senators and approved by 90 Senators, and anticipating similar result, a broadly-supported compromise bill, being produced in conference).

[281] John R. Hibbing and James T. Smith, What the American Public Wants Congress to Be, in Lawrence C. Dodd and Bruce I. Oppenheimer, Congress Reconsidered (7th ed.) 45, 48-52, 61-63 (2001). It should be noted that the idea that partisan debate produces negative consequences may be limited to modern Congresses (the data from which the hypothesis is derived and tested are from post-World War II Congresses, so the relation may not hold historically), and many members of Congress appear to behave as if it were not true, as they often engage in intensive partisan debate.

the public spotlight. Electoral concerns were thereby aided at the cost of a comprehensive consideration of the implications of the legislation.

It is far from clear how realistic the Republicans' expectation of achieving a better result in the conference committee was at the time of the floor debate: some studies by political scientists, for example, have suggested that the Senate has the upper hand in conference.[282] But whatever the merits of the strategy, with hindsight, that calculation proved to be seriously mistaken. The conference compromise strategy unraveled as a rapidly changing environment, once the conference committee convened, made the political landscape considerably more hostile to the Republicans' less regulatory-oriented position. That is, events overtook them: intensive media coverage calling for government action and attacking the House bill as inadequate[283] took a toll in the wake of additional revelations of accounting irregularities at WorldCom and its

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[282] For a review of studies indicating Senate dominance in conference see William J. Keefe and Morris S. Ogul, The American Legislative Process (8th ed.) 181-82 (1993). The studies they review do not provide much in the way of a theoretical explanation for that result, except to note that in the appropriations context in some of the studies, the Senate is required to move second, and Keefe and Ogul caution that it is difficult to tell who "wins" given the complexity of legislation. Other political scientists emphasize that Senate rules give it an advantage in conference: the greater power of individual Senators to hold up legislation translates into a supermajority vote necessary for that chamber's adoption of the conference's output, compared to only a majority in the House. Barbara Sinclair, The New World of U.S. Senators, in Dodd and Oppenheimer, supra note 281, at 1, 17. But it is, in all likelihood, impossible for there to be any long-term, predictable, systematic institutional difference in conference success rates, because the losing chamber would become cognizant of that fact and adapt its legislative strategies to offset the disadvantage, such as, by revising the initial content of proposed bills to alter the nature of the conference bargaining process to its advantage, or by otherwise redesigning its procedural rules.

[283] E.g., Editorial, Mr. Oxley Punts, Washington Post, Apr. 24, 2002. The intensified national network news coverage of the corporate scandals, see text and accompanying notes 276-77 supra, framed the issue as a "national and systemic problem" rather than one of "individual or corporate misdeeds," necessitating government action. Bowman, supra note 276.

subsequent bankruptcy filing, the tanking of the stock market, and fear that there might be additional revelations of corporate misconduct that would further depress the market and would make corporate scandals a potent reelection issue. Internal polls indicated that public confidence was dropping, and that made Republicans concerned that any delay in acting on corporate governance legislation (which meant adopting the Democrats' bill), would be "politically perilous."[284] As a lobbyist for the Chamber of Commerce, which opposed the Senate bill, put it, "When the WorldCom scandal hit, it became to me, a bit of a --a very different attitude and atmosphere, if not a political tsunami."[285]

Those factors -- a media frenzy, the precipitous drop in the stock market in conjunction with reelection concerns -- led the conference committee to act quickly and report a bill virtually identical to the Senate bill, with only a few minor changes (such as inclusion of the House's lengthier criminal sanctions).[286] The Republicans, that is, capitulated to the Democrats' bill. As the House minority leader, Richard Gephardt, put it, the Republicans' action was "an

[284] Gail Russell Chaddock, Congressmen, too, feel pocketbook panic, Christian Science Monitor, July 25, 2002, p.2.

[285] ABC News, supra note 10 (remarks of Bruce Joston, Executive Vice President, Government Affairs, U.S. Chamber of Commerce).

[286] The Republican position in the House debate over the Democrats' motion to instruct the House members of the conference committee regarding the Senate's bill emphasized that the House bill had tougher criminal penalties than the Senate bill; the House Democrats favored the Senate bill because of its extension of the statute of limitations for securities fraud and of the rights of whistle blowers to bring civil actions, 148 Cong. Rec. H4838-46 (Jul. 17, 2002), items, it should be noted, of interest to an important constituent of the Democratic party, the trial bar, as discussed in part III.E, infra. Two changes, advocated by business groups, on the certification requirement, were also adopted in conference, but a third, to eliminate the statute-of-limitations extension, was not. Hilzenrath et al., supra note 246.

unconditional surrender."[287] This may well have been a prudent decision for Republicans from the perspective of their electoral ambitions, as opposed to improving the quality of public policy regarding corporate governance: as one commentator has suggested, the electoral gains Republicans made in the mid-term 2002 election were due to national security (September 11) being the public's dominant concern rather than, as had been expected, corporate scandals, which were thought to be an issue favoring the Democrats.[288] The enactment of SOX may have contributed to a shift in public focus by removing corporate scandals from the public policy agenda.

C. The Role of Policy Entrepreneurs

Congressional hearings serve multiple functions in the formulation of public policy, often educating the public, more than legislators, about proposed legislation. Information gleaned from the hearings held by the committees that produced SOX confirms that public policy entrepreneurs, most of whom were former government officials, along with the Senate banking committee chairman, Senator Sarbanes, were key in the formulation of SOX's corporate governance provisions. The House financial services and Senate banking committees, which, with jurisdiction over securities law, were the originating committees for SOX, held seven and ten hearings, respectively, from December 2001 to April 2002, before reporting bills to their respective chambers. Two of the House committee hearings were directed at draft legislation (the majority and the minority bills). The Senate banking committee held no hearings on the bill

[287] Jim Drinkard, Deal reached on business reform, USA Today, July 25, 2002, p.1A.

[288] E.g., Alan Ehrenhalt, The Vast Right-Wing Conspiracy and How it Grew: Thoughts on Thirty Years of Politics (Nov. 3, 2003) (American Enterprise Institute video, available at http://www.aei.org/event476).

it introduced on the Senate floor in response to the House bill (nor on any other draft bill). But most of the ten hearings that it held on Enron-related concerns focused on issues that were included in the reported bill (such as, the structure of a new oversight agency for accountants, and a prohibition on non-audit services).

1. Witnesses at the Hearings

Table 7, which tallies the witnesses who testified before the committees, indicates that the Senate's inquiry was more focused on issues involving the accounting profession, as it heard from a larger number of accounting industry regulators and members than did the House. But because all five of the Senate witnesses from the accounting industry were affiliated with the AICPA and testified on the same panel, the industry was not as well represented as it might appear,[289] since by placing all of the industry's testimony into one session, with individuals expressing one institution's policy perspective, the potential impact of the testimony on Senators and the public through the media covering the hearings was subtly diluted. By contrast, accounting regulators were also grouped together on panels, but they testified over several sessions and consequently there was a greater opportunity for legislators to assimilate their positions and for the media to showcase their perspective.

The Senate also heard from a larger number of academic or policy institute-based witnesses than the House. However, in contrast to the House, remarkably, the Senate heard not a single witness from the business community, even though they were an anticipated object of regulation, and ostensibly even among the potential beneficiaries of the legislation – they would

[289] It should further be noted that the SEC chief accountants are classified as government officials, not accounting regulators, in Table 7, and, thus, the number of accounting regulators testifying (compared to industry representatives) is even higher than appears in the Table.

for instance benefit from any improvement in the quality of auditing accomplished by legislation. In other respects, the makeup of witnesses was similar: the largest number of witnesses in both committees were government and former government officials (virtually all from the SEC), and a few witnesses represented institutional investors, consumer groups and unions.

Before attempting to trace the relationship between the mandates in the Senate bill and the testimony of committee witnesses, it should be noted that witness lists are obviously not random. Committees select their witnesses. The presence or absence of a specific class of witnesses in one chamber compared to the other, is a conscious choice which relates to specific policy objectives. A hearing provides an opportunity to showcase potential legislation, and may therefore be "orchestrated to make a record for (or against) a particular proposal."[290] Given that the House and Senate were controlled by different parties, they would not be expected to have identical witnesses lists, as the parties' legislative objectives differed markedly. Moreover, an important institutional difference is that in the House, the majority party exercises far greater control over the legislative process than in the Senate. Thus, the selection of witnesses can be expected to be more one-sided in the House than in the Senate. In this regard, it is instructive that the House minority demanded a hearing, which they had of right under the House rules,[291]

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[290] Kernell and Jacobson, supra note 234, at 225. Hearings may also be used "to generate publicity for committee members as well as issues." Id. The hearings of other committees (not summarized in the Table) investigating Enron's collapse, which summoned as witnesses Enron executives who they knew were going to invoke their Fifth Amendment rights, fall in that category.

[291] Enron Hearings II, supra note 88, at 127 (Apr. 9, 2002) (Rep. La Falce). The focus of the hearing was a comparison of the Democrats' bill with that of the majority. It was held after the committee's hearings were completed, right before the committee was to mark up the Republican bill.

whereas the Senate minority expressed its satisfaction at the hearings conducted by Senator Sarbanes.[292] There was, in fact, little overlap between the House and Senate witnesses.[293]

A final difference between the two chambers' hearings should be noted, as a factor that may have affected policy entrepreneurs' effectiveness and thereby contributed to the absence of corporate governance mandates in the House compared to the Senate legislation. The House committee hearings were on specific legislative proposals, which tightly focused witnesses' remarks. By contrast, Senate witnesses could range far more freely, as they were not directed to comment on particular bills. Senator Sarbanes circulated a draft of his bill after the conclusion of the hearings, that had been completed without much input from committee members including those of his own party (although as has been noted, he then tempered his bill on non-governance

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[292] E.g., 148 Cong. Rec. S6333 (Jul. 8, 2002) (Sen. Gramm) ("I would like to say for the record that no one can object to the hearings we had, the approach the chairman has taken"); id. at S6338 (Sen. Enzi) ("Had it been my choice to call the witnesses, I would have chosen nearly every person who testified.")

[293] Only a minority (six) of the witnesses testified to both the House and Senate committees. Five were government and former/government employees: Harvey L. Pitt (then SEC Chairman), Roderick M. Hills (SEC chairman, 1975-77) and Lynn E. Turner (SEC Chief Accountant, 1998-2001, during Arthur Levitt's term as Chairman), who testified to both chambers' committees; Richard C. Breeden (SEC Chairman, 1989-93) and David M. Walker (Comptroller General of the United States, U.S. General Accounting Office, serving a 15-year term, to which he was appointed in 1998), who testified at a Senate committee hearing and at the hearing held at the request of the minority of the House committee. The sixth, a union official, Damon A. Silvers (Associate General Counsel, AFL-CIO), testified to both committees, although his appearance at the House hearing was specifically identified as being at the request of the ranking minority member. Not included in that count are two organizations that were represented by different individuals in the two chambers, the Consumers Federation of America (whose representative for the Senate hearing was the chairman, a former Senator) and TIAA-CREF, although its Senate witness, the chairman John Biggs, appears to have been called not as a representative of that specific institutional investor, but as a corporate governance expert because of his participation (along with the other witness on his panel) on the Blue Ribbon Committee, as well as on the Public Oversight Board (the other members of which testified on subsequent Senate panel).

dimensions to gain the requisite votes).[294]

2. Executive Loans

The origin of the executive loan provision in the Senate bill is the easiest of the corporate governance mandates to trace. At the initial Senate hearing, one witness expressed concern about executive loans. This was former SEC chairman Richard C. Breeden, who recommended that all loans should be disclosed in corporate proxies and, when above a specified amount, subject to shareholder approval.[295] This resonated with Senator Sarbanes, who proceeded to ask six other witnesses (witnesses on two panels considered to have expertise in corporate governance) what they thought of Breeden's testimony regarding loans. Only one witness, former Senator Howard Metzenbaum, representing the Consumer Federation of America, thought that loans to officers should be banned.[296] The other witnesses – who represented institutional investors, the AFL-CIO, and a prominent corporate governance attorney – only

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[294] See Karen Hosler, A Slow Path to Audit Reform, Baltimore Sun, June 5, 2002, at 2A (Sarbanes' "draft bill [was] written mostly without [Democrats'] consultation"); David L. Greene, Bush Signs Bill to Battle Fraud by Businesses, Baltimore Sun, Jul. 31, 2002, at 1A (bill was "crafted largely by Sen. Paul A. Sarbanes"). There were other bills: Senators Corzine and Christopher Dodd had co-sponsored legislation before the hearings had concluded, and Senator Enzi drafted the Republican's bill, which was a "less sweeping" regulatory bill than Senator Sarbanes' bill. The Sarbanes and Enzi bills were the rival bills in the end, each unable to obtain a committee majority, as the committee composition was virtually evenly divided between the parties. See Senate May Switch Strategy on Enron Accounting Bills; Hold Hearings Before Vote, Securities Week, June 3, 2002, at 1. In particular, there were eleven Democrats and ten Republicans on the committee, but the Senate's most conservative Democrat, Zell Miller, who voted more often with Republicans than his own party, was one of the Democrats.

[295] Senate Hearings, supra note 40, at 62 (Feb. 12, 2002). He also suggested prohibiting the use of stock to repay loans. No other witness included the regulation of loans in their prepared statements.

[296] Id. at 1024 (Mar. 20, 2002).

expressed support for disclosure.[297] Indeed, one of the witnesses noted how company loans originated for the legitimate purpose of assisting relocations and that it would "get very messy" if Congress were to say "You can never lend money to an employee."[298]

Richard Breeden was also a witness at the House hearing called at the request of the minority, but the issue of executive loans was not mentioned in his House testimony.[299] His written statement responded to specific questions posed by the committee to the witnesses in advance, none of which explicitly mentioned loans. Although the questions mentioned corporate governance and disclosure of conflicts of interests, Breeden did not take the opportunity to include a recommendation regarding loan disclosure in any of his responses. As his testimony to the House occurred two months after he had testified to the Senate, whatever the reason for the omission, it was not because the issue had not occurred to him. It is possible that Breeden did not refer to loans because the House bill contained a loan disclosure provision, but he specifically

[297] Id. at 370 (Feb. 27, 2002) (John H. Biggs, Chairman, TIAA-CREF; Ira M. Millstein, attorney and co-chairman, Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees); id. at 1024, 1026 (Mar. 20, 2002) (Sarah Teslik, Executive director, Council of Institutional Investors); id. at 1025 (Damon A. Silvers, Associate general counsel, AFL-CIO); id. at 1026 (Thomas A. Bowman, President, Association for Investment Management and Research, the financial analysts association).

[298] Id. at 1026 (Sarah Teslik).

[299] In the House hearings, executive loans came up only once, at an early hearing held before a bill had been drafted (and before Breeden's testimony to the Senate), when a representative asked Harvey Pitt whether he thought a "more efficient disclosure mechanism" was needed under the insider trading disclosure regulations for insiders selling stock back to their company, "whether to pay off loans or what," and more generally for all executive loans. Enron Hearings II, supra note 88, at 44 (Feb. 4, 2002). Pitt replied that the SEC needed to take a closer look, as more disclosure might be needed, and that it probably had sufficient authority to take care of disclosure issues, but he could "understand why Congress might deem it appropriate to legislate here." Id. That response must have satisfied the representative, as the issue was not raised again in the hearings.

addressed other provisions in the bill to commend or criticize their inclusion, so that would not appear to be a satisfactory explanation for the omission. This suggests an additional possibility, that corporate loan regulation was not high on Breeden's agenda. Indeed, disclosure of executive loans was only one of a number of proposals that Breeden had suggested to the Senate committee, and he raised one of those other ideas in his written House responses.[300] Senator Sarbanes mulled over Breeden's proposal regarding executive loans with other witnesses, and adopted that approach in his bill, paralleling the provision in the House bill, which was neither inspired nor discussed by Breeden (nor any other House witness).

The minimal discussion of executive loans during the hearings tracks the absence of discussion of the issue in the floor debates. In the frenzy during which the legislation was being considered, however, the provision requiring loan disclosure was altered to a prohibition. The ban on executive loans was one of the corporate governance ideas floated by the President at the time the bill was being considered in the Senate that was acceptable to Democrats and meshed with populist hostility towards corporate executives, and they therefore inserted it in the legislation. Just why the President made the suggestion is unknown. Perhaps he was seeking to immunize himself from further criticism of loans that he had received when he was in business.

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[300] Among his other proposals were moving to multi-year contracts for auditors with serious periodic review, a cooling-off period before public corporations could hire a member of the outside audit team in senior financial positions, and requiring accounting firms to have independent boards of directors. Senate Hearings, supra note 40, at 61, 65. Only the first of these was mentioned in his House statement, in response to a question regarding mandatory rotation; House CARTA Hearings, supra note 88, at 476: in response to a question regarding what corporate governance reforms were necessary, he suggested disclosure of waivers of company ethics or conflicts codes, and of any conflict of interest of a senior officer. Id. at 473. Breeden was not the only witness to refer to a cooling-off period in the Senate hearings, and it was included in the bill.

But whatever the reason, the President's remarks appear to have upped the ante in the Senate, and without deliberation, a relatively innocuous idea from the perspective of corporate governance, that of increased disclosure of conflicted transactions, was transmuted into a major federal preemption of state law that had, in fact, previously been explicitly rejected by the legislator paying the most attention to governance issues, Senator Sarbanes.

Whether Senator Sarbanes would have included a disclosure provision if he had foreseen its transformation into a ban cannot be ascertained with hindsight. It is probable, given the timing of the President's remarks, that the prohibition would have been included as an amendment to the Senate bill even had there been no provision touching on loans; it is unlikely that any Senator would have objected and the subject matter would surely have been deemed germane. But it is ironic that the avenue facilitating its inclusion, the loan disclosure provision, was an idea that appealed more to the committee chairman than to its originator, Richard Breeden, for whom it was one, and, in all likelihood, not the most important one, of a series of proposals, most of which were not pursued by the committee. A further irony is that the amendment, which was rather reflexively unanimously agreed to on the Senate floor, increased the divergence between the two chambers' bills at the same time as the Republicans were promoting cloture as a mechanism to bring their chamber's bill more in line with that of the House. As with virtually all of the disagreements across the chambers resolved in conference, the House abandoned its version and accepted the loan prohibition.

3. Independent Audit Committees

The origin of the Senate provision requiring independent audit committees is a bit murkier to trace than the loan provision. The composition of the audit committee was a concern emphasized by former SEC chairman Roderick Hills, in both chambers' earliest hearings, although his specific proposal was to require the appointment of the members of the audit committee to be by nominating committees consisting exclusively of independent directors.[301] It should be noted that the initial stock exchange requirement of an audit committee occurred on his watch as SEC chairman, in 1974, in the wake of a corporate scandal involving "sensitive" payments to foreign officials.[302] Hills perceived his recommendation as being a timely and necessary follow up to that legislation, the provision of a "legislative endorsement" or a "more formal legal status" of audit committees.[303]

Other witnesses on the Senate panel with Hills also referred to the importance of independent audit committees or a vague need to "enhance" their independence, but they did not provide specific proposals.[304] In later sessions, however, witnesses made more concrete recommendations on independence, that are similar to the provisions included in the Senate bill.

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[301] Senate Hearings, supra note 40, at 83 (Feb. 12, 2002); House CARTA Hearings, supra note 88, at 262 (Mar. 13, 2002). He further elaborated this recommendation in a written addendum sent to the committee as a follow-up to his testimony, Id. at 92 (letter dated Feb. 19, 2002) ("I particularly recommend that Congress mandate that independent competent audit committees must be present on all boards of companies whose stock is held by more than some minimum number of shareholders.")

[302] Id. at 78. The foreign payment scandal also produced federal legislation, the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494, which prohibited such payments and required public companies to adopt a system of internal controls.

[303] Id. at 92.

[304] E.g., Senate Hearings, supra note 40, at 67 (Feb. 12, 2002) (written statement of Richard Breeden) (states should "enhance audit committee independence" but no specific proposal); id. at 73 (written statement of David S. Ruder, SEC Chairman, 1987-89) (noting role of audit committee is "particularly important" but no specific proposal); id. at 75 (written statement of Harold M. Williams, SEC Chairman. 1977-81) (noting "need to address," among other topics, the composition of the board and audit committees, but no specific proposal).

Most notably, Lynn Turner stated that the stock exchange rules permitting exceptions to the requirement that all audit committee members be independent should be eliminated.[305] Another former SEC chief accountant, Michael Sutton also recommended requiring all independent audit committees.[306] The third former SEC chief accountant who testified on the panel, Walter Schuetze, stated that Enron's problems were inherent to current accounting rules (that assets and liabilities are not marked to market), rather than due to lack of auditor independence or oversight, and provided copies of his articles discussing how accounting ought to be reformed, which also referred to another article's "excellent analysis" of why the presence of independent audit committees cannot improve the quality of an audit.[307] He did not, however, challenge his co-panelists' recommendation on audit committee composition, nor was he asked for his views on that matter, and the suggestion in his articles that independent audit committees would not alleviate the problem was not picked up on by any Senator. It was simply ignored.

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[305] Id. at 198-99 (Feb. 26, 2002). He also advocated changing the definition of independence to prohibit payments on behalf of the director to charitable organizations. Audit committee independence did not come up in Turner's testimony to the House, but his proposals to eliminate exceptions from the stock exchange rules on audit committee independence and to modify the definition of director independence were included in his written statement. House CARTA Hearings, supra note 88, at 288 (Mar. 13, 2002).

[306] Sutton did not refer to this recommendation in his oral remarks but opined in his written statement that audit committees "should be made up of entirely independent directors." Senate Hearings, supra note 40, at 243 (Feb. 26, 2002) (written statement of Michael H. Sutton, SEC Chief Accountant, 1995-98). The written recommendation was picked up by Senator Miller, who asked another witness, who was a corporate governance expert, what he thought of it. Id. at 362 (Feb. 27, 2002) (Sen. Miller) (addressing Ira Millstein, "Yesterday Mr. Sutton went so far as to recommend that the audit committee ought to be made up entirely of independent directors. What do you think about that?")

[307] Id. at 189, 291 (opening statement and written statement of Walter P. Schuetze, SEC Chief Accountant, 1992-95).

The recommendation regarding audit committee independence of the other two former SEC chief accountants was not, however, ignored. Senator Sarbanes, for example, stated at the outset of the Senate hearing that came after their testimony that suggestions had been "brought to [the committee's] attention to require the stock exchanges to toughen board and committee independence standards." [308] The objective of that subsequent hearing was, in fact, "to consider numerous corporate governance issues raised by recent corporate difficulties," and among the list of such issues Senator Sarbanes identified as receiving "widespread attention," was the independence of directors and audit committees.[309] That day's panel was comprised of two witnesses called as experts on corporate governance, the co-chair of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, Ira Millstein, a prominent corporate lawyer, and John Biggs, the chief executive of the activist institutional investor, TIAA-CREF, who was a member of the Blue Ribbon Committee and the Public Oversight Board.

Neither of the corporate governance expert witness' statements referred to audit committee composition, and when asked whether audit committees should consist solely of independent directors, both witnesses replied that was already the practice (a reason, presumably, for their not addressing the matter in their prepared remarks).[310] Mr. Millstein had recommended requiring (through SEC encouragement of new stock exchange listing requirements) that a substantial majority of boards be independent directors, and that the nominating and

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[308] Id. at 342 (Feb. 27, 2002) (Sen. Sarbanes).

[309] Id. at 341.

[310] Id. at 362 (Ira Millstein) (stating independence of committee already required by stock exchanges); id. (John Biggs) (stating independence "pretty standard" now).

compensation committees consist of all independent directors, as well as standardizing the definition of director independence to be the stock exchanges' definition of independence for audit committee members (which followed the Blue Ribbon Committee's definition).[311] In this regard, Mr. Millstein echoed the position of former SEC Chairman Hills, concerning the need for independent nominating committees. Mr. Millstein in his testimony never even referred to the existence of a literature that was at odds with his position on board independence, of which he was fully aware as he had co-authored an article at variance with the literature on the point.[312] It was instead treated as though it did not exist. The committee bill did not follow his further suggestions, however; it focused solely on audit committee composition.

As with the issue of executive loans, Senator Sarbanes also asked the witnesses on the second panel devoted to corporate governance their views on the need to strengthen audit committee independence, but on this occasion he referred to former SEC Chairman Hill's testimony regarding the relation between audit and nominating committees, rather than that of the former chief accountants. The reaction of this panel was similar to that of the prior panel of experts. None of the witnesses offered specific responses directed at the composition of the audit committee, although the written statement of the witness representing the Consumers Federation

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[311] Id. at 354, 362. Although Congress did not pick up on this suggestion, the stock exchanges amended their listing requirements to require listed companies to have a board majority of independent directors and nominating and compensation committees consisting of all independent directors. SEC Release No.34-48745, Self-Regulatory Organizations, Order Approving Proposed Rules Changes, 68 Fed. Reg. 64154 (Nov. 4, 2003) (approving NYSE Final Rule, Final Corporate Governance Listing Standards, to be codified at NYSE Listing Manual 303A; and NASD Amendments to Rules 4200 and 4350(c).)

[312] Paul W. MacAvoy and Ira M. Millstein, The Active Board of Directors and Performance of the Large Publicly Traded Corporation, 98 Colum. L. Rev. 1283, 1296-98 (1998).

of America advocated requiring stock exchanges to adopt the Blue Ribbon Committee's recommendation of entire independence, and the witness from the Council of Institutional Investors, in response to written questions, advocated tightening the definition of independence.[313] It should be noted that both of those witnesses, in the written documents provided to the committee, also recommended requiring that a majority of the board be independent, as did the witness representing the financial analysts' organization.[314]

Finally four Senate witnesses raised as an issue the independence of the audit (or nominating) committee in their testimony but only one actually recommended complete independence of the audit committee, and that was a circumspect recommendation.[315] An equal

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[313] Id. at 1040 (written statement of Sen. Howard Metzenbaum); id. at 1057 (written responses to questions from Sen. Akaka of Sarah Teslik). Sen. Metzenbaum's response to Sen. Sarbanes' question regarding audit committee independence was to suggest that a procedure be developed whereby "outside sources" would recommend who to put on the audit committee, rather than have management select them, while Ms. Teslik's oral response was to suggest having audit committees select the auditor and certify their firm's financials. Id. at 1022.

[314] Id. at 1040 (written statement of Sen. Howard Metzenbaum) (recommending exchanges be pressed to adopt a listing requirement that a majority of the board be independent, and tighter definitions of independence); id. at 1057 (written response to questions from Senator Akaka of Sarah Teslik) (recommending requiring 2/3 of boards be independent); id. at 1048 (written statement of Thomas A. Bowman, President and Chief Executive Officer, Association for Investment Management and Research, the professional organization of financial analysts) (recommending requiring a board majority of independent directors, along with board rather than management appointment of the members of the audit, nominating and compensation committees). Arthur Levitt also expressed the opinion that stock exchanges should adopt listing standards requiring a majority of independent directors on boards, but he did not advocate that as a legislative reform. Id. at 15.

[315] These included two of the academic/policy analyst witnesses and two government/former government officials. Id. at 533 (Joel Seligman, Dean, Washington University School of Law) (stating he was "struck by the testimony" of former SEC Chairman Hills and recommending to strengthen the independence of the audit committee and to create independent nominating committee that appoints the audit committee); id. at 876 (written statement of Robert E. Litan, Vice President and Director, Economic Studies Program,

number of witnesses emphasized the need for audit committee members to have greater auditing, finance, and accounting expertise.[316] None of the witnesses expressed the slightest awareness of a literature bearing on whether director independence (on the audit committee or on the board as a whole) or expertise mattered for audit quality (or corporate performance). It is therefore understandable why an audit committee independence requirement was viewed as unproblematic: the idea had been advanced by former high-ranking government officials who were well-regarded by members of the banking committee, the committee Chairman found the idea attractive, and the committee never had to confront the reality that there was a relevant literature whose learning was starkly at odds with this regulatory focus. As far as the committee was concerned, it did not exist.

In the House hearings, a few witnesses raised the issue of audit committee independence,

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Brookings Institution) (noting "best available" option for increasing auditors' incentives to improve performance was to require all members of audit committees to be independent, but cautioning it was not perfect because management influenced who was on the committee and committees would have to spend much more time than current practice and be compensated more highly); id. at 554 (David Walker) (list of questions Congress needed to consider included whether independence rules for audit committees were adequate); id. at 968 (L. William Seidman, Chairman Federal Deposit Insurance Corp., 1985-91 and former Chairman, Resolution Trust Corp.) (noting there are many independence rules in place for audit committees, and need to "take care" not to unduly burden those committees as that would reduce availability of good directors to serve, and recommending independent nominating committees).

[316] These included one academic, two members of the accounting profession and one of the witnesses classified as "other." Id. at 692 (Arthur R. Wyatt, Professor of Accountancy, Emeritus University of Illinois and former AICPA Chairman); id. at 819 (James G. Castellano, AICPA Chairman); id. at 826 (Olivia F. Kirtley, AICPA Chairman, 1998-99 and retired CFO, Vermont American Corp.); id. at 920 (John N. Whitehead, Co-Chair, Blue Ribbon Committee, former Co-Chairman, Goldman Sachs & Co. and former Deputy Secretary of State).

and none advocated requiring a majority of independent directors on the board.[317] Former SEC Chairman Hills testified to the House committee, as he had to the Senate, and again, although he emphasized the importance of the audit committee, his proposal focused on the nominating committee, as he noted his concern that an audit committee could not be independent unless it was appointed by an independent nominating committee.[318] As in the Senate, in the House hearings, only one witness suggested a need for completely independent audit committees, and a few witnesses emphasized a need for greater expertise.[319] Again, no witness referred to, or indicated any awareness of, the existence of a scholarly literature on director independence. In addition, two witnesses who were asked by House Democrats for their opinions of former SEC

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[317] The written statement of the witness representing TIAA-CREF noted the organization's position in favor of majority independent boards and fully independent audit, compensation and nominating committees, but it did not include requiring director independence in its list of needed reforms. House CARTA Hearings, supra note 88, at 399, 401 (Mar. 20, 2002) (written statement of Peter C. Clapman, Senior Vice President and Chief Counsel, Corporate Governance, TIAA-CREF).

[318] Id. at 55 (Mar. 13, 2002) (Roderick Hills). On this occasion he also noted that Enron, as it happened, had an independent nominating committee. Id.

[319] Id. at 11 (Barry C. Melancon, President and Chief Executive Officer, AICPA) (audit committees "should be composed of outside directors with auditing, accounting or financial expertise"); id at 229 (written statement of Ted White, Director of Corporate Governance, California Public Employees' Retirement System) (advocating requiring more than one audit committee member with expertise); id. at 104 (Mar. 20, 2002) (Philip B. Livingston, President and Chief Executive Officer, Financial Executives Institute, professional organization for chief financial officers, controllers and treasurers) (need to toughen requirements of financial expertise for audit committee members); id. at 113 (Jerry J. Jasinowski, President, National Association of Manufacturers) (indicating support for idea in ranking Democrat's bill on independent nominating committees, although opining legislation might not be necessary; the NAM's written statement did not include any proposed reforms regarding any board committee's independence, although it did state that audit committee members should have expertise).

Chairman Hills' testimony did not directly endorse his position.[320]

No doubt, the difference in testimony and emphasis on audit committee independence across the chambers reflects the difference in party control: this was not a top concern of Republicans in the House, and the witnesses they called were either also not interested in the issue or determined it was best to direct their attention to matters the majority deemed a priority. In fact, even the ranking Democrat, Representative LaFalce, who considered reform of boards and audit committees' independence a top priority, in contrast to the Republicans who did not include such issues in their draft legislation, indicated that he believed legislation unnecessary because committee independence was within the SEC's rule-making authority.[321] Accordingly, with the difference in agenda control, the different dynamics across the chambers on the issue of audit committee independence sheds light on the difference in the content of the chamber's bills: no witnesses in the House advocated legislation on independent audit committees and fewer

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[320] Id. at 76 (Harvey Pitt) (in response to question from Rep. La Falce for his opinion on former SEC Chairman Hills' testimony regarding independent nominating committees, he considered the suggestion "constructive" and noted that the SEC had asked the stock exchanges to "come forward with corporate governance proposals"); id. at 118 (Franklin D. Raines, Chairman, Corporate Governance Task Force, Business Roundtable) (in response to question from Rep. Maloney for opinion on former SEC Chairman Hills' testimony regarding need to give "legal status" to audit committees and the appointment of independent directors by independent nominating committees, he stated that audit committees already have status in corporations, objected to designating any committee as independent of the board, noted that audit committees "should be populated by independent directors" and that directors should be appointed by board nominating committees). It should be noted that the Business Roundtable's Statement on Corporate Governance advocates a "substantial majority" of the board be independent, although it considers appropriate a less restrictive definition of independence for the full board than is required by the stock exchanges for audit committee members. Id. at 339.

[321] Id. at 4, 55 (Mar. 13, 2002) (Rep. LaFalce). Thus there was no provision regarding audit committee composition in his substitute bill. See House Committee of Rules, supra note 249, at 7 and ff.

witnesses raised the issue, compared to the situation in the Senate, and the House committee chairman did not latch onto the idea as worthy of pursuit.

4. Executive Certification of Financial Statements

The origin of the executive certification requirement can be briefly related, as it presents a similar pattern to the other two provisions, although it was a focus of less attention. In the Senate, former SEC Chief Accountant Lynn Turner was the first to recommend the requirement, which he noted was a practice followed in foreign jurisdictions.[322] Thereafter three other witnesses expressed support of a certification requirement, as an incentive device to improve reporting.[323] These endorsements were volunteered, as Senator Sarbanes did not seek other witnesses' views on Turner's proposal. Senator Sarbanes' lack of follow-up on Turner's suggestion may well have been a function of disinterest in the recommendation. The certification requirement was, in fact, the one governance mandate to which Senator Sarbanes did not refer in his remarks on the Senate floor during the deliberations on SOX. But a week after Turner's testimony, the President announced a ten point plan for improving corporate responsibility,

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[322] Senate Hearings, supra note 40, at 199 (Feb. 26, 2002) (Lynn Turner).

[323] Id. at 943 (written statement of Charles A. Bowsher, Chairman Public Oversight Board and former U.S. Comptroller General) (management should have to attest to compliance with internal controls in annual SEC document, which the auditor would review, as a procedure that would improve the quality of audits); id. at 1023, 1041 (Mar. 20, 2002) (Sarah Teslik) (CEO and audit committee should have to sign financials, as that would make them think twice, just as individuals do when signing tax returns) ; id. at 1068 (Mar. 21, 2002) (Harvey Pitt) (SEC implementing the President's directive to require executive certification of financials in order to improve financial reporting by increasing individual accountability for disclosure). In addition, one witness who was advocating increased frequency of financial reporting despite objections that the information would be unaudited, referred to the Administration's proposal to require certification of quarterly as well as annual financials as a proposal that might mitigate the objection, depending on the sanctions, even though the quarterly data would still be unaudited. Id. at 878 (Mar. 14, 2002) (Robert Litan).

which included a similar certification requirement, and the SEC indicated that it was intending to implement that proposal on its own.[324] These comments were, without doubt, critical to the certification requirement's inclusion in the committee bill, given Senator Sarbanes' low level of personal interest in it. The legislative history notes that the bill "in effect" adopted the President's proposal, while crediting the precise formulation to Senator Miller,[325] who was a crucial committee vote in Senator Sarbanes' effort at producing a bipartisan bill.[326]

In contrast to the Senate, only one witness at the House hearings raised the issue of executive certification of financials. That witness was once again Lynn Turner, who now endorsed the Administration's suggestion of certification in response to questions by the ranking member, Representative LaFalce, concerning how to improve auditor independence and the need to restructure audit committees.[327] The House hearing was held after the President had announced his corporate responsibility proposals, but also after the Republicans had drafted their

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[324] President's Ten-Point Plan, supra note 195; Senate hearings, supra note 40, at 1068 (Mar. 21, 2002) (statement of Harvey Pitt).

[325] Public Company Accounting Reform and Investor Protection Act of 2002, Report to accompany S. 2673, Sen. Banking, Housing and Urban Affairs Comm., Report No. 107-205,107th Cong., 2d sess. 25-26 (July 3, 2002).

[326] Hilzenrath et al., supra note 246. As discussed in part III.C.6, infra, Senator Miller appears to have been the median voter on the committee, the voter whose preferences determine the outcome in standard political science voting models of two-party systems. For a review of the median voter theorem and its limitations, see, e.g., Dennis C. Mueller, Public Choice III, 230-32, 243-46 (2003).

[327] House CARTA Hearings, supra note 88, at 55 (Mar. 13, 2002) (Lynn Turner). Although at the time Representative LaFalce expressed skepticism whether certification would be adequate, id. at 56, the only other reference to a certification requirement in the House hearings was by the congressman himself when he referred in passing to such a provision's inclusion in the bill that he had just introduced at the April hearing called at his request. Id. at 129, 146 (Apr. 9, 2002) (Rep. LaFalce).

bill, which did not include a certification provision. Because the President's proposal did not require legislative action –the SEC could (and did) implement it under its own rulemaking authority– the House Republicans did not have to amend their bill for the Administration's proposal to move forward, nor would there be a need to include it to distinguish themselves from the Administration, as would be so for Democrats.

In fact, many of the points in President Bush's ten point plan did not require legislative action, and were hortatory or could be executed by the SEC (and some were already on the SEC's agenda).[328] They also did not take the form of corporate governance mandates. Four of the President's ten points called for action, which the SEC began to implement, but in contrast to the certification requirement, these proposals also appeared in the House bill: the call for an independent regulatory board for accountants (Harvey Pitt's plan), the SEC's banning officers who "abuse their power" from serving on corporate boards, forfeiture of executive bonuses based on financial statements if the statements were false, and more timely disclosure of insider trading.[329]

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[328] These included: a call for investors' access to necessary information on a quarterly basis; a call for investors' "prompt access to critical information"; a call for the "authors of accounting standards" to be responsive to investors' needs; a call for auditors to compare firms' accounting systems with "best practices" and not "minimum standards," and the statement that "investors should have complete confidence in the independence and integrity of companies' auditors." See President's Ten-Point Plan, supra note 195. It should be noted that the rather vaguely formulated point in the plan regarding investor confidence in auditors, was articulated differently in the President's speech that introduced the plan: in his remarks he called on the SEC to do "more to guard against conflicts of interest, requiring, for example, that an external auditor not be permitted to provide internal audits to the same client." See President Outlines Plan to Improve Corporate Responsibility, supra note 195. As earlier discussed, the accounting profession had agreed to that restriction on the non-audit services category of internal audits in the aftermath of Enron's collapse. See note 258, supra.

[329] See President's Ten-Point Plan, supra note 195, and H.R. 3763, 107 Cong., 2d Sess.

A plausible conjecture explaining the difference in the House bill's posture on these provisions compared to the certification requirement is that the U.S. Chamber of Commerce supported the forfeiture and ban on office and directorship provisions, but was "concerned" about the certification requirement.[330] The Chamber of Commerce sent a letter on the House bill the day of the floor debate that solely expressed opposition to any amendment that would weaken or repeal the 1995 Private Securities Litigation Reform Act, which made private securities lawsuits more difficult to pursue.[331] Because the letter did not voice any concern regarding any provision in the bill, it is plausible to assume that the Republicans had factored the Chamber's position into the crafting of their bill, and that the noticeable absence of a certification requirement -- which was included in the ranking Democrat's bill paralleling the plank in the President's corporate governance program – reflected the Chamber's position at the time. This explanation is purely conjectural, however, because the Chamber took a public position on those issues in conjunction with its lobbying effort on the Senate's bill, at which time it expressed support for the forfeiture, director and officership ban and certification provisions; still, representatives of the Chamber had earlier voiced concern over the certification requirement but

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[330] See Thomas S. Mulligan, The WorldCom Scandal: reaction to Pitt's Proposal is Mixed, Los Angeles Times, June 28, 2002, pt. 3, p.1 (quoting concern over whether certification requirement was workable by president of U.S. Chamber of Commerce and other business leaders).

[331] U.S. Chamber of Commerce, Letter to the U.S. House of Representatives on H.R. 3763, the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (Apr. 24, 2002), available at http://www.uschamber.com/government/letters/020424hr3763.htm. This issue was also raised in two letters to the Senate during its consideration of the legislation: Chamber Senate Letter, supra note 275; U.S. Chamber of Commerce, Letter to the U.S. Senate on PSLRA and the Uniform Standards Act (July 11, 2002), available at http://www.uschamber.com/government/letters/020711s2673c.htm.

not the other two proposals.[332]

5. Provision of Non-Audit Services

The remaining corporate governance mandate, restriction of auditors' provision of non-audit services, attracted considerably more attention from witnesses in both chambers, as it had a history as a political issue. Thirty Senate, and 14 House, witnesses referred to the issue; as three of these House witnesses testified at the minority's hearing, the data indicate the Democrats' far greater interest in the subject than the Republicans, because the hearings in their control had a much higher percentage of witnesses speaking to the issue. But only about half of the witnesses in either chamber expressed a view supporting prohibition or a more restrictive approach to the matter than the accounting profession's position which was embodied in the House Republicans' bill.[333] The testimony of the witnesses does not have to be examined, however, to identify the

[332] Chamber Senate Letter, supra note 275; Mulligan, supra note 330. The Chamber of Commerce opposed the Senate bill's prohibition on the provision of non-audit services by auditors and the new accounting regulator, as duplicative or conflicting with the SEC's oversight. Chamber Senate Letter, supra note 275. It should be noted that the Chamber had expressed opposition to Harvey Pitt's specific proposal for a new accounting oversight entity that was unveiled after the House enacted its bill but prior to the Senate's action. Walter Hamilton, SEC's Oversight Proposal Derided, Los Angeles Times, June 21, 2002, pt.3 p.1.

[333] This classifies Richard Breeden's House testimony as not in the prohibition group; if he is included, then exactly one-half of the witnesses are on each side. That classification is adopted because he stated that some consulting services should not be banned, including tax services, and that the businesses should not be separated, although he also stated that the Republican bill did not go far enough in some regards. House CARTA Hearings, supra note 88, at 468-71 (written statement of Richard Breeden). This testimony is inconsistent with his earlier Senate testimony, where he advocated action by Congress to require separation of consulting from auditing firms, as well to leave to the SEC the decision of what activities to prohibit. Senate Hearings, supra note 40, at 65 (written statement of Richard Breeden). He is therefore classified as supporting prohibition in the Senate tally. A possible source of the difference in his statements is that in the House he was testifying in relation to a specific bill proposal, whereas in the Senate, with no proposal on the table, he was advancing his grab bag of ideas on the topic. In the House, the other half of witnesses expressed support for the Republicans' bill (or even less regulation).

policy entrepreneur behind the non-audit services provision, for its genesis, as already discussed, was Arthur Levitt's failed initiative from two years earlier.

But in contrast to the other corporate governance mandates, the testimony on this provision underscores the problematic relation between entrepreneurial policymaking, issue salience, and the quality of legislative decisionmaking implicated by SOX. Three of the witnesses who opposed expanding the restrictions on non-audit services referred to data --that there was no evidence that the provision of non-audit services compromised audit quality– to support their position.[334] However, only one of the witnesses testifying in favor of prohibition or greater restrictions on non-audit services even acknowledged the existence of empirical findings

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In contrast, because there was no specific proposal before the Senate, several of its witnesses did not express a position, although they may have had a point of view, so it cannot be concluded that they would have supported the House bill. For example, one witness, Joel Seligman, recommended that Congress "should consider whether a statute or regulation should require separation [of consulting services from auditing firms] and if so, how best to define which consulting services and which accounting firms should be subject to the new law or rule." Id at 533. While such a recommendation might imply that he believed a change in the status quo was warranted, because it is not explicit, he is not so classified. Similarly, James Beresford, the FASB Chairman, 1987-97, when asked for his views on the need to prohibit non-audit services, stated that he did not include the issue in his testimony because he did not feel he was enough of "an expert" compared to SEC officials, said it was a "tough call" and suggested that it was an issue that should be "left" to the careful consideration of an entity such as the former accounting regulator, the Public Oversight Board. Id. at 216. This statement could be taken to imply that he was of the view that even the Republican House bill went too far, but again, with no explicit reference to specific legislation, that would be a stretch so he is not classified. And one witness opined that the subject was not an appropriate subject for legislation, although it is not apparent that the witness would not have supported any specific measure, including the House bill, as he also stated that the presumption should be against the provision of non-audit services. Id. at 356 (Ira Millstein).

[334] As earlier noted, they were a Senate witness from a big four accounting firm also representing the AICPA, the professional accounting organization, a House witness from a policy institute, and the chairman of the Panel on Audit Effectiveness, which had compiled the data in question. See note 95, supra. Only one of these witnesses referred to an academic study discussed in the text; the others referred to the findings of the Panel on Audit Effectiveness. Id.

contrary to that position, let alone attempted to distinguish them.

The position of that witness, Lee Seidler, was rather unique: he had served on a 1978 AICPA commission that did not prohibit consulting services because it found no evidence that such services compromised audits, and he had been asked to testify on a panel with the chairman of the more recent Panel on Audit Effectiveness that had reached the same conclusion. In contrast to other witnesses, circumstances appear to have compelled him to address the data inconsistent with his policy stance, but he did so indirectly; he stated, in support of his position to restrict non-audit services, that his "conclusion was not based on empirical evidence."[335] It should be noted that other witnesses who advocated a prohibition, such as Arthur Levitt, were, without question, fully aware of both reports, but one would not have known that from their testimony. The quality of the testimony, in which witnesses did not even attempt to square their policy recommendations on corporate governance with the available data, is embarrassing.

Legislators only compounded the problem, however, by failing to follow up on the rare occasional references that were inconsistent with the direction in which the legislation was heading. The passing references by three witnesses to studies that were at odds with prohibiting

[335] Senate Hearings, supra note 40, at 687 (Lee J. Seidler, Deputy Chairman, 1978 AICPA Commission on Auditors' Responsibilities and retired managing director, Bear Stearns). In his written statement, he referred to the Panel on Audit Effectiveness' report, as well as a similar finding by the 1978 Cohen Commission, that the "theory [that consulting services compromised audit quality] was not supported by empirical evidence," and therefore offered an alternative "theory" that it was not the provision of consulting services, but the receipt of fees, that created the problem. Id. at 733-34. The contention makes no sense because the auditors in the Panel's data set received fees for their non-audit services, so that was captured in the analysis (and of course, all of the scholarly research discussed in the text uses fee data to study the question). Another witness submitted the Frankel et al. study (then an unpublished manuscript) to the committee after his testimony, in support of his position on prohibition, but he did not attempt to distinguish, let alone refer to, the empirical literature that was inconsistent with his position. Id. at 302 (Mar. 1, 2002) (submission of Lynn Turner).

non-audit services were ignored. This fact is striking because at the time of the hearings, in contrast to the situation when the conference committee convened, the accounting profession was not yet considered to be politically radioactive.

It should be noted that the then SEC chairman, Harvey Pitt, sought to delimit the scope of the auditor services regulation by advocating caution and waiting to ascertain the impact of the SEC's recently adopted rule on non-audit services.[336] He also did not endorse, in extensive testimony before both the House and Senate committees, the independent audit committee requirement, nor the executive loan ban, although several provisions in SOX originated in his agenda (in particular, the new accounting regulator and the certification requirement). Many of the witnesses who advocated those policy proposals were, however, former SEC officials, and the proposals typically were extensions of agendas they had advanced when they were at the agency. Accordingly, in the assessment of one former SEC commissioner, who is critical of what SOX wrought, the SOX corporate governance mandates are the successful culmination of a multi-decade effort by the agency's personnel to assert authority over public corporations in areas long considered the jurisdiction of the states.[337] Harvey Pitt's position on those issues was simply at variance with long-standing institutional objectives that, in the crisis environment in which the legislation was drafted, resonated with the Senate banking committee chairman.

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[336] See, e.g., id. at 1070.

[337] See Roberta S. Karmel, Realizing the Dream of William O. Douglas - The Securities and Exchange Commission Takes Charge of Corporate Governance, Brooklyn Law School Public Law and Legal Theory Research Paper Series, no. 7 (2004) (relating SOX provisions to history of thwarted SEC initiatives to regulate corporate governance matters, such as director independence and compensation, shareholder voting, fiduciary duties, and the accounting and legal professions).

6. The Impact of Senator Sarbanes

Given Senator Sarbanes' pivotal role in the inclusion of the governance mandates in SOX, a thumbnail sketch is in order. He has been a Senator since 1976, following service in the House and in the Maryland legislature. The son of Greek immigrants, he was educated at Princeton, Oxford (as a Rhodes Scholar), and Harvard Law School, and practiced law in Baltimore before beginning his career in public service in 1966.[338] SOX was the first major piece of legislation associated with Senator Sarbanes, who had a reputation as a "workhorse" rather than "showhorse" politician, and as a low-key personality who shied away from the limelight and media publicity and operated as an "invisible senator" largely behind the scenes.[339] His only major national role before SOX was in 1974, while a member of the House, when he was responsible for introducing the first article of impeachment against then President Richard Nixon.[340] One financial industry representative offered the following assessment when the Senator became the chairman of the banking committee in 2001 (the circumstance that placed

[338] An official biography is available at http://sarbanes.senate.gov/pages/biography_2004.html.

[339] See Richard A. Oppel, Jr., A Point Man on Corporate Change, N.Y. Times, Jul. 14, 2002 (section 3), at 2; Kristen Schmidt, Sarbanes, Daily Times (Salisbury, MD), Jul. 21, 2002, at 1; Hsu and Day, supra note 213.

[340] Hsu and Day, supra note 213; Greene, supra note 294 ("Having long operated in relative obscurity, [Senator Sarbanes] was thrust this month into his most visible public role since he first rose to national attention during the Watergate scandal."). Senator Sarbanes' web biography bears this out, as it highlights, for all his years of national service, only his service on the Watergate impeachment committee and SOX. See http://sarbanes.senate.gov/pates/biography_2004.html. Indeed, at the time SOX was considered, he "reject[ed] the idea that [SOX] was the crowning moment in his career, pointing instead to his role in writing an article of impeachment against Richard Nixon in July 1974, when he was a member of the House Judiciary Committee." Schmidt, supra note 339.

him in the position of drafting SOX): "Sarbanes had sponsored no major legislation and ... until the Democrats took over the Senate, 'the best he could have hoped for was having a Metro stop named after him'."[341]

Senator Sarbanes' voting record places him ideologically in the left wing of his party, as well as of the Democratic members of the banking committee. Political scientists Keith Poole and Howard Rosenthal have constructed measures of legislators' preferences over time, derived from all congressional roll call votes, known as nominate scores, that line up on a left-right continuum in which more liberal Senators have negative scores and more conservative Senators have positive scores.[342] Only a handful of Senators voted more liberally than Senator

[341] Hsu and Day, supra note 213. The Senator's response to that assessment was that his "name was on the first article of impeachment of the president of the United States" and that "having done that, [he did not] feel any great compulsion to throw out [his] name." Id.

[342] The Poole-Rosenthal nominate scores are constructed through a multidimensional scaling technique of all roll-call votes in all congresses. The methodology is extensively analyzed in Keith T. Poole and Howard Rosenthal, Congress: A Political-Economic History of Roll Call Voting (1997). The technique assumes a spatial model of legislators' preferences that are single-peaked over issue dimensions recovered by the statistical technique. The statistical technique essentially recovers the dimensions that account for the same people voting together repeatedly. Nominate scores consist of two dimensions, the first of which is associated with legislative divisions on issues that line up on a left-right continuum, and is interpreted as a measure of the legislators' political ideology (more liberal Senators have negative scores, and more conservative Senators, positive scores). This dimension, which is the more significant of the two in that it explains the bulk (80 percent) of the differences in voting, is therefore the nominate score that is used in the discussion in this paper. Poole and Rosenthal have estimated both static (w-nominate) and dynamic (dw-nominate) nominate scores; the dynamic estimation permits legislators' preferences to move over time and creates a score permitting comparisons across congresses; the static estimates have been rescaled into a common space to enable comparisons across congresses and chambers. All of the coordinates of nominate scores estimated by Poole and Rosenthal are highly correlated. An explanation of the different nominate data is available at Keith Poole's website: Description of Nominate Data (readme.txt), at http://voteview.uh.edu.page2a.htm. Nominate scores are preferable to the more publicized interest group ratings of legislators, such as ADA scores, because the procedure uses all roll call votes, while interest group scores select only a few votes of interest to the group to construct a

Sarbanes.[343] Thus, on both the banking committee and the floor of the Senate, his policy preferences would be significantly to the left of the median voter, as well as the veto-proof (60 percent) voting majority. These preferences were well-recognized in the media. For example, press reports evaluating the Senator's 36-year political career and his achievement in enacting SOX, characterized him as a "formidable liberal force, taking stands to support low-income housing, environmental safeguards, investor protection and consumer privacy," and referred to his "lifelong pursuit of liberal economic policies [being] rewarded."[344]

Senator Sarbanes' priors would thus make him favorably disposed to proposals for government intervention into, and mandates for, the private sector. This is an important datum for appreciating how this key Senator with agenda control organized the committee hearings and processed the information they produced. As the objective was to produce a bill that was both acceptable to his party and that would get through the Senate, Senator Sarbanes had to be open, of course, to compromise on some of the hotly disputed issues regarding the regulation of the accounting profession (such as permitting accountants to serve on the new accounting regulator's

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rating, which may produce outlier rankings. In addition, nominate estimations are scaled so as to be comparable across congresses, and chambers, while interest group rankings are not.

[343] Senator Sarbanes' common space w-nominate score in the 107th Congress of -.433 was exceeded (more negative) by only six Senators, one of whom was also a member of the banking committee, Senator Corzine (score of -.523). There is only a slight difference if the dynamic dw-nominate estimates are considered instead: Senator Sarbanes' dw-nominate score of -.555 was exceeded (more negative) by only eight Senators, and he now has the third most liberal score on the banking committee (surpassed by Senators Jack Reed and Corzine at -.585 and -.744, respectively). His position on the left of the Senate is stable: in the immediately prior Congresses, even fewer Senators had scores more to the left (more negative) than his. Nominate scores for legislators and party chamber medians are available at http://voteview.uh.edu.

[344] Oppel, supra note 339; Hsu and Day, supra note 213.

board) and stock option accounting.[345] But on the shape of the corporate governance provisions, by contrast, he had considerable room as the drafter of the legislation, given their low visibility during the legislative process. It is understandable why the few references to data inconsistent with the recommendations on non-audit services' restrictions and audit committees' independence of witnesses who, for the most part, shared his world view, such as Arthur Levitt, did not enter into his calculation and temper his adoption of their recommendations . The detailed mandatory form of the governance provisions surely reflects his political viewpoint.

Senator Sarbanes' relation with the groups most affected by SOX is also informative for understanding the final form of the legislation. He did not receive any campaign contributions from the accounting profession in the 2002 election cycle, but he did receive $14,000 in the 2000 cycle when he was up for reelection.[346] This was the third lowest sum received from the accounting profession of the eight banking committee members who were on the conference committee (and less than all but two of the House financial services committee's conferees). The accounting profession is thus likely to have had less access to Senator Sarbanes than to other Senators during the drafting process, and compared to the former SEC officials on the other side

[345] Hilzenrath et al., supra note 246. It should be noted that in the 1994 Senate debate over option accounting, Senator Sarbanes voted, along with the vast majority of his colleagues, for Senator Lieberman's resolution to retain the status quo (no expensing), see note 268, supra. He also voted for Senator Levin's parallel resolution, that Congress should not meddle in the FASB's affairs, as did the vast majority of his colleagues (roll call vote no. 97 Leg., on Sen. Amendment no. 1669 to Sen. Amendment 1668, adopted 94:2) (May 3, 1994), available at http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=103&session=2&vote=00097.

[346] See Center for Responsive Politics, Accounting Industry Contributions to the Conference Committee, available at http://www.opensecrets.org/news/accountants/accountants_conference.asp. Campaign contributions are discussed in detail in part III.E, infra.

of the issue, such as Arthur Levitt, with whom the Senator would have had ongoing interaction from his committee's oversight function of the agency. The opposite is most likely true for members of the legal profession. Senator Sarbanes received substantial contributions from lawyers ($133,091 in the 2000 election cycle), along with many other conference committee members, and it bears noting that he was a vocal opponent of the 1995 private securities litigation reform legislation, being in the distinct minority (30 Senators) who voted against the bill and to sustain President Clinton's veto. Moreover, while he agreed in the conference committee to changes in the criminal certification provision that were a matter of concern to several conferees and the business community, he held the line against their effort to alter the extension of the statute-of-limitations for private securities actions, which was a provision that he had sought, albeit unsuccessfully, to have included in the 1995 securities legislation that he opposed.[347]

D. Where Was the Delaware Delegation in the Legislative Process?

Given the political dynamics of the legislative process, the question arises, where were the legislators from Delaware, the state that dominates as the choice of domicile for public corporations, and thus the state with the greatest interest in corporate governance matters, in this process of federal preemption of part of Delaware's domain? The members of the Delaware delegation belonged to the majority party in their respective chambers (the Senators were Democrats and the sole Representative was a Republican). More important, they were all

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[347] See Hilzenrath et al., supra note 246; Additional Views of Senators Sarbanes, Bryan and Boxer, Private Securities Litigation Reform Act of 1995, Report of the Sen. Banking, Housing and Urban Affairs Comm. to Accompany S. 240, Sen. Report No. 104-98, 104th Cong., 1st Sess 36 (1995).

members of committees involved in the drafting of SOX: Congressman Michael Castle was on the House financial services committee, Senator Thomas Carper was on the Senate banking committee, and Senator Joseph Biden was on the Senate judiciary committee. Thus, they were all strategically positioned to have some influence on the legislative outcome, compared to most legislators, although that influence would not be at all commensurate with that of the committee chairmen who controlled the agenda.

All three Delaware legislators participated in the congressional debates, and their positions paralleled that of their party. This is not surprising because the Delaware legislators are ideologically close to, but closer to the center than, their chamber's party's median voter, as well as their party's median committee member.[348] This contrasts with the Senate committee chairs who controlled the agenda, as they were ideologically further from their party centers (in the committee and in the chamber) than the Delaware Senators.[349]

The House bill did not contain any corporate governance mandates, and Congressman Castle did not refer to any such issues in his remarks on the chamber floor. In the relevant

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[348] The first dimension of the Poole-Rosenthal w-nominate (dw-nominate scores) for the 107th Congress of Senators Biden and Carper's scores was, respectively, -.143 (-.235) and -.335 (-.327), considerably to the right of Senator Sarbanes. Both were to the right of the Senate Democratic median dw-nominate score of (-.382), although they fell on different sides of their party's median w-nominate score of -.274. Congressman Castle's w-nominate (dw-nominate) score was .199 (.214), considerably to the left of his party (House Republican median w-nominate score of .3795 and median dw-nominate score of .3795). For information on the nominate score data see notes 342-343, supra.

[349] The committee chairs and median member w-nominate (dw-nominate) scores are: Senate banking committee chair, Senator Sarbanes, -.433 (-.555); Democratic committee median, -.331 (-.457); Senate judiciary committee chair Senator Leahy, -.375 (-.48); Democratic committee median, -.3375 (-.427); and House financial services committee chair Congressman Oxley, .363 (.406), Republican committee median, .37 (.436).

committee votes, he voted, along with the other members of his party, against Democrats' amendments to include corporate governance provisions (all of which amendments were defeated), such as, amendments to prohibit independent directors from serving as consultants, to permit the removal of unfit officers and directors and ban their future service in such positions, to require audit committee approval of all non-audit services, and to require executive certification of financials.[350] He also joined his party in opposing the Democrats' effort to instruct the conference committee members to support the Senate bill over the House version on criminal penalties (which included the controversial extension of the statute-of-limitations for securities litigation). Accordingly, it would be difficult to characterize the sole Delaware member of the House as having ignored, or acted contrary to, Delaware's interest in the matter of state sovereignty over corporate governance, but it would also be difficult to characterize this as a prominent issue in the House debates and therefore a matter of his focus. Although he was not appointed to the conference committee, even had he been on the committee and so inclined, as earlier detailed, there was little Congressman Castle, or any House Republican, could do, in the end, to maintain their position (that would have minimized federal involvement in corporate law) in conference.

[350] He did, however, join the Democrats (with a few other Republicans) and vote for an amendment (that also failed) to require shareholder approval of executive stock option plans. The votes are reported in the committee report on the bill. See House Report, supra note 239, at 20-30. Shareholder voting on compensation plans, it should be noted, is not required by state corporate law, but is required, in certain circumstances, under stock exchange listing rules, circumstances that were expanded in the wake of the corporate scandals. See, e.g., NYSE Listing Manual Rule 303A.8 (proposed Oct. 7, 2002; approved Jun. 30, 2003). Congressman Castle was not present at the March committee hearings on the Republican bill. He was present at the earlier February hearings on Enron's collapse, during which his focus was on the failure of the auditors as the reason for considering changing any rules. See Enron Hearings II, supra note 88, at 110 (Feb. 5, 2002) (opening remarks of Rep. Castle).

The more interesting and potentially puzzling behavior therefore concerns the Delaware Senators, and particularly Senator Carper, who served on the committee that formulated the governance provisions, compared to Senator Biden, whose committee's jurisdiction was delimited. Senator Biden's remarks on the floor focused on criminal penalties, contained in the Leahy amendment and in his own amendment, co-sponsored with Senator Hatch, which enhanced penalties for certain crimes not in the original amendment, and more importantly, added the criminal certification requirement. It would be fair to say that Senator Biden focused on criminal sanctions because he was most interested in those issues and he could take credit for them, having been integrally involved in their drafting.[351] In contrast, Senator Carper mentioned

[351] Of the issues tabulated in Table 6, in addition to discussing the criminal and certification provisions, Senator Biden joined in the debate on the accounting for stock options. It is possible, but it would be pure speculation, to attribute significance, with regard to safeguarding Delaware's interests in state control of corporate law, to Senator Biden's omission of the more intrusive governance mandates in his floor remarks, since, as discussed in part II, the certification requirement was the least intrusive of the governance mandates on state law. First, Senator Biden's reference to the certification requirement was to the criminal provision contained in his amendment, and included in his remarks when the amendment was offered, so that it is difficult to attribute these particular remarks as a conscious choice to deemphasize the other governance mandates. Second, apart from his floor remarks, in a related hearing his comments regarding his state's corporate law prominence were decidedly not directed at reflecting on its jurisdictional sovereignty. In his role as a judiciary subcommittee chairman, he held three hearings on white collar crime penalties at the time SOX was being considered in the Senate, which hearings produced the Biden-Hatch amendment that included the criminal certification requirement. During those hearings, Senator Biden's other principal expressed interest besides enhancing criminal penalties, involved the trial bar, an interest not unusual for a Democratic officeholder, as discussed in part III.E, infra, rather than, for instance, the interplay between federal criminal law and state law involving corporations. For example, at the outset of one of those hearings he had noted that he was going to be introducing an amendment to expand the rights of investors to bring securities lawsuits, and he later stated, in justification of his position to a witness, that although he was from a "corporate state" in "terms of the culture," when a CEO who was his supporter asked him why he supported the trial bar and opposed tort and securities litigation reform, his response was that it was to "save [the CEO's] soul," and that lawsuits were necessary to provide incentives to corporations to not produce harmful products because fiduciary duties to shareholders made such decisions difficult for them, and therefore he didn't mind if a plaintiff's

three of the governance mandates (the provisions on non-audit services and audit committee independence, and the loan provision as it appeared in the committee bill, which was a disclosure requirement, not a ban), although he too noted the criminal penalties added by the judiciary committee amendments.

Neither Senators' remarks suggest that they appreciated that the SOX mandates might have a potential impact on their state's dominance as a state of incorporation. This contrasts with 1998 securities litigation reform legislation, that explicitly preempted state actions, in which there was a "Delaware" carve-out for state fiduciary claims.[352] There is ample evidence that the Senators are attuned to their constituents' interest in incorporations: Senator Biden, who at times refers to his state as the "corporate State of America",[353] has, for example, protected, through his position on the judiciary committee, the elimination of statutory domicile as a basis for bankruptcy filings (which became a focus of debate when bankruptcy claims surged in Delaware in the 1990s),[354] and when he was governor, Senator Carper led a state delegation on a trip to

lawyer became rich. See Penalties for White Collar Crime, Hearings before the Subcomm. on Crime and Drugs of the Sen. Jud. Comm., 107th Cong., 2d Sess. 198-99 (Serial No. 107-923) (Jul. 24, 2002) (hereafter White Collar Crime Hearing).

352 See The Securities Litigation Uniform Standards Act of 1998, Report of the Sen. Banking, Housing and Urban Affairs Comm. to Accompany S. 1260 together with Additional Views, Sen. Report No. 105-182, 105th Cong., 2d Sess. 6 (1998). Some commentators consider the "so-called Delaware carve-out" the "most notable" exemption in the 1998 Securities Litigation Uniform Standards Act that otherwise preempted state securities actions. See, e.g., James D. Cox, Robert W. Hillman, and Donald C. Langevoort, Securities Regulation: Cases and Materials 808 (3d ed. 2001).

353 See White Collar Crime Hearing, supra note 351, at 163 (Jul. 10, 2002).

354 See, e.g., Hon. James E. Queenan, Filings in the State of Incorporation: Are They Legal?, BCD News and Comment (Jan. 17, 2001) ("And as long as Delaware Senator Biden remains in a position of influence, there will be no amendment to Section 1408 [bankruptcy code

Israel, in order to promote Delaware "as a home for incorporations and business location."[355] Even though the governance mandates were of extremely low salience in the legislative debate, then, one might have expected the Senators to have been more attuned to their constituents' interest being implicated by the mandates and publicly to express some concern, even if they could not alter the legislation's course by the time it reached the Senate floor.

Senator Carper attended half of the banking committee hearings and was not especially active compared to other Senators, and in particular, Senator Sarbanes, in those hearings.[356] His concerns were directed at whether legislation was necessary, compared to regulation (federal agency action) and market responses. He asked the panel from the accounting profession for advice on what they thought should be done by Congress, regulators, and the industry itself, the

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venue provision that include incorporation state] !").

[355] Delaware Gov. Carper to Lead Trade Mission to Israel, PR Newswire, July 2, 1999, available in LEXIS, NEWS library, ARCNEWS file (released from the Delaware Office of the Governor).

[356] There were eleven Democrats on the Senate banking committee; three of them attended more of the committee hearings on Enron than Senator Carper: the committee chair, Senator Sarbanes, attended all ten hearings; Senator Corzine attended eight; and Senator Miller attended seven (although he did not ask questions at half of the hearings he attended). Five Democrats attended fewer hearings than Senator Carper, including New York Senator Schumer, who, as a representative of a leading commercial and financial state, arguably, would have had a potentially equally strong constituency-based interest in the legislation as Senator Carper, although it should be recalled that he was the sponsor of the amendment to prohibit executive loans. It is interesting to note that Senator Schumer, who is often characterized as a liberal Democrat and who served on both the banking and judiciary committees, was ideologically the median Democrat on both committees using the dw-nominate scores (his score is -.457), although he is one voter to the left of the Democratic committee member median using the w-nominate scores (his score is -.344, and the medians were -..331 and -.3375, for the banking and judiciary committee Democrats, respectively).

three potential sources he saw for "correcting" the problem at hand.[357] When the panelists provided no specifics and emphasized the need for all three groups to work together on reform, the Senator expressed frustration that his question had not been clear, and concluded his time by restating the question with the annotation that he thought what Congress "needed to do" was "probably rather limited."[358] As the subject was regulation of the accounting profession, the omission of state governments as an explicit corrective source from the Senator's list is ambiguous as to whether he was attuned to the federalism concern implicated by congressional legislation on corporate governance. Only marginally more informative is his other interaction, a question to then-SEC Chairman Harvey Pitt. Senator Carper asked for Chairman Pitt's opinion on a requirement that directors hold their companies' stock for the long-term, which was a suggestion that the Senator had come across when meeting with "people in [his] state" about how to motivate boards to engage in active oversight. When Chairman Pitt responded that in his view the SEC should not take over the governance of corporations, however, the Senator did not pick up on the reply and make the straightforward connection to his state's role in regulating corporate governance, as opposed to the federal government.[359]

Although the two sets of questions that the Senator raised do not suggest someone intensely focused on preventing Congress' treading on his state's traditional turf, nor do they suggest someone oblivious to the issue, as his explicit view that downplayed the need for federal legislation is consistent with an objective of maintaining state control. It should also be

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[357] Senate Hearings, supra note 40, at 842-43 (Mar. 14, 2002).

[358] Id. at 844.

[359] Id. at 1090-91 (Mar. 21, 2002).

reiterated that the Senate hearings were not tied to any specific legislative proposal, and in all likelihood, Senator Carper did not expect, at the time of the hearings, that the legislative outcome would be adverse to his state's interest.

There are, in fact, good reasons militating against concluding that the Delaware Senators were totally out of touch with an important state interest because they appeared not to recognize the implications for the state of the SOX corporate governance provisions. First, it is probably safe to say that whatever the federal government does short of preempting the entire field of corporate law, its action would not result in another state's unseating Delaware as the leading incorporation state. That is, federal intrusion can be expected to have only a second order, indirect effect on Delaware, in that any action that raises the cost of doing business and thereby lowers the share value of public corporations potentially reduces Delaware's welfare, as its fiscal prosperity is related to the profitability of publicly traded corporations.[360]

Second, the corporate governance mandates appeared very late in the legislative process, which meant that Delaware state officials, or members of the Delaware bar, would not have had

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[360] Firms reincorporate out of Delaware principally when they are operating on the margin (performing poorly), such that they need to save the additional franchise tax of a Delaware domicile, a difference often amounting to relatively small amounts for any profitable public company, such as a few thousand dollars. See, e.g., Citadel Holding Co. Proxy ($10,000 tax saving as reason proposing reincorporating in Nevada from Delaware) (Nov. 22, 1999); Banner Corp. Proxy ($75,000 tax saving as reason for reincorporating in Washington from Delaware) (Jun. 10, 1998); Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J. Law, Econ. & Org. 225, 257 (1985) (sample range of franchise fees saved between $2,000 and $50,000). To the extent that SOX will result in a reduction of firms going public, see, e.g., notes 375-376, infra, that will be costly for Delaware, as its dominance is in the public, not private, corporation market, and the majority of firms going public incorporate in Delaware (if they are not already domiciled there) at the time of the offering. See, e.g., Robert Daines, The Incorporation Choices of IPO Firms, 77 N.Y.U. L. Rev. 1559, 1571 (2002) (56% of sample IPO firms incorporated in Delaware).

much time to develop and coordinate an effective strategy for lobbying Congress, nor would their Senators have much time to organize a response. Indeed, state officials did not speak out publicly against the legislation, and the concern subsequently expressed by the former Chief Justice of Delaware[361] could not have been easily communicated to Congress without, at least, having been asked to do so as a witness, for it might have been awkward or deemed injudicious for judges, let alone state court judges, publicly to interject themselves, uninvited, into the federal political process.

Third, and more important, it is improbable that the Delaware Senators could have done much to prevent the mandates' inclusion in SOX even had they been cognizant of the implication for their state, and wanted to do something about it. As has been elaborated, the chairman of the banking committee, Senator Sarbanes, was particularly interested in the corporate governance provisions, and the political environment had produced a demand for federal action, such that any appearance of resistance to the legislative bandwagon would have been perceived as tilting at windmills. The limitation on the floor debate resulted in virtually no reshaping of the legislation – particularly in the direction of lesser regulation – from committee bill to final form. Neither Senator was appointed to the conference committee, but as previously discussed, even conferees who had expressed the view that getting into conference expeditiously would facilitate

[361] For example, while Chief Justice, Norman Veasey noted that "the intrusions [of the federal government into state law from SOX] are not all that bad," but after completing his term, expressed a less sanguine view, calling SOX "intrusive of Delaware law" and expressing concern regarding Delaware's vulnerability to "federal encroachment" and that "if there ever is a more significant intrusion, the significance of Delaware law will be lost." See Corporate Governance: Business Judgment Rule 'Alive and Well,' Delaware Chief Justice Tells Directors' Group, BNA 35 Sec. Reg. & Law Rep. 1485 (Nov. 3, 2003); Corporate Governance: Former Del. Supreme Court Chief Justice: Federal Power Threatens Role of Del. Law, 36 BNA Sec. Reg. & Law Rep. 1493 (Aug. 16, 2004).

significant alteration of the Senate bill, did not have the ability to do so once WorldCom failed after the committee convened.

Thus, the only point at which the Delaware Senators could have influenced the outcome was before the provisions entered the committee draft (and whether that was foreseeable to the Senators at the time cannot now be reconstructed). When Senator Sarbanes' draft bill was initially circulated to the Democrats on the committee, Senator Carper was noncommittal to reporters, hedging a comment on there being a "place for legislation" with emphasizing a "belief that preventing future Enron-like debacles would be achieved largely through regulation and market forces," the themes of his few comments at the hearings.[362] Senator Carper was, in fact, mentioned as one of the last three Democratic committee members to support Senator Sarbanes' bill, indicating he was positioned to exert some influence on the form of the bill, but he was also identified as the "first of the three to pledge allegiance," without reference to his gaining specific modifications of the bill in exchange for his support, in contrast to the other two Democrats, Senators Miller and Evan Bayh, who were said to have obtained "some flexibility" in the bill's restrictions on non-audit services and elimination of a provision requiring the SEC to study expensing of stock options.[363]

One could speculate that the governance mandates were a nonnegotiable item for Senator Sarbanes, similar to the statute-of-limitations extension, in contrast to stock option expensing, given the interest he showed in those provisions, and Senator Carper could not barter for their

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[362] Sarbanes Holds Sessions on Enron Accounting Legislation, National Journal's Congress Daily, May 9, 2002.

[363] Hilzenrath et al., supra note 246.

exclusion. But that would be pure conjecture. The more compelling explanation for all three Senators' reticence is that they were the most conservative Democrats on the committee, as measured by their nominate scores,[364] and they would not have been favorably predisposed to increase government regulation of business, when, as noted earlier, at the time of the committee mark-up, SOX was no longer perceived to be emergency legislation requiring immediate action.

Finally, it should be noted that the Delaware Senators might appear to have been subject to similar political pressure as Republicans to support the legislation, despite being from a "corporate" state (although unlike some Republicans, they did not voice reservations over any part of the legislation at the same time as they supported it). For instance, they might have feared it would be difficult to justify a no vote on SOX due to the governance mandates, given the prominent other features of the legislation enhancing criminal sanctions and accounting profession regulation, that were not directly related to Delaware's interest in preserving the domain of state corporate law. Consistent with this view, Senator Biden, who was up for reelection in 2002, stated during his subcommittee hearings on penalties for white collar crime: "Everyday . . . people want to know what we are going to do. . . .I haven't had this much spontaneous concern expressed to me and calls for penalties for wrongdoers . . . since the

[364] Senator Bayh's w-nominate (dw-nominate) score, of -.2 (-.287) is somewhat more liberal (more in the direction of the party committee median) than Senator Carper's score of -.143 (-.235), while Senator Miller's score of .009 (.032) is slightly closer to the median Republican than Democratic party committee member's score, which were, respectively, .4015 (.426) versus -.331 (-.457). As reflected in his score, as Hilzenrath et al., supra note 246, state, Senator Miller was "a conservative Democrat renowned for disagreeing with his more liberal colleagues."

beginning of the drug epidemic in this country."[365] However, concern over reelection – as opposed to inability to influence the outcome – is implausible as the explanation for the Delaware Senators' support of SOX. The Delaware officeholders who were up for reelection (Senator Carper's seat was not up until 2007) had "safe" seats and the probability of an upset was remote.[366]

E. Interest Groups and Campaign Contributions in relation to SOX

The analysis of the political dynamics of SOX has so far omitted any discussion of the connection between the legislation and the interests groups with a stake in the outcome, and, in particular, an inquiry into whether there is a connection between policy outcomes and affected interest groups' campaign contributions. The connection, if any, between campaign contributions and legislative decisionmaking is a matter of considerable controversy in the political science literature. Contributions are widely understood as providing donors with access (the "politician's ear") but there is little consensus on whether they purchase anything else.[367] The evidence on whether campaign dollars are significantly correlated with legislative action,

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[365] White Collar Crime Hearing, supra note 349, at 165 (Jul. 10, 2002). He further noted that the concerns were expressed to him at July 4 celebrations throughout Delaware by blue collar workers, not white collar workers, who had stock in their 401(k) pension plans and had lost money, and that the Business Roundtable had sent him a letter urging him to support the Sarbanes bill. Id. at 163.

[366] Election Preview 2002: Mid-Atlantic, Roll Call, May 20, 2002. In particular, Senator Biden's seat was considered "safe" because he had won his previous election with 63 percent of the vote, and as one press report put it, he was given "another free pass for reelection"with no serious challenger being put up by the Republican party, as the best candidate, Representative Castle, who was a very popular politician and former governor, declined to give up his House seat (also considered "safe", having won his last election with 68 percent of the vote), saying that it "would upset the good relationships enjoyed by the state's Congressional trio.

[367] E.g., Kernell and Jacobson, supra note 234, at 421.

such as floor votes, for example, is inconclusive.[368] However, Kenneth Shepsle and Mark Bonchek contend that because floor votes are highly visible, such inconclusive findings are to be expected and one must look to other venues in order to track financial influence, such as what happens to proposals or bills in committees, whose work is less observable.[369]

As there were no votes on the SOX corporate governance provisions in either chamber, and as all of the Senate votes, the chamber in which the provisions originated, were virtually unanimous, as was the House vote on the conference committee report that adopted the Senate bill containing those provisions, we can, in any event, only consider campaign contributions in a qualitative analysis, in relation to committee actions with regard to SOX. The focus of attention in this section is the conference committee that had to reconcile the House and Senate bills, which consisted of 32 members, 23 Representatives and nine Senators (nine and five of which were Democrats, respectively),[370] and the contributions and lobbying efforts of the three interest

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[368] See Kenneth A. Shepsle and Mark S. Bonchek, Analyzing Politics 338 (1997).Voting studies control for legislators' constituents' economic interests (which are strongly correlated with voting behavior), and differences in conclusions regarding the impact of contributions on votes depend on whether in the model tested the campaign contributions variable is significant after controlling for economic interests. See Mueller, supra note 326, at 489-90. If the policy views of contributors match those of the legislators' voting constituents, then the effect of campaign contributions is not of any particular importance politically.

[369] Shepsle and Bonchek, supra note 368, at 339.

[370] Conferees typically are on the standing committee in which the bill originated and the members "most actively involved for and against the legislation." Kernell and Jacobson, supra note 234, at 231. In addition to members of the financial services committee, where the bill originated, the House conferees included 12 members not on that committee, whose negotiating authority was limited to specific bill provisions within the jurisdiction of the standing committee on which they sat. For example, the conference consideration of bill provisions relating to employee pensions was committed to members of the House committee on education and the workforce. See Conference Report, Sarbanes-Oxley Act of 2002, Rep. 107-610, 107th Cong., 2d sess. 69-70 (July 24, 2002). It should be noted that in conference each chamber votes as a

groups most implicated by SOX, accountants, the business community and the bar, although the corporate governance mandates were of greatest import to managers of corporations, directed at the members of the conference committee.

1. The Split in the Business Community

While a united business community can be a powerful political force, its political clout is often misunderstood and overstated. As has been carefully demonstrated, when business unites behind legislation, labor tends to be united on the other side, and as a consequence, if business "wins," it is because public opinion and election outcomes are tilting toward business' policy position, and not due to financial leverage exerted by business over legislators.[371] SOX was, however, not a unifying issue. The business community was split over the Senate bill: the Business Roundtable, whose membership consists of large corporations, supported that bill, while the Chamber of Commerce did not. The lack of unity among core constituents is likely to have contributed to the failure of the Republicans to adhere to their preferred legislative position in the conference committee.

The difference in the position of the business umbrella organizations can plausibly be explained by the disparity in expected compliance costs for the organizations' members: the

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separate unit, and a bill is not reported out until a majority of both delegations approves, so the relative size of the delegations is "not important." Kernell and Jacobson, supra note 234, at 231.

[371] See Mark A. Smith, American Business and Political Power (2000). As Smith details, business unifying issues are ideological (the issue separates liberals and conservatives), partisan (the issue separates Democrats and Republicans), and salient (high visibility to the public). Thus Smith finds that in these issue contexts, direct resources or forms of power wielded by business (campaign contributions, lobbying capacity) do not explain legislative outcomes, but public opinion polls reflecting attitudes toward business and the partisan composition of elected lawmakers do.

small and medium-sized firms that are the membership base of the Chamber of Commerce were expected to find it far more costly to meet the proposed legislative mandates than large firms.[372] Accordingly, the Chamber supported Senator Gramm's proposed amendment to permit the new accounting regulator to exempt small businesses from the non-audit services prohibitions (which was not enacted).[373]

A recent survey of companies' projected expenditures to meet the SOX internal controls provisions lends support to this explanation: companies with annual revenues over $5 billion projected external consulting, software and additional audit fees of $2.8 million, compared to a projection of $220,200 by companies with annual revenues under $25 million.[374] Taking the

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[372] For example, several members of Congress expressed concern that the non-audit services prohibition would adverse affect small businesses, which relied on their outside accountants more for a variety of services than large firms. E.g., 148 Cong. Rec. S6335 (July 8, 2002) (Sen. Gramm); id. at S6339 (Sen. Enzi); 148 Cong. Rec. S 6693 (July 12, 2002) (Sen. Santorum).

[373] U.S. Chamber of Commerce, Letter to the Senate, Support Senator Gramm's Amendment to S.2673 (July 11, 2002), available at http://www.uschamber.com/government/letters/020711s2673a.htm. Senator Gramm's amendment was introduced, 148 Cong. Rec. S 6537 (July 10, 2002) (amendment no. 4184 to division 1 of amendment no. 4174, "Purpose: to provide the Board with appropriate flexibility in applying non-audit services restrictions to small businesses"), but never voted on in the wake of the compromise on the Leahy amendment in which the division was withdrawn, see text and accompanying note 266, supra.

[374] The survey was conducted by the Financial Executives International, the professional organization of chief financial officers, treasurers and controllers, and a summary is available on its website, http://www.fei.org/news/404_survey.cfm (hereafter FEI Survey). The results were also reported in Large Companies Expect to Spend Millions to Meet SOXA Internal Controls Requirements, 36 BNA Securities Regulation & Law Report 315 (Feb. 16, 2004). The large companies projected an expense of roughly $1.8 million on 35,000 hours of "internal manpower;" to satisfy the requirements, whereas small companies expected to incur an "average of 1,150 people hours" (dollar conversion not provided). Fewer small firms (less than $25 million revenues) responded than large firms (over $5 billion revenues) (ten compared to 61 firms, or 3 percent compared to 20 percent of respondents, respectively); a total of 321 firms

revenue thresholds as a benchmark, smaller companies' projected outlays as a proportion of revenue are an order of magnitude greater than larger corporations (.009 compared to .0006). But the projected increase in external audit fees due to the new attestation requirement accompanying the certification requirement (auditors must attest to management's certification of its internal controls, just as they attest to the accuracy and fairness of the financial statements) was similar across firm size, averaging a 38 percent increase.[375]

Further support for the Chamber of Commerce's concern about the legislation's potential disproportionate effect on its members can be found in two recent studies of going-private decisions before and after the enactment of SOX. Ellen Engel, Rachel Hayes and Xue Wang found that going-private transactions have increased post-enactment and that smaller firms

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responded. It is not clear to what extent the survey responses represent one-time start-up costs of compliance systems, since only 25 percent of respondents indicated that they had already put in place a "permanent" solution for compliance with the statutory mandate on certification of internal controls, and 14 percent indicated that they had no specific plans to implement a solution tool. FEI Survey, supra (Question 8).

[375] Id. (Question 3b). A survey by a law firm estimated that the cost of being a public company had increased 90 percent the year after SOX and similarly found that the increase disproportionately affected small and mid-cap firms. Thomas E. Hartman, The Increased Financial & Non-Financial Costs of Staying Public (May 5, 2004), available at http://www.aei.org/docLib/20040505_Hartman.pdf. Moreover, in a follow-up survey, the law firm found that costs continued to increase in 2004. Thomas E. Hartman, The Cost of Being Public in the Era of Sarbanes-Oxley (May 19, 2004), available at http://www.foley.com/news/news_detail.aspx?newsid=709. According to the later study, the average cost of being public increased 130 percent ($1.6 million) from SOX's enactment through fiscal year 2003 for firms with annual revenue under $1 billion, with costs continuing to increase for compliance, auditors and outside directors). However, these figures must be treated with considerable skepticism because the survey response rate is extremely low: only 145 firms, 30 of which were private companies, including non-profits, responded from a mailing to 9,000 officers and other individuals at public and private firms (neither mix, nor number, of firms, indicated). Some inputs into the calculation of the estimates, such as accounting fees, are more reliable because they were obtained from proxy statements of a random sample of 908 firms in a database maintained by Standard and Poor's.

appear to be particularly affected.[376] The frequency of going-private transactions increased per quarter, and totaled 142 firms in the 18 months post-SOX compared to 93 in the 19 months before SOX; the difference in mean transactions for all quarters pre- and post- SOX is significant at 3 percent. In addition, Engel and colleagues find that firms going private post-SOX are smaller, less liquid and have higher insider ownership, than pre-SOX firms, characteristics that they contend indicate firms that would experience higher costs and lower benefits from the statutory provisions.

Stanley Block surveyed firms going private before and after SOX and found that the most common reason for doing so was to avoid the cost of being public (30 percent), and that the frequency of that response was higher for firms going private post-SOX (60 percent).[377] He also suggests that the impact of SOX appears to be greatest on small firms: the public company cost

[376] Ellen Engel, Rachel M. Hayes and Xue Wang, The Sarbanes-Oxley Act and Firms' Going-Private Decisions (manuscript May 6, 2004). The sample consists of 353 firms going private from 1998-2004. A study by the accounting firm Grant Thornton comparing going private transactions the year before and the year after SOX similarly found that the number of companies seeking to go private increased (by 30%) post-SOX, while deal size decreased substantially (the median deal size was half) and the proportion proposed by management increased; Grant Thornton suggests that the change is due to SOX's having increased the cost of remaining public for small companies. Cono Fusco, American Enterprise Institute Sarbanes-Oxley: A Review, Panel III: Do the Costs of the Act Outweigh the Benefits? (May 5, 2004), available at http://www.aei.org/docLib/20040505_Fusco.pdf.

[377] Stanley E. Block, The Latest Movement to Going Private: An Empirical Study, 14 J. Applied Fin. 36 (2004). Block obtained survey responses from 110 of 236 firms that went private between January 2001 and July 2003 as reported by the Securities Industry association, all of which firms had been listed on NASDAQ. The other reasons, in order of frequency, were pressures and time constraints on top management, lack of coverage by security analysts, absence of liquidity in the public market, no opportunity for secondary market, and threat of delisting (10 percent of the sample). It should be noted that the second-most frequent response, top management time, was also a concern related to SOX: survey respondents indicated that this factor became "especially burdensome" after SOX due to the certification requirement. Id. at 37.

explanation as the primary reason for going private was significantly related to firm size (market capitalization) but not to other firm characteristics, such as stock price, price to book and price to earnings ratios. Finally, the survey respondents reported the cost of being public had more than doubled after SOX, rising, on average, from $900,000 to $1.95 million, with the increase attributed primarily to higher audit, insurance and outside director fees.[378] It should also be noted that the problem does not appear to be simply one for small domestic firms that are the Chamber's constituents: recent reports indicate that foreign firms have begun to delist from (or not list on) U.S. exchanges because of the high cost of SOX.[379]

The differential cost of SOX's corporate governance requirements is not the only instance of federal securities regulation marketed as benefitting investors yet adversely affecting small firms.[380] But the burden placed on small firms by the SOX corporate governance mandates is unusual in that it originated in Congress rather than the SEC: indeed, the one mandate that emanated from the SEC's agenda, the certification requirement, was extended by the Senate bill to include all public firms, in contrast to the SEC's requiring only the largest corporations to

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[378] Block does not provide revenue data for the sample firms, so these firms' figures cannot be compared precisely with the FEI survey data, see note 374, supra, in which the reported cost increase was smaller. In all likelihood, Block's sample would fall at the smaller end of the FEI survey (Block's sample's median market capitalization was $61.7 million, and 27 firms had negative earnings over the prior year).

[379] Silvia Ascarelli, Citing Sarbanes, Foreign Companies Flee U.S. Exchanges, Wall St. J., Sep. 20, 2004, C1.

[380] For example, Armando Gomes and colleagues find that the SEC's initiative to equalize access to corporate information among public investors and analysts, Regulation Fair Disclosure, imposed a welfare loss on small firms, significantly increasing their cost of capital. Armando Gomes, Gary Gorton and Leonardo Madureira, SEC Regulation Fair Disclosure, Information and the Cost of Capital (Wharton School, manuscript 2004).

certify their financials. In the administrative rule-making process, by contrast, Congress has required the SEC to ensure that proposed regulations do not have an adverse economic impact on small businesses.[381] The media frenzy over burgeoning corporate scandals and a free-falling stock market made it impossible to legislate broad exemptions – that could have been perceived as not being "tough" on business and have electoral repercussions – resulting in the reversal of Congress' historic protection of small businesses from regulatory burdens.

A further source of divergence in the position of the Business Roundtable and the Chamber of Commerce may have been the accounting scandals' concentration among the largest public corporations. The calculation of the members of the Business Roundtable would differ from Chamber members in that, by supporting the legislative proposal perceived to be "tougher" on corporate crime and accountability, they would be distancing themselves in the public mind from scandal-tinged firms, a factor of little moment to smaller businesses. Accordingly, even without the turn of events in July 2002 that resulted in the adoption of the Senate Democrats' bill, the lack of unity in the business community on key elements of the legislation would have affected its ability to influence the legislative process. When core constituents are divided on an issue, there is no obvious winner or loser for a legislator to support. Thus, as the media lauded the Democrats' bill as appropriately tough on the culprits in the corporate scandal, accountants and executives, compared to the Republicans' bill, with the split across the key business constituents, there was no reason for Republicans potentially to alienate other voting constituents, individuals whose pension and stock portfolios had declined precipitously.

[381] The Regulatory Flexibility Act directs federal agencies to consider "significant alternatives to the proposed rule which accomplish the stated objectives of applicable statutes and which minimize any significant economic impact ...on small entities." 5 U.S.C. § 603(c).

2. Tracing the Money

Table 8 provides aggregate information on campaign contributions to conference committee members from four sectors: accountants, lawyers, business associations and organized labor.[382] As that table makes graphic, the Chamber of Commerce's provision of campaign contributions was minimal, compared to other interested groups. It must be noted, however, that corporations, which are prohibited from making campaign contributions, can contribute through their own political action committees, and through specific industry-based groups that are separate from the Chamber of Commerce. The Table thus understates business' role in campaign financing by focusing on Chamber of Commerce contributions, but I believe the focus is informative in this context because the Chamber was one of the most vocal business lobbyists during the SOX deliberations, individual corporations and industry-specific groups did not take public positions or testify before the congressional committees, and the Business Roundtable

[382] The data are obtained from the contributing organizations' required filings with the Federal Election Commission, as compiled by the Center for Responsive Politics. See note 257, supra. The Chamber of Commerce's contributions are included in the Center's category of "Business Associations," which consists of the national and local chambers as well as other "small business, pro-business and international trade associations." In that category, the U.S. Chamber of Commerce was the third largest donor. The Business Roundtable does not appear as a campaign contributor on the Center's website; it does engage in lobbying (as do the other organizations and professions whose contributions are discussed in the paper), which is separately tracked by the Center. The National Association of Manufacturers, whose position was similar to the Chamber of Commerce with regard to criticism of the Senate bill, and which has a more varied membership size than the Business Roundtable, like the Roundtable, also does not appear as a contributor to individual campaigns on the Center's website (it shows up only as a donor of approximately $17,000 in 2000 to Republican party election committees.) Four of the Senators (two from each party) were not up for election in either of the cycles covered by the Table, and a third Republican Senator, who would have been up for reelection in 2002, Senator Gramm, was retiring from the Senate. But Senators raise money in all cycles, whether or not they are standing for election, and the highest total from a sector, within a party, in some cases, went to one of the Senators not up for reelection in either cycle.

supported the Senate bill. The relatively low level of conferees' campaign funding by the Chamber of Commerce (compared to other interested participants -accountants, lawyers and unions- and compared by party, Democrats versus Republicans) is consistent with minimal attention being paid to the Chamber's concerns by the Senate Democrats, who, it should be recalled, did not call any witnesses from the business community to testify at any of their hearings.

Accountants, by contrast, were a significant source of campaign financing, although this was to no avail in the political turmoil enveloping the adoption of SOX. It should be noted first that in both election cycles surrounding the legislation, 2000 and 2002, the accounting industry was in the top 50 industries giving to members of Congress.[383] In the 2002 cycle, accountants ranked 28th, giving a total of $5,760,050 (of which 63 percent went to Republicans), and in the 2000 cycle they ranked 22nd, giving a total of $6,750,190 (of which 61 percent went to Republicans). But the top-ranked industry in both the 2000 and 2002 cycles, dwarfing the contributions of accountants, was the legal profession (total contributions of $18,836,831 and $35,473,930 respectively). Much of those contributions were provided by the plaintiffs' bar,[384]

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[383] The industry rankings are available on the website of the Center for Responsive Politics, which compiles industry profiles from the federal election contributions that it tracks, at http://www.opensecrets.org/industries. An election cycle starts in the January of the year prior to the election and runs through the December thereafter: for example, the 2000 election cycle consists of contributions received from January 1, 1999 through December 31, 2000. The industry figures provided in the text include only contributions going to current incumbents.

[384] The Center for Responsive Politics notes that the individuals in the lawyer category are mostly plaintiffs' attorneys, and give 3/4 of their funds to Democrats, but that there are also corporate lawyers (corporate law firms) in the category, who give to Republicans. The Association of Trial Lawyers of America is the largest contributor in the lawyers' category, every cycle. Milberg, Weiss et al., the largest securities class action plaintiffs' firm, was the sixth highest contributor in the category in 2002 and 17th in 2000; in the election cycles surrounding

and in contrast to accountants, lawyers directed 60 percent of their contributions to Democrats in both cycles.

Given that the corporate governance provisions (with the exception of the non-audit services provision) were technical in nature and not a principal focus of media attention, this is the low visibility sort of situation in which campaign contributions could make a difference. But little data can be adduced to support such a conjecture. There is, at best, tangential support, in that, the differential campaign financing patterns of lawyers and accountants track significant differences across the Senate and House bills regarding provisions affecting those groups but that were unrelated to the corporate governance mandates. The Democratically-controlled Senate's bill included an extension of the statute-of-limitations in securities actions, a provision of principal interest to the plaintiff's bar, which provides the backbone of lawyers' campaign contributions. Similarly, the Republican House's bill followed the SEC's approach to the accounting oversight entity, which was the approach preferred by the accounting profession. But as already noted, an apparent pattern connecting voting and campaign financing does not demonstrate that interest groups are exerting influence on legislators: it bears repeating that interest groups may finance legislators who share their world view, and in particular, their views may parallel the views of the voting constituents of the legislator in his or her home state or district.

While accountants have contributed more to Republicans than to Democrats overall from 1999-2002, as indicated in Table 8, members of both parties on the conference committee, in

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the 1995 enactment of the Private Securities Litigation Reform Act, 1994 and 1996, Milberg, Weiss was the second and third highest contributor, respectively, among lawyers and law firms.

fact, received substantial contributions from the accounting profession (with the contributions to Senate conferees roughly comparable across party lines).[385] The accounting profession was, however, unable to exert significant influence over the final legislation because it was tarnished by the corporate scandals that were the impetus for congressional action. After initially opposing any increased professional regulation, the accounting industry expressed support for the oversight proposal of Harvey Pitt and for restrictions on certain non-audit services that it had previously opposed, in recognition of the public pressure for government action in the unfolding Arthur Andersen document-shredding scandal.

The regulation supported by the accounting industry was codified in the House bill. But in the fast-moving events of the summer of 2002, the Republicans were unable to sustain that position. Still, several regulatory proposals opposed by the profession that had been floated during the Senate hearings (such as, mandatory rotation of auditors and prohibition of tax services) did not make it into SOX. The absence of such proposals in the legislation is consistent with Shepsle and Bonchek's contention that any influence exerted by campaign contributions is more likely to function at the committee level, and in particular, in a committee's important exercise of veto or blocking power (here, in what did not appear in the Senate banking committee's bill). Although suggestive, whether such speculation is accurate would be impossible to ascertain.

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[385] The source for the accountants' contributions data is: Center for Responsive Politics, Accounting Industry Contributions to the Conference Committee (update 1/30/02). As the Center notes, accountants traditionally gave most of their contributions to members of Congress on the tax committees, as that was their major perennial concern, but with the regulatory battle in the wake of Enron, they shifted their resources. The contributors in the accounting sector include the AICPA, the largest accounting firms, and independent CPAs.

As indicated in Table 8, campaign contributions to conference committee members from the legal profession were substantially higher than those from accountants. Moreover, the lawyers' contributions, in contrast to the accountants', remain more starkly one-sided for conference committee members, paralleling the general pattern of giving that favored Democrats. It is plausible to assume that of those funds, the Democrats received contributions principally from the plaintiffs' bar while corporate law firms' contributions went to Republicans. Besides the statute-of-limitations extension, which the conference committee retained despite lobbying by the business community for its removal, and which is a provision whose differential party support in the chambers parallels the parties' differential financial support from lawyers, SOX included one significant regulation of the legal profession. That regulation, which was adopted as a floor amendment to the Senate bill, requires corporate counsel to report violations of law up the corporate ladder to the board.[386] It consequently, does not impose a burden on the plaintiffs' bar, and thus would not have been of concern to the Democrats' principal law firm donors.[387] But in contrast to SOX's provisions directed at the accounting profession, the details regarding

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[386] 148 Cong. Rec. S6778 (July 15, 2002) (rollcall vote no. 175 Leg., approved 97:0.).

[387] Whether such reporting will facilitate private litigation is uncertain: for example, it is possible that documentation of attorneys' going up the ladder could indicate executive inaction that would facilitate establishing a fiduciary breach, but it could also facilitate management's reaction to problems and thereby reduce the likelihood of successful litigation. One commentator has characterized the provision as making the attorney an arm or 'agent" of the SEC's policing of public companies. Karmel, supra note 337, at 56. The prohibition on non-audit services is a provision that could arguably be characterized as benefitting lawyers, by stemming the development of the multi-practice professional firm, the efforts of accounting firms to encroach on legal practice, which have been successful in other nations where, in contrast to the United States, restrictions on multidisciplinary partnerships do not exist, see, e.g., Daniel R. Fischel, Multidisciplinary Practice, 55 Bus. Lawyer 951 (2000). But again, this is not an aspect of legal practice that would seem to be of moment to the trial bar.

the regulation of lawyers' conduct were left to SEC rulemaking (which the corporate bar was later able to lobby successfully to eliminate proposed rules for a "noisy withdrawal," which would have required lawyers to go public with violations where the corporate response was inadequate[388]).

It is possible that Congress' more accommodating attitude toward the regulation of the legal, compared to the accounting, profession was affected by its larger contributions to committee members. However, it is difficult to draw any definitive conclusion in this instance since the provision was introduced as a floor amendment by Senator Edwards, a prominent member of the plaintiffs' bar prior to elected office who was not even on the banking committee, adopted unanimously, and, as was true of virtually all of the bill's provisions, left untouched by the conference committee.

3. Lobbying Expenditures

The discussion has focused on campaign contributions, as those funds directly benefit legislators, in comparison to funds that interest groups expend on lobbying. But lobbying expenditures merit brief mention. That is because, although the Chamber of Commerce made virtually no campaign contributions to any member of Congress, let alone the conferees, its lobbying expenditures were substantial. In 2002, it reported lobbying expenditures of $4.92 million on several pieces of legislation, which included, in addition to the House and Senate bills that produced SOX, terrorism risk insurance legislation, bills entitled "Class Action Fairness Act," and "The Motor Vehicle Franchise Contract Arbitration Fairness Act," and federalism and

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[388] See, e.g., SEC Staff Watching Attorney Conduct While Mulling 'Noisy Withdrawal Rules, 36 BNA Securities Regulation & Law Report 665 (Apr. 12, 2004).

preemption issues.[389] The other institutions that expressed varying degrees of concern over SOX also made nontrivial lobbying expenditures in 2002, although like the Chamber, these organizations lobbied on numerous legislative issues, so the amount that they spent on attempting to affect SOX cannot be determined. The Business Roundtable, for example, reported expending $11.88 million for lobbying on legislation related to homeland security, credit reporting, education, energy, the environment, healthcare, terrorism risk insurance, pension reform, taxes, trade, and tort reform, in addition to SOX and related bills on expensing stock options and the SEC's proposed rules implementing SOX.[390] The big 4 accounting firms spent a total of $8 million, lobbying on legislation, in addition to SOX, concerning bankruptcy, privacy, pensions, trade, and tax shelters and other tax issues.[391]

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[389] See http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/538 /000538267|8. Lobbyists are required to file semi-annual reports with Congress identifying their clients and the income received, and companies have to report their overall lobbying expenditures. Congress makes the reports available online, at sopr.senate.gov. The Chamber spent an additional $17.4 million in the second half of 2002, but that report did not identify any activities related to SOX. See http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2003/01/030/212/030212455|11.

[390] See http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/537 /000537032|14 and http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/522 /000522441|13.

[391] The filings of Deloitte & Touche, Ernst & Young, KPMG, and PriceWaterhouseCoopers can be found at:
http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/548/000548818|6,
http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/544/000544956|5,
http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2003/01/000/323/000323573|1,
http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/597/000597928|7,
http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/589/000589702|7,
http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/518/000518732|9,
http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/554/000554145|11,
http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/564/000564282|5,
http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/573/000573437|7. Arthur Andersen did not expend any lobbying funds on SOX (as it was out of business by the time the

The amounts expended in 2002 were not unusually high for those organizations, which further renders it difficult to make any assessment of whether the lobbying on SOX should be considered outside the norm. In 2000, for instance, the Chamber spent nearly $24.9 million and the Business Roundtable spent close to $21.5 million, while accountants spent nearly $12.4 million.[392] The 2002 expenditures of the Chamber and Business Roundtable are therefore in line with the amounts they expended in 2000, when corporate scandals were not an issue. Moreover,

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legislation was enacted), but it did pay a lobbyist $200,000 for work on the Enron bankruptcy and related congressional inquiries. See http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/551/000551964|5.

[392] The Center for Responsive Politics aggregated the expenditures detailed in the congressional lobbying reports by industry sector for 2000 (and earlier years). See http://www.opensecrets.org/lobbyists. As they put it, expenditures under $1 million are "small potatoes in the lobbying game," since in 1999, 281 organizations spent more than $1 million and 135 organizations spent more than $2 million. See http://www.opensecrets.org/lobbyists/guide.asp. The Center reports that lawyers/law firms spent $12 million in 2000, an amount roughly equal to that expended by accountants; though both professions spend far less than the business associations, their members are not affected by as many potential legislative areas (their interests are not as broad) as the business groups' members. (And as previously noted, they do spend more on campaign contributions than these umbrella business organizations.) I did not attempt to come up with a figure for 2002 lobbying expenditures for the legal sector because the Center's data indicate a very large number of law firms are in the category, the firms appear to vary over time, and to obtain information from the congressional database one must have the name of the specific client or lobbyist (the law firm name), which makes it impossible for me to come up with an accurate tally. I did check the expenditures of the Association of Trial Lawyers of America (which in 2000 expended the most, $3 million, in this sector, according to the Center's data), and SOX was not part of its active agenda: the Association spent approximately $2.6 million in 2002 on lobbying over legislation proposing to disallow asbestos litigation claims in bankruptcy. See http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/2002/01/000/539/000539775|16. The absence of lobbying on SOX by the trial bar is not that surprising, since lobbyists have to prioritize, given limits of time and money, and the asbestos legislation was far more important to the interest of the trial bar than SOX, which had little direct relation to litigation, with the exception of the provision to extend the statute-of-limitations for securities class actions, which was added by the Senate Democrats to the Judiciary committee bill that contained popular provisions increasing criminal sanctions and was therefore expected to pass the Senate easily, creating an uphill battle for the opponents of the measure and little need for specific lobbying.

these differential spending levels appear to be a general phenomenon: business groups (corporations and trade associations) had the highest lobbying expenditures in the 1990s, accounting for over 80 percent of lobbying expenditures, at both the state and federal level.[393]

The impact these expenditures had on the content of SOX was, however, highly circumscribed, given the politically difficult environment for those organizations at the time. Business lobbyists had to prioritize, and they focused on only three issues on which to lobby the conferees, two involving the scope of the criminal certification mandate, and the third, the statute-of-limitations extension. They were successful in modifying the bill on the certification issues but not the statute-of-limitations,[394] which, it must be noted, was a provision that implicated, on the opposing side, the interest of a more significant campaign contributor, the trial bar.

F. Were the SOX Governance Mandates an Instance of Symbolic Politics or Window-Dressing?

The SOX corporate governance mandates were not carefully considered by Congress, and, in particular, they were not evaluated in light of the empirical literature questioning their efficacy. Before drawing policy inferences from this apparent mismatch of means and ends, there is a remaining question to address, whether Congress would still have adopted those mandates had members been alerted that they were not likely to improve audit quality or

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[393] John M deFigueiredo, The Timing, Intensity, and Composition of Interest Group Lobbying: An Analysis of Structural Policy Windows in the States, NBER Working Paper No. 10588, at 18-19 (2004). The federal lobbying data in this paper is from 1998, while the state data is multi-year data.

[394] E.g., Hilzenrath et al., supra note 246.

otherwise benefit investors? An affirmative response would require viewing the SOX mandates as symbolic politics or, more cynically, as window-dressing, that was of particular importance to accomplish in an election year. Though this is certainly a possible explanation, descriptively, it does not accord well with the legislative process or public perception.

The contention from a symbolic politics perspective is that, despite the mandates' known probable ineffectiveness, their enactment provided an expressive or symbolic benefit, Congress' demonstration to a concerned public that it was remediating a serious problem. There is a fundamental flaw in this argument, however. If the rationale for supporting the governance provisions was symbolic, then we would expect legislators to have engaged in at least some credit claiming regarding those provisions (in contrast to other provisions or the more general symbol of passing any legislation, regardless of its content).[395] That is, senators and representatives should have been widely publicizing the corporate governance mandates in their floor speeches on the bill, or focusing on those initiatives when questioning witnesses at hearings, to communicate to their constituents how they were solving problems through those features of the legislation. Yet as Table 6 and the discussion of the progress of those provisions through the hearings indicate, they did not do so. Rather, as Table 6 indicates, far more floor time was spent on SOX's enhanced criminal penalties for corporate misconduct, as well as the

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[395] In a classic of American politics, David Mayhew described the election-related activities of members of Congress of "advertising, credit-claiming and position-taking" that are important for reelection in order to identify the incumbent with benefits to constituents and popular messages containing little content or controversy. David R. Mayhew, Congress: The Electoral Connection 49-76 (1974). While the activities he identifies – roll call votes, signatures on discharge petitions, bill amendments – are somewhat easier for constituents to inform themselves about than the floor speeches considered here, the symbolic effect is the same, and the opportunities to engage in those other activities with respect to SOX were essentially unavailable (amendments were severely restricted and there were few roll call votes).

controversial new regulator for the accounting profession. If there was an aspect of symbolic politics in SOX's enactment, the increased criminal sanctions, which many legislators highlighted, would fit more squarely into such a scenario than the corporate governance mandates.[396]

The public's view of the efficacy of legislation to deal with the problem at hand also undercuts a symbolic politics explanation. Public opinion polls throughout the period in which Congress was deliberating over SOX reported that an overwhelming majority expected the legislation to have either a minor or no effect on corporate misconduct.[397] In such a context, it is not plausible to maintain that members of Congress were supporting the SOX governance mandates while aware of the literature questioning their efficacy because they expected to obtain a political benefit by enacting those provisions.

Taking the more cynical view of SOX as window-dressing, an observer could contend,

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[396] This is because the increased criminal sanctions in SOX are consistent with a pattern of congressional activity in election years. In 1990, for example, an election year during the escalating cost of the bailout of the savings and loan industry, Congress enacted enhanced banking crime penalties, yet it had increased banking crime sanctions in the banking reform package only a year before, and from 1982-94, Congress enacted increased criminal sanctions in most election years (albeit for violent, rather than white-collar, crimes). Brian T. FitzPatrick, Congressional Re-election through Symbolic Politics: The Enhanced Banking Crime Penalties, 32 Am. Crim. L. Rev. 1, 13-15, 39-40, n.229 (1994). Increasing criminal penalties is arguably symbolic politics because, as several reputable scholars have contended, the length of sanctions does not appear to be among the most influential factors affecting crime rates. Id. at 2 nn. 2-3. Vik Khanna puts a further spin on the symbolic politics explanation of corporate criminal legislation: he maintains that such laws satisfy the need for Congress to react to a public outcry over corporate scandals at minimal cost to corporations; that is, corporations prefer such legislation because, he contends, it deflects liability from individual officers to entities and avoids more detrimental forms of legislative responses, such as facilitation of private civil litigation. See Vikramaditya S. Khanna, Corporate Crime Legislation: A Political Economy Analysis, 82 Wash. U.L.Q. 95 (2004).

[397] See note 232, supra.

along with Senator Gramm, that SOX was not a terrible regulatory outcome compared to what could have been enacted, and that it is relatively costless since much of the mandates were not that different from the prevailing state of the law. Executives had to sign SEC filings prior to SOX, the stock exchanges already required independent audit committees, and the SEC had prohibited in 2000 most of the non-audit services prohibited by SOX. In my judgment, however, that would be an incorrect assessment, even if much worse legislation could have been produced and was avoided. As previously noted, compliance costs to meet the certification requirement appear to be considerable, at least for smaller firms, and there are some costs that are difficult to quantify but could prove to be substantial, such as the contraction in financing opportunities for small and mid-sized businesses, as public firms are deterred from acquiring private and foreign firms (because the acquisition will make the acquirer responsible for certifying the accuracy of the entity's not-yet-certified books and records), or those small firms do not go public because of the SOX mandates.[398] To the extent that acquirers' transaction risk has increased because of the certification requirement, the efficiency of the market for corporate control could be affected, a potentially serious, and unintended, cost of the legislation.

More important, the extent of the full cost of the SOX governance mandates is still not known because much depends on the SEC's implementation of the mandates, and whether it will be able to use SOX as a springboard to assert a more expansive regulatory authority. This is a real possibility. The SEC's implementation of the audit committee independence rules has

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[398] See text and accompanying notes 207 and 376, supra. As David Silk and David Katz note, SOX has "beyond question" increased the risks to acquirers of doing deals. David M. Silk and David A. Katz, Doing Deals 2004 Keeping Pace With A Rapidly Changing Market, in Practising Law Institute, Corporate Law and Practice Course Handbook Series, Takeover Law and Practice 2003, 1410 PLI/Corp 1139, 1267 (Feb. 2004).

already raised operating costs for small companies beyond the previous regime, by eliminating the stock exchanges' exclusion for small businesses and provision for exceptions within a board's discretion from full committee independence.[399] In addition, the SEC has recently proposed a significant incursion into corporate governance that mandates shareholder nomination of directors under specified circumstances, which utterly disregards state law and has no connection to Congress' specific derogation of state law in the corporate governance provisions in SOX.[400]

Finally, the form of the mandates in SOX, compared to their prior permutation, creates a set of hidden costs that further renders dubious the innocuous window-dressing perspective on the mandates. The audit committee composition and non-audit services requirements have now been codified, whereas pre-SOX they were contained in stock exchange and SEC rules. It is far easier to revise exchange or agency rules than to amend a federal statute, if dynamic business conditions regarding accounting practices necessitate a rule change, or if it turns out that a chosen rule was mistaken. In sum, it is difficult to characterize SOX's governance mandates as no or low cost window dressing, that made sense to adopt in the context of a media frenzy over corporate scandals, even if more costly governance proposals could be imagined.

IV. Policy Implications

The analysis of the empirical literature and political dynamics relating to the SOX corporate governance mandates indicates that those provisions were poorly conceived, as there is

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[399] See SEC Release No. 33-8220, supra note 30, at 18792-93.

[400] Proposed Rule: Security Holder Director Nominations, SEC Release No. 34-48626, 68 Fed. Reg. 60784 (Oct. 23, 2003).

an absence of a factual basis to believe the mandates would be efficacious. Hence there is a disconnect between means and ends. The straightforward policy implication of this chasm between Congress' action and the learning bearing on it is that the mandates should be rescinded. The easiest mechanism for operationalizing such a policy change is to make the SOX mandates optional, serving as statutory default rules that firms choose whether or not to adopt. An alternative and more far-reaching approach, which has the advantage of a greater likelihood of producing the default rules preferred by a majority of investors and issuers, is to remove corporate governance provisions completely from the federal statutes and remit those matters to the states.

A. Converting Mandates into Statutory Defaults

Were the SOX corporate governance mandates treated as defaults, this would permit corporations to opt out of the federal mandates by shareholder vote. In this way, for example, small firms for which the audit committee composition, non-audit services and certification requirements pose substantial costs would be able to sidestep coverage, in contrast to larger firms with lower compliance costs, whose owners might perceive a positive benefit-cost ratio from the mandates and wish to retain them. This is the easiest method by which Congress' misconceived corporate governance provisions can be revised, because it can be done without congressional action, by the SEC under its general exemptive authority.[401]

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[401] 15 U.S.C. § 78mm ("the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.") Given the sharp increase in the cost of being publicly-traded in the United States for small and foreign firms that has already been identified, one plausible exercise of its exemptive power would be to exclude either of both of

State corporate law consists principally of enabling provisions that operate as defaults from which firms opt out if such tailoring better suits their organizational needs. Firms can therefore particularize their corporate charters, as well as pick the state code which best matches their requirements, so as to minimize the cost of doing business, thereby increasing the return to their investors. The defaults incorporated in state codes are those expected to be selected by the vast majority of firms, which further reduces transaction costs (most firms will not need to incur the cost of particularizing their charters). Transforming the SOX mandates into optional defaults for firms would move the federal regime conceptually to be along the lines of the state law approach to corporate governance.

From a transaction cost-reducing perspective of corporate governance regulation, it is problematic whether all, or even most, of the SOX mandates would be chosen by a majority of firms, and consequently, whether they should be defaults from which firms can opt out, as

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those categories of firms. It is, however, exceedingly unlikely that the SEC would exercise its exemptive authority regarding SOX requirements, either generally, or more narrowly with respect to small firms. Among numerous recent decisions lending support to this prediction is the SEC's new audit committee rule implemented pursuant to SOX. Prior to SOX, the exchange rules that mandated fully independent audit committees gave corporate boards the discretion to include a non-independent director on the committee. The SEC's implementation of the SOX mandate on audit committees not only eliminated that discretion, but rejected even a de minimus exception. SOX specifically provided the SEC with exemptive authority regarding the statutory definition of independence of audit committee members for "particular relationship[s]" as it deemed fit. Section 301 (codified at 15 U.S.C. 78f(m)(3)(C)). But in implementing the audit committee independence rules, the SEC stated that it considered the elimination of the exchanges' previous exemptions from full independence to be consistent with the "policies and purposes" of SOX, and it further accepted the position of public pension and labor union funds opposing any exceptions to the rule by flatly rejecting the request by issuers for a de minimus exception (that would have exempted trivial sums paid to a director, or to relatives or the business with which the director is affiliated, since the SEC's definition of independence prohibits both indirect and direct payments to the director). See SEC Release No. 33-8220, supra note 30, at 18792-93. Thus, when presented with the opportunity to mitigate the effect of Congress' misconceived mandate on audit committee composition, the SEC in fact compounded the error.

opposed to defaults into which firms opt in. Some pertinent facts lend support to an opt-in approach. States, for instance, could have enacted similar requirements to SOX as statutory defaults, but none chose to do so. Indeed, in the case of executive loans, state corporation codes contained precisely the opposite substantive default rule, specifying the criteria for undertaking such transactions. The most reasonable and straightforward inference to draw is that there was no demand for the SOX mandates: if there had been a significant demand, then the provisions would have appeared in state codes.[402]

In addition, despite state corporation codes' silence, firms could have declined to purchase non-audit services from auditors, refused to make executive loans, and created all independent audit committees (prior to the stock exchange requirement of such committees). Many firms chose not to do so, and the literature suggests they had good reasons: fully independent audit committees add no significant benefit over majority independent committees (and the benefit from even majority independent committees is an open question); purchasing non-audit services from auditors does not diminish audit quality; and executive loan programs can serve bona fide purposes that benefit shareholders. Were the SOX mandates rendered optional, firms that found the mandates beneficial would be unaffected, as they could continue to follow the SOX strictures. For example, firms that did not wish to purchase non-audit services from their auditor could continue to follow such a policy, and to demonstrate their commitment they could opt in (or not opt out) of the federal rule.[403]

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[402] For a further discussion of this point see part IV.B infra.

[403] Even before SOX, there were firms that apparently voluntarily followed such a practice. For example, many firms in the Kinney et al. study of audit firms' services did not purchase any of the subsequently prohibited non-audit services from their auditors, and a small

Although the transaction cost-reducing default rule is, in all likelihood, not retention of the SOX corporate governance mandates, retention with an opt-out option (rather than repeal with an opt-in option) could be an acceptable approach for mitigating the negative impact of the problematic SOX provisions. At state law, the method by which statutory defaults are altered is the charter amendment process, which has a structural asymmetry that advantages managers over shareholders, in cases where their interests regarding a default rule diverge, because the board has the exclusive right to invoke the charter-amending process.[404]

This asymmetry in the state law amendment process has led commentators to recommend opt-in rather than opt-out defaults for provisions that are expected to generate a conflict of interest between managers and shareholders, such as statutes facilitating defenses to takeovers.[405] The concern is that the costs to shareholders of opting in and opting out are not symmetrical, given the charter amendment process: shareholders might be able to block adoption of a management proposal that is required in an opt-in regime for an antitakeover statute by voting no, for example, but they will not be able to remove such an undesirable statutory default in an opt-out regime since managers can block the necessary charter amendment that opts out of the statute by refusing to put it up to a vote. If the mechanism for choosing whether to be covered by

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number of firms purchased no non-audit services, including the tax and audit-related services the purchase of which SOX continued to permit. Kinney et al., supra note 171, at 574. It is, however, possible that the firms were not deliberately shunning the use of their auditor as required by SOX, but simply had no need for such services.

[404] See e.g., Del. tit. 8, § 242.

[405] For discussion of when state corporate laws should be phrased as opt-in or opt-out provisions see Lucian Arye Bebchuk and Assaf Hamdani, Optimal Defaults for Corporate Law Evolution, 96 Nw. U.L. Rev. 489 (2002); Roberta Romano, The Political Economy of Takeover Statutes, 73 Va. L. Rev. 111, 186-87 (1987).

SOX mandates were to follow the usual state law charter amendment procedure, then to the extent that those provisions pose a conflict of interest between managers and shareholders, it would be better to adopt an opt-out regime, in which the provisions are statutory defaults that apply without the need for corporate action. Managers would therefore have to initiate the opt-out decision, which shareholders could reject.

An alternative approach would be to not adopt the state law practice for charter amendments and to adopt instead a symmetrical procedure that provides shareholders, as well as managers, the right to propose a vote on whether a corporation should be covered by a specific SOX governance default provision.[406] With the asymmetry between managers and shareholders removed from the decision rule on a statutory default's applicability, there would be no particular reason to adopt a default rule that is an opt-out rather than opt-in one. The advantage is that the statutory default can now be set so as to mirror the majority of firms' practices and state law defaults pre-SOX (that is, the SOX provisions would not apply unless specifically chosen), since even if the substance of the SOX provisions is characterized as involving a conflict of interest, it is of no import because shareholders can propose on their own to opt in. An opt-in default should reduce transaction costs compared to an opt-out one, assuming, as seems probable given the empirical literature, that prior practices maximized firm value and were not managerialist, because firms will not have to take action if they do not wish to comply with the SOX provisions (to be covered they must opt into the statute). Thus, to recap the alternatives, opt-outs should be

[406] Adoption of such a procedure would not be a usurpation of state law if the SOX provisions are maintained as a federal default regime: since a federal statute is not a term in a state corporate charter, changing the applicability of such a statute is not equivalent to amending a charter.

the rule if the state charter amendment process is used to determine when a federal corporate governance default applies to a corporation and it appears likely that there is a conflict-of-interest between managers and shareholders concerning the provision, and opt-ins should be the rule if shareholders are provided the same rights as managers to initiate the voting process on the default.

There is one potential remaining state law asymmetry bearing on the effectiveness of the proposed symmetrical procedure for determining the applicability of a SOX statutory default. The asymmetry originates from the fact that managers can use the corporate treasury to finance their efforts to alter or retain a statutory default (since the corporation pays for the cost of running the proxy process through which the vote on SOX defaults would have to take place), while shareholders cannot. To remedy the situation, the SEC's approach to shareholder proposals could be adopted. That approach requires corporations to finance shareholders' access to the proxy mechanism, by regulating the inclusion of shareholder proposals in management's proxy materials at no cost to the proposal proponent.[407] A shareholder who wanted a corporation to opt out of (or opt into) a statutory mandate would provide a timely notice to management of the request prior to the annual shareholder meeting, and management would have to include a statement explaining the issue in the proxy materials and submit it to a vote. To prevent abuse

[407] 17 C.F.R. § 240.14a-8. Rule 14a-8 has minimal shareholder eligibility requirements: continuous ownership of shares equal to $2000 in market value or 1 percent of the securities entitled to vote on the proposal at the meeting, for one year before the date of the proposal's submission and through the date of the shareholder meeting. There is no need, however, to extend that limitation to the SOX mandate context, because the use of the proxy mechanism here is restricted subject-wise to matters equally affecting all shareholders, in contrast to the rule 14a-8 procedure, which is open to frivolous proposals, including proposals not directed at increasing firm value or in the interest of non-proposing shareholders, despite the fact that the non-proposing shareholders are the ones who bear the cost of the submission.

from repeated efforts to alter a SOX default upon a failure to obtain sufficient voting support, a limit could be placed on the frequency with which proposals can be presented that are subsidized by the firm (in distinction to those paid for by the proposal's proponent, as in a proxy fight), whether the proposal is sponsored by a shareholder or incumbent management.[408]

B. Returning Corporate Governance to the States

The absence of state codes or corporate charters tracking the SOX mandates further suggests that board composition, the services corporations purchase from their auditors, and their credit arrangements with executives, the substance of the SOX mandates, are not proper subjects for federal government action, let alone mandates, and that rendering them optional is not the optimal solution compared to their outright repeal.[409] The states and the stock exchanges are a

[408] The shareholder proposal rules have some limits on resubmission based on a proposal's failure to receive a minimal level of votes. For example, management may exclude proposals that received less than 3 percent of the votes and were proposed once within the five preceding calendar years. Id. In the SOX context, it would be plausible to make any resubmission exclusion absolute, and not to depend on the level of votes received in a given year, as the voting shareholders will not be uncertain of a proposal's effect –there is no question whether the proposal can or will be implemented should it obtain a majority vote– which might otherwise cut against informed voting. This also would reduce the waste of corporate funds from shareholders' use of the mechanism as a nuisance device (which could be a particular problem as there will be no restriction on the size of share holdings for seeking a default change), as well as from non-value-maximizing managers who disregard shareholders' expressed view of their welfare, since they will no longer have free use of the proxy mechanism. A further safeguard from abuse of process would be either to reimburse the proponent of an opt-in or opt-out solely if the proposal passes, or to provide only a partial reimbursement of expenditures on failed proposals, in proportion to votes obtained. For a similar suggestion regarding shareholder proposals see Roberta Romano, Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance, 18 Yale J. Reg. 174 (2001).

[409] A basis for rendering optional the certification requirement is the disparate event study data, discussed in part II.D.2, supra, that suggest that only some firms' investors benefitted from the information provided by the provision. One cannot draw any inference from the absence of such a provision in state codes because the regulation of audited financial statements has been a matter of federal, not state, law since the 1930s . Given that the latter requirement is federal, in

far more appropriate locus of regulatory authority for those governance matters than Congress and its delegated federal regulatory agents.[410] They are closer to the affected constituents (corporations) and they are less likely to make regulatory mistakes. This is because they operate in a competitive environment: corporations choose in which state to incorporate and can change their domicile if they are dissatisfied with a legal regime, just as corporations choose, and can change, their trading venue.[411] Moreover, any regulatory mistakes made will be less costly, as

contrast to the other mandates that should be removed from the federal statute and left to state law, the certification provision could be maintained, albeit rendered optional, as part of the federal regulatory system.

[410] For a more detailed explanation of why state competition for corporate charters is preferable to exclusive federal regulation, see, e.g., Roberta Romano, The Genius of American Corporate Law (1993). The SEC's exercise of authority over exchange rules would need to be eliminated or severely restricted, however, for the stock exchanges to become an effective source of corporate governance standards. This is because the SEC now uses its authority to force the exchanges to adopt uniform standards that it considers desirable, which undermines the benefit of exchange-based governance, which stems from the market-based incentives of competing exchanges to offer the rules that enhance the value of listed firms. See generally Mahoney, supra note 193. A more preferable approach to exchange standards regarding corporate governance than that of the U.S. exchanges is that taken by the London Stock Exchange, which follows a form of a "disclose and explain" rule: listed firms are required to disclose whether they comply with a code of best practices (and if they do not conform, to explain why they do not). SOX's audit committee expert provision (section 407) is of a similar form. The reason for the difference in approach is not obvious given that there are differences in both the regulatory and domestic market environments. Namely, the difference could be due to the SEC's preferences (that is, the agency imposes the listing mandates through its oversight authority), or because the competition among U.S. exchanges fosters a product differentiation strategy in which an exchange can benefit from adopting mandatory standards through which listed firms signal quality to investors. It should be noted, however, that Jonathan Macey and Maureen O'Hara contend that stock exchanges such as the NYSE no longer provide a reputational function (at least for domestic firms). See Jonathan R. Macey and Maureen O'Hara, The Economics of Stock Exchange Listing Fees and Listing Requirements, 11 J. Fin. Intermediation 297 (2002).

[411] It should be noted that until recently, it was difficult to delist from the New York Stock Exchange (NYSE). See, e.g., A.C. Pritchard, Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers, 85 Va. L. Rev. 925, 992 (1999) (noting recent dilution of delisting rule, which, in contrast to other exchanges, required shareholder

not all firms will be affected.

Regulatory competition offers an advantage over a monopolist regulator because it provides regulators with incentives, and the necessary information, to be accountable and responsive to the demands of the regulated, an important regulatory characteristic in the corporate context because firms operate in a changing business environment, and their regulatory needs concomitantly change over time. Namely, there is a feedback mechanism in a competitive system that indicates to decisionmakers when a regime needs to be adapted and penalizes them when they fail to respond: the flows of firms out of regimes that are antiquated and into regimes that are not. In other words, decisionmakers who fail to update their regimes to accommodate new business circumstances will lose corporations to more innovative regimes that have adapted.[412]

There are incentives for states to prefer having more locally-incorporated corporations to less and therefore to respond to a net outflow of firms: they receive annual franchise fee payments, and an important political constituency, the local corporate bar, profits from local

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approval for delisting); David Alan Miller and Marci J. Frankenthaler, Delisting/Deregistration of Securities under the Securities Exchange Act of 1934, 17 Insights 7, 11 (Oct. 2003) (noting further easing of NYSE delisting requirements in 2003); Jonathan R. Macey & David D. Haddock, Shirking at the SEC: The Failure of the National Market System, 1985 U. Ill. L. Rev. 315, 326 (criticizing NYSE's delisting rule, which had SEC support, requiring supermajority shareholder vote to delist, for making it "extraordinarily difficult" to delist voluntarily).

[412] E.g., Romano, supra note 18, at 239 n.140. It should be noted, in this regard, that states are able to act more quickly than Congress. For instance, the Delaware legislature responded to what was considered an undesirable corporate law decision on director liability 1.5 years after the holding, whereas Congress has averaged 2.4 years when reversing judicial opinions invalidating federal statutes, Romano, supra note 409, at 49, and, although the wisdom of the overruling is questionable, the Supreme Court decision on the statute of limitations overturned by SOX was decided in 1991, over a decade earlier.

incorporations.[413] Exchanges, similarly, prefer more listings to less, since listing fees are a major source of revenue.[414] While even a monopoly regulator is interested in increasing the number of firms subject to its regulatory authority,[415] the SEC has done so not by principally trying to induce a voluntary increase in registrants by improving its regulatory product, but rather, by either aggressively interpreting the scope of its authority to include previously unregulated entities, or by lobbying Congress for a statutory expansion of jurisdiction.[416] Competing regulators, by contrast, can increase the number of firms under their jurisdiction solely by providing a product of higher value to firms. Thus, states can be expected to do a better job in setting the appropriate corporate governance default rules than Congress, or the SEC; they have a greater incentive to get things right.

V. Conclusion

This paper has examined the substantive corporate governance mandates adopted by Congress in the wake of the Enron scandals. An extensive academic literature suggests that

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413 Id. at 28.

414 See Macey and O'Hara, supra note 409.

415 See, e.g., William A. Niskanen, Jr., Bureaucracy and Representative Government 38-41 (1971).

416 For example, the SEC has recently proposed to regulate hedge funds, although they are not a public investment vehicle, see Judith Burns, SEC May Widen Hedge-Fund Rules, Wall St. J., Apr. 29, 2004, at D9, and it has lobbied Congress successfully in the 1960s to expand its regulation of firms trading in over-the-counter markets and unsuccessfully from the 1970s through the 1990s to include stock-based financial derivatives in its jurisdiction, see Joel Seligman, The Transformation of Wall Street (1995) (describing SEC activities leading up to 1964 amendments expanding registration requirements to firms traded over-the-counter); Roberta Romano, The Political Dynamics of Derivative Securities Regulation, 14 Yale J. Reg. 279 (1997) (describing SEC's failed efforts to shift regulatory jurisdiction over financial derivatives to itself from the Commodity Futures Trading Commission).

those mandates were seriously misconceived as they are not likely to improve audit quality or otherwise enhance firm performance and benefit investors as Congress intended. Moreover, in the frantic political environment in which the law was enacted, legislators adopted proposals of policy entrepreneurs, with neither careful consideration, nor assimilation of the literature at odds with the policy prescriptions. The policy implication drawn from the paper's analysis of the literature and political dynamics is that the mandates should be rescinded, either by transforming them into statutory defaults which apply to firms at their option, or by removing them completely and redirecting the jurisdictional authority to the states.

Congressional repeal of SOX's corporate governance mandates is not on the near-term political horizon as the corporate accounting scandals have not receded from view. The alternative of treating SOX as a set of default rules could be implemented by the SEC under its general exemptive authority but it is improbable that the agency will do so given its current leadership, whose instinct is to move in the wrong direction. It is therefore important to work to educate the media, the public, political leaders and agency personnel regarding the reality that Congress committed a public policy blunder in enacting SOX's corporate governance mandates, and that there is a need to rectify the error.

Tables and Figure

Table 1. Gallup Public Opinion Polls of Confidence in Big Business, 1990-2003.

Poll	Date	Sample size	Percent expressing “great deal (quite a lot) of confidence” = total of both categories
Gallup	Aug. 1990	1,241	9 (16) = 25
Gallup	Feb. 1991	1,012	11(15) = 26
Gallup	Oct. 1991	1,009	7 (15) = 22
Gallup	Mar. 1993	1,003	7 (16) = 23
Gallup/CNN/USA Today	Mar. 1994	1,036	9 (17) = 26
Gallup/CNN/USA Today	Mar. 1995	1,008	8 (13) = 21
Gallup/CNN/USA Today	May, 1996	1,019	7 (17) = 24
Gallup/CNN/USA Today	July, 1997	1,004	11(17) = 28
Gallup/CNN/USA Today	June, 1998	1,003	11(19) = 30
Gallup/CNN/USA Today	July, 1998	1,035	13(18) = 31
Gallup/CNN/USA Today	June, 1999	1,016	11(19) = 30
Gallup	June, 2000	1,021	9 (20) = 29
Gallup/CNN/USA Today	June, 2001	1,011	10(18) = 28
Gallup/CNN/USA Today	June, 2002	1,020	7 (13) = 20
Gallup/CNN/USA Today	June, 2003	1,029	8 (14) = 22

Poll data obtained from the iPoll databank of The Roper Center for Public Opinion Research at the University of Connecticut.

Table 2. Studies on Audit Committee Independence

Study	Sample	Performance measure	Findings
Klein (1998)	485 S&P firms, 1992; 486 S&P firms, 1993	Return on assets; Jensen Productivity measure; 1-year raw market return	No association with percent independent and any measure; no stock market effect for change in composition of committee
Cotter and Silvester (2003)	109 large Australian firms, 1997	Market value	No association
Vafeas and Theodorou (1998)	250 U.K. firms, 1994	Market to book ratio, stock return and accounting measures	No association
Weir, Laing and McKnight (2002)	311 firms from 1996 Times1000 (U.K.)	Tobin's Q	No association
Klein (2002)	692 S&P firms, 1992-93	Abnormal accruals	No association with 100% independent; negative relation with majority independent or percent independent
Chtourou, Bédard and Courteau (2001)	300 firms, 1996	Abnormal accruals	No association with 100% independent; negative association with high accruals with percent independent who are also not managers of other firms
Xie, Davidson and DaDalt (2003)	282 S&P 500 firms, 1992, 1994, 1996	Abnormal accruals	No association; negative association with proportion of investment bankers or other corporate officers on committee
Agrawal and Chadha (2003)	159 pairs of firms, 2000-01	Earnings restatements	No association with percent independent or 100% independent; Negative relation with financial expert on committee
Beasley (1996)	75 firms, 1980-91; 26 pairs with audit committees	Financial statement fraud	No association with percent independent
Abbott, Parker and Peters (2002)	129 pairs of firms, 1991-99	Financial reporting misstatements or fraud	Negative relation with 100% independent or absence of financial expert on committee
Abbott, Park and Parker (2000)	78 pairs of firms, 1980-96	Financial statement fraud	Negative relation with variable combining 100% independent and 2 meetings a year

Study	Sample	Performance measure	Findings
Beasley et al. (2000)	66 firms in high technology, health care and financial services industries, 1987-97	Financial statement fraud	Univariate test: Negative relation for 100% independent in two of three industries
McMullen and Raghunandan (1996)	51 firms with financial problems pre-1989; 77 control firms	SEC enforcement action or quarterly earnings restatement	Univariate test: Negative relation for 100% independent and for presence of accounting expert on committee
Uzun et al. (2004)	133 firms accused of fraud from 1978-2001 paired with no-fraud firms	Allegations of third-party and government contract fraud, financial statement fraud, and regulatory violations	No association for percent independent; positive association for percent of "grey" (affiliated) directors
Felo, Kristhnamurty and Solieri (2003)	119 firms, 1992-93; 130 firms, 1995-96 (77 firms in both periods)	Financial analysts' score for quality of financial reporting	No association with percent independent; positive relation with proportion of financial experts on committee in 1995-96; no association with expert with accounting background; change in score from 1992-93 to 1995-96 positively related to percentage experts in 1992-93 and to change in number of experts over the period
Anderson, Deli and Gillan (2003)	1,241 firms, 2001	Stock market response to unexpected earnings (earnings informativeness)	Earnings response significantly related to board independence with no incremental significance of audit committee independence

Note. Jensen productivity is the change in market value and equity minus a benchmark return on investment, defined as the change in net property, plant and equipment multiplied by the firm's cost of capital (assumed to be 8%); Tobin's Q is the ratio of a firm's market value to the replacement cost of its assets (proxied for by total assets).

Table 3. Studies on the Provision of Non-Audit Services

Study	Sample	Independence Measure	Audit Quality Measure	Findings
Frankel, Johnson and Nelson (2002)	3074 firms (2012 firms in earnings tests)	fee ratio, percentile ranking of client's non-audit fees, total fees, audit fees	discretionary accruals; earnings surprises or small increases	Positive association between ratio and non-audit fees rank and accruals and surprises; negative association between audit fees rank and accruals; total fees rank insignificant
Dee, Lulseged and Nowlin (2002)	203 S&P 500 firms	fee ratio	level of discretionary accruals	Positive association
Ferguson, Seow and Young (2003)	610 U.K. firms averaged over 1996-98	fee ratio, nonaudit fees, decile ranking of client's non-audit fees by regional office	discretionary accruals; news report of analyst criticism or regulatory investigation into accounting; restatements or adjustments under 1999 U.K. accounting rule change	Positive association for all measure pairs except for decile ranking and news report
Ashbaugh, LaFond and Mayhew (2003)	3,170 firms (1666 firms in earnings tests)	fee ratio, total fees, audit fees, non-audit fees	discretionary accruals (controlled for performance); earnings surprises or small increases	Association between ratio and accruals is only for income-decreasing accruals; negative relation between audit fees and total fees and small increases; no other systematic significant associations
Chung and Kallapur (2003)	1871 clients of Big 5 firms	client importance (ratio of non-audit and of total fees, to total revenues; also estimated at local office level	discretionary accruals	No association; if use Frankel et al.'s model, positive association between ratio and accruals only for smallest group of firms
Francis and Ke (2003)	1588 firms (5208 quarterly earnings observations	fee ratio, total fees, non-audit fees, dummy for ratio greater than .5, percentile ranking of dollar amount of non-audit fees and of total fees	earnings surprises (controlling for large negative earnings)	Association between ratio and surprises only for firms with large negative earnings; no other associations

Study	Sample	Independence Measure	Audit Quality Measure	Findings
Gore, Pope and Singh (2001)	4779 U.K. firm-years (1992-98)	fee ratio	discretionary accruals	No association for big 5 firms, positive for non-big 5
Antle et al. (2002)	2443 U.K. firm-years (1994-2000); 1430 U.S. firms	audit fees, non-audit fees, fee ratio	discretionary accruals (simultaneous estimation of accruals and fees)	Negative relation between non-audit fees and accruals; positive association between audit fees and accruals; accruals do not explain fees; positive relation between fees; no significant associations in non-simultaneous estimation; ratio insignificant (non-simultaneous estimation)
Jenkins (2003)	303 Fortune 1000 firms (2000-01)	fee ratio; percentile ranking by auditor of non-audit fees, total fees, audit fees	discretionary accruals	Positive association for absolute accruals; negative for directional accruals when variables measuring audit committee effectiveness and its interaction with audit fees are included in model, but when audit committees are effective, no relation between fees and accruals; negative relation for income-decreasing accruals, negative for income-increasing accruals when performance controlled
Larcker and Richardson (2003)	3424 firms (2000-01)	fee ratio; client importance; abnormal client importance fees	discretionary accruals	No association; positive association for 8.5% of sample using fee ratio and nondirectional or negative constrained accruals, which group has poor corporate governance features; negative relation using client importance measures and nondirectional and constrained accruals
Krishnan (2003)	5430 firm-years (2000-01)	total fees, fee ratio, audit fees, non-audit fees, client importance, and unexpected ratio and fee measures	earnings conservatism	Greater conservatism for high-fee clients than for low-fee clients (total, audit and non-audit fees); no association for fee-ratio or client importance measures

Study	Sample	Independence Measure	Audit Quality Measure	Findings
Ruddock, Taylor and Taylor (2003)	4708 Australian firm-years (1993-2000)	fee ratio, and ratio scaled by assets	earnings conservatism	No association
Defond et al. (2002)	1158 firms (96 received first-time going concern reports)	fee ratio, non-audit fees, audit fees, total fees; client importance fee ratio and fees; unexpected ratio and unexpected fees	going concern audit reports (simultaneous model estimated as robustness check)	No association
Craswell, Stokes and Laughton (2002)	1062 Australian firms in 1994 and 1045 in 1996	client fee ratio, measured at both national firm and local office level	qualified opinion	No association
Pringle and Buchman (1996)	47 bankrupt firms, 1978-82	fee ratio	qualified opinion	No association
Craswell (1999)	885 Australian firms in 1984, 1477 in 1987, and 1079 in 1994	fee ratio	qualified opinion	No association
Lennox (1999)	837 U.K. firms, 1988-94	fee ratio and non-audit fees	qualified opinion	No association; positive association in 1 specification (non-audit services increases audit quality)
Li, Hay and Knechel (2003)	177 large New Zealand firms in 1999, 224 in 2000 and 243 in 2001	non-audit fees, fee ratio, client importance (total client fees to total revenues)	qualified or modified opinion	No association; positive association in 1 year in 1 specification (higher non-audit fees increase probability of qualified opinion)
Firth (2002)	1112 U.K. firms on International Stock Exchange, 1996	non-audit fees standardized by total assets of client	qualified opinion	Negative association (higher ratio reduces probability of qualified opinion)
Sharma and Sidhu (2001)	49 bankrupt Australian firms delisted 1989-96	fee ratio	going concern opinion	Negative association
Reynolds and Francis (2001)	6747 firms at 499 offices of Big 5 firms in 1996 (4952 for accruals and 2439 for going concern	client influence (ratio of client log sales to total client sales of local office)	discretionary and total accruals, volatility of accruals; going concern opinions	Client dependence associated with decreased client discretion (lower accruals) and in some specifications higher rate of going concern opinions; no association if

Study	Sample	Independence Measure	Audit Quality Measure	Findings
Reynolds and Francis (2001) (continued)	opinion tests)			national rather than local office used for influence calculation
Agrawal and Chadha (2003)	159 pairs of firms, 2000-01	fee ratio, non-audit fees over $1 million	earnings restatements	No association
Raghunandan, Read and Whisenant (2003)	3591 firms (of which 110 issued restated financials); some tests on 84 pairs of firms	unexpected fee ratio, audit and non-audit fees	financial restatements	No association
Bajaj, Gunny and Sarin (2003)	100 pairs of firms, 2001-02	fee ratio, total fees, non-audit fees, audit fees	securities class actions alleging accounting improprieties	No association; higher fee ratio and non-audit fees for sued firms for subset of 33 firms with the largest stock price drop over class period
Kinney, Palmrose and Scholz (2003)	432 restating and 512 non-restating firms; 289 pairs (76 pairs for first restatement year), 1995-2000	non-audit fees by type of service; audit fees	earnings restatements	No association with prohibited non-audit service fees; negative relation with tax services (permitted) fees;positive relation with audit fees and miscellaneous non-audit services fees (permissibility ambiguous); no association in paired sample tests

Notes: 2000 data unless otherwise indicated; earnings surprises are defined as earnings meeting or just beating the consensus analysts' forecast (that is, an indicator variable for a 0 or 1 cent difference between reported earnings and forecast); small increases are earnings greater than surprises; fee ratio is the ratio of non-audit fees to total fees (in Antle et al., Pringle and Buchman, and Li, Hay and Knechel the denominator is audit fees; Bajaj et al. use both denominators); Jenkins uses the ratio of audit fees to total fees, but for consistency in comparison of the results across studies, the table reports the results as if she had used the same fee ratio as the others (it reverses the sign of the results in the paper); total fees are the total of non-audit and audit fees; client importance computation of computes the fee measures (fee ratio, non-audit fees or total fees) in relation to the auditor's total U.S. revenue; Craswell et al., fee ratio is ratio of client audit or client non-audit fees to total fees.

Table 4. Study of Executive Loan programs (Shastri and Kahle, 2003)

Type of loan (number in sample)	Mean loan amount (mean secured)	Mean interest rate	Prime spread	Mortgage spread	Call money spread	Findings on incentive alignment hypothesis
Stock purchase (334)	$2.5 million (.636)	6.057	-2.3	-1.479	-1.074	Ownership increases; much higher increases for managers with low stock ownership
Stock option purchase (246)	$1.7 million (.784)	6.187	-2.293	-1.35	-1.076	Ownership increases
Relocation (91)	$770,000 (.753)	3.910	-4.483	-3.597	-3.255	No effect on ownership

Note: sample of 70 firms issuing loans to executives 1996-2000, for a total of 2,018 person-year observations, of which 700 are observations of executives with outstanding loans; 1,469 person-year observations for ownership calculations; mean secured for stock and option purchase loans is mean secured by stock; for relocation loans, mean secured is mean secured by assets (purchased house); prime spread is the difference between the interest rate on the loan and average prime rate during life of loan; mortgage spread is the difference between the interest rate on the loan and the average 30-year mortgage rate; call money spread is the difference between the interest rate on the loan and the average call money rate.

Table 5. Event studies on Executive Certification of Financials

Study	Sample	Findings
Bhattacharya, Groznik and Haslem (2002)	902 firms required to certify (of these, 22 non-certifiers)	No significant abnormal returns to any portfolio; non-certifiers did not experience abnormal trading volume or volatility; firm characteristics not significantly related to magnitude of abnormal return
Hirtle (2003)	42 bank holding companies (all certified by deadline)	Positive abnormal returns on certification date; portfolio result driven by early certifiers (when subdivided by certification date, only early certifiers' returns are significant); firm characteristics of opacity related to size of abnormal return but not to timing of certification

Table 6. Congressional Debates on SOXA

A. Senate-Sarbanes bill, July 8-12, 15,2002

Issue	No. Speakers
Audit Committee Independence	8
Restriction on Non-audit Services	21
Loans to Officers	6
Certification of Financials	9
Accounting Profession Regulator	21
Statute of Limitations for Class Actions	7
Accounting for Stock Options	13
Stock analysts	10
Executive Forfeiture of Bonuses	6
Increased Criminal Penalties	23
Total speaking on any issue	53

B. House of Representatives- Oxley bill, April 24, 2002

Issue	No. Speakers
Restriction on Non-audit Services	15
Certification of Financials	6
Accounting Profession Regulator	24
Stock Analysts	8
Executive Forfeiture of Bonuses	9
Total speaking on any issue	47

C. House of Representatives-Judiciary Committee bill, July 16,2002

Issue	No. Speakers
Certification of Financials	7
Statute of Limitations for Class Actions	6
Civil Penalties	3
Increased Criminal Penalties	13
Total speaking on any issue	21

D. House of Representatives- Motion on Conference committee instructions, July 17, 2002

Issue	No. Speakers
Certification of Financials	1
Statute of Limitations for Class Actions	6
Accounting for Stock Options	3
Stock Analysts	1
Increased Criminal Penalties	6
Total speaking on any issue	19

Note: All speakers in table D also speakers in table B; 11 of speakers in table C also speakers in table B and 7 of speakers in table C also speakers in table D.

Table 7. Witnesses at the Senate Banking, Housing and Urban Affairs Committee and House Financial Services Committee Hearings, 2001-02.

Witness type	House hearing*	House minority hearing	Senate hearing
Enron/Arthur Andersen officials	3	0	0
Accounting Regulator	0	0	6
Accounting Industry	1	0	5
Federal Government/former federal government official	6	2	10
Business groups	3	0	0
Unions	1	1	1
Securities Industry	1	0	1
Securities analysts	1	0	2
Institutional Investors	3	0	2
Consumer groups	1	0	1
Academics and policy analysts	1	1	6
Other+	1	0	5
Total witnesses	22	4	39

Notes: * The union witness was invited to the committee hearing at the request of the ranking minority member and two House witnesses (a government and an Arthur Andersen official) appeared at two different House hearings and are therefore counted twice.

+ House witness: attorney; Senate witnesses: former head of FDIC who is an accountant; investment banker who chaired, and lawyer who served, on the Blue Ribbon Committee on Audit Independence; accountant/investment bank partner who was deputy chair of 1978 Cohen commission on accounting; accountant who chaired the Panel on Audit Effectiveness.

The House committee hearings were held on: December 12, 2001, February 4-5, 2002, and March 13, 20, 2002; the Democratic minority held a hearing on April 9, 2002; the witnesses at the committee's hearing on Global Crossing on March 21, 2002 are not included in the table (one government official and seven executives from company and industry). The Senate committee hearings were held on: February 12, 14, 26, 27, 2002, and March 5, 6, 14, 19, 20, 21, 2002.

Table 8. Campaign Contributions to Conference Committee Members.

A. Accounting Profession Contributions, Jan. 1, 1999-July 8, 2002

Chamber	Total to Republicans Range	Total to Democrats Range	Chamber Average
House (23)	$439,222 (14) $2,700 - $77,293	$44,050 (9) ($3,000) - $37,800	$22,914
Senate (9)	$121,261 (4) $4,750 - 60,511	$126,504 (5) 0 - $68,000	$27,520

Notes: Numbers in parentheses are number of legislators on the Conference Committee. Of the nine House Democrats, two received no contributions and one's total contributions were negative (due to returned funds); of the five Senate Democrats, one received no contributions.

Source: Center for Responsive Politics, Accounting Industry Contributions to the Conference Committee (update 1/30/02) (contributions compiled from 2000 election cycle and 2002 election cycle through July 8, 2002).

B. Lawyers/Law Firm Contributions, Jan.1, 1999-Dec. 31, 2002

Chamber	Total to Republicans Range	Total to Democrats Range	Chamber Average
House (23)	$790,947 (14) $31,300 - $112,470	$1,394,733 (9) $33,175 - $443,436	$95,030
Senate (9)	$364,788 (4) $17,650 - $221,488	$1,187,434 (5) $31,870 - $581,041	$172,469

Notes: Numbers in parentheses are number of legislators on the Conference Committee.

Source: Center for Responsive Politics (compiled by author from Lawyers/Law Firm Industry Members to Congress file from election cycles 2000 and 2002).

C. <u>Business Associations Contributions, Jan. 1, 1999-Dec. 31, 2002</u>

Chamber	Total to Republicans Range	Total to Democrats Range	Chamber Average
House (23)	$119,963 (14) $1,500 - $18,000	$23,831 (9) 0 - $7,750	$6,252
Senate (9)	$29,119 (4) $250 - 12,750	$20,500 (5) $750 - $6,250	$5,513

<u>Notes</u>: Numbers in parentheses are number of legislators on the Conference Committee. Of the nine House Democrats, two received no contributions. The Business Associations category consists of chambers of commerce and small-business, pro-business and international trade associations.

<u>Source</u>: Center for Responsive Politics (compiled by author from Business Associations Members to Congress file from election cycles 2000 and 2002).

D. <u>Organized Labor Contributions, Jan.1, 1999-Dec. 31, 2002</u>

Chamber	Total to Republicans Range	Total to Democrats Range	Chamber Average
House (23)	$432,505 (14) 0 - $199,000	$2,536,584 (9) $79,500 - $539,600	$129,091
Senate (9)	$43,000 (4) 0 - $31,000	$1,106,600 (5) $1,000 - $466,950	$127,733

<u>Notes</u>: Numbers in parentheses are number of legislators on the Conference Committee. Of the 23 House Republicans, one received no contributions and one netted zero over the two cycles.

<u>Source</u>: Center for Responsive Politics (compiled by author from Labor (Unions) Members to Congress file from election cycles 2000 and 2002).

Figure 1. S&P 500 Composite Index Closing Price, Sep. 9, 2001-Oct. 1,2002.