Testimony of John C. Coates IV[1]

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Committee on Financial Services

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on

Reassessing Sarbanes-Oxley: The Cost of Compliance in Today's Capital Markets

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Chairman Wagner, Ranking Member Sherman, and members of the Subcommittee, I thank you for inviting me to testify. Effective law and regulation are crucial foundations for capital markets, and by protecting investors and lowering the cost of capital, they are central to America's success. I am honored to participate in a reassessment of the Sarbanes-Oxley Act, about which I have published peer-reviewed articles in law, accounting, and economics journals.

Background and Experience

Before joining Harvard, I was a partner practicing securities law at Wachtell Lipton Rosen & Katz, working on matters from Arkansas to Idaho, from Maine to Texas. I represented companies going public for the first time, and I was a primary lawyer on more than 50 large M&A deals, for both buyers and sellers, involving public and private companies, multinational banks and family-owned businesses. I worked for Goldman Sachs and other major banks, as well as small, independent brokers and investment advisers. During that practice, I helped companies cope with disclosure and control obligations, as well as mitigate and respond to the risks created by their absence when (for example) representing public companies buying privately held businesses.

In 2021, I had the honor of serving as General Counsel of the Securities and Exchange Commission, and before that, as Acting Director of the Division of Corporation Finance during the largest IPO boom in world history. In those roles, I oversaw enforcement of the Sarbanes-Oxley Act and participated in the SEC's oversight of the PCAOB. From time to time, I have advised the PCAOB, working with other academics from the Graduate School of Business at the University of Chicago, to help the

Board align its practices and standards with the best information and insight that serious research can offer.

At Harvard, I have for nearly thirty years taught, researched and written about disclosure and the costs and benefits of law and regulation of disclosure, in both the law school and the business school, in degree programs and executive education sessions with directors, CEOs, and general counsels. I published one of the first evaluations of the Sarbanes-Oxley Act (in the *Journal of Economic Perspectives* in 2007, cited more than 750 times by other scholars),[2] and in 2014 co-authored with a colleague at the business school a ten-year, multi-disciplinary literature review of research on that law that became one of the top-cited articles at the intersection of accounting and corporate governance in all peer-reviewed journals focused on accounting and auditing.[3] I have authored two studies of economic analysis of financial regulation, including a detailed cost-benefit analysis of one of the most important parts of SOX, item 404, which requires disclosures about financial controls.[4]

Finally, I note that for seven years, I served as an independent monitor for the DOJ and a compliance consultant to the SEC overseeing a systemically important financial institution. In that work, I managed a team of more than 25 lawyers and forensic accountants and other specialists. I was required to and did evaluate the costs and benefits of control and compliance systems, and experienced firsthand the challenges of deterring,

[2] The Goals and Promise of the Sarbanes-Oxley Act, 21 J. Econ. Persp. 91 (Winter 2007).
[3] John C. Coates and Suraj Srinivasan, SOX After Ten Years: A Multidisciplinary Review, 28:3 Accounting Horizons 627 (2014).
[4] Towards Better Cost-Benefit Analysis: An Essay on Regulatory Management, 78 Law and Contemporary Problems 1 (2015); Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications, 124 Yale Law Journal 882 (2014-2015).

mitigating and responding to control weaknesses through policies, procedures, testing, internal auditing, and engagement with external auditors and regulators.

In the rest of this written testimony, I offer (a) a few general observations about the Sarbanes-Oxley Act, (b) a summary of some of the effects of the law, and (c) a concluding point about compliance costs.

1. <u>General Observations about the Sarbanes-Oxley Act</u>

In this section, I make a few general points to clarify what SOX did and did not do: (1) SOX is a disclosure law, and disclosure laws provide enormous benefits to the economy; (2) control systems long pre-dated SOX, and were not imposed by SOX; (3) SOX never imposed a "one size fits all" rules on US businesses; (4) the creation of the PCAOB directly followed from the failure of self-regulatory bodies to preserve quality audits for US public companies; (5) the requirement that PCAOB-supervised auditors be retained by broker-dealers was a direct result of the Madoff and Stanford scandals; and (6) the PCAOB plays a particularly important role in protecting US investors in China-based companies.

1.1. <u>SOX is a Disclosure Law and Disclosure Law Add Enormous Value</u>

The core of SOX, as with the rest of the securities laws, is a set of disclosure obligations. Disclosure has many virtues, and as compared to command-and-control regulation, imposes fewer costs. Disclosure enhances legitimacy. Disclosure is necessary for accountability. It allows investors and enforcement officials to hold corporate agents responsible for theft, fraud, or violations of other laws. Disclosure provides a basis for lawmakers to evaluate whether current laws are doing what they are intended to do. These lawmakers include Congress, the SEC, and ultimately, in a democracy, the public. Disclosure provides a foundation for improving law more generally over time.

As an economic matter, disclosure improves the allocation of capital for sustained growth. Basic theorems of economics that undergird our nation's preference for free trade commonly assume among other things that stock traders are on a basic, level, informational playing field, which allows them to differentiate themselves based on insight, analysis and their own research, and mitigates the risk that a would-be seller is simply trying to engage in fraud. Disclosure laws help move capital markets towards that ideal. While voluntary disclosure is common and valuable, well-designed disclosure laws add value. They create standards, ensure comparability across companies, add enforcement tools, greatly improve the credibility and reliability of the disclosures, and reduce the risk of theft and fraud. With respect to SOX, more than 45 asset managers led by the Council of Institutional Investors have stated that auditor attestation of control disclosures is "an important driver of confidence in the integrity of financial statements."[5]

Disclosure laws are not a panacea. They have costs, although those costs are often overestimated. Generally, those costs fall – often dramatically – over time.[6] But disclosure is a mild and often clearly efficient means to address specific problems. The public tends to demand legal change in response to crises, market crashes or corporate scandals. Those responses can be prescriptive, especially if the behavior involved took place in the dark. Disclosure reduces overreactions.

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[5] https://tinyurl.com/yjmd27u2.

[6] See Coates and Srinivasan, supra note 2; see also John C. Coates, Towards Better Cost-Benefit Analysis: An Essay on Regulatory Management, 78 Law and Contemporary Problems 1 (2015); John C. Coates, Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications, 124 Yale Law Journal 882 (2014-2015).

The role of sunlight in deterring misconduct is too well known to elaborate. Disclosures can be processed by analysts, who provide summaries and recommendations to others. For example, as I have written about with Dean Glenn Hubbard -- who served as Chairman for President George W. Bush's Council of Economic Advisors -- the Investment Company Act is one of the most successful disclosure laws of all time.[7] It requires disclosure of much information that few investors ever learn about directly. But the disclosures are consumed, analyzed and simplified by financial advisors and intermediaries such as Morningstar. The U.S. has the most successful fund industry in the world, thanks in significant part to mandatory disclosure laws.

Consistent with these observations, many countries imitated the U.S. in adopting SOX-like statutes or regulations following the market downturn in 2001.[8] In 2006, for example, Japan adopted its own so-called ''J-SOX'' statute, with provisions equivalent to sections 302 and 404 of SOX. In 2006, the European Union, too, adopted an Eighth Directive on securities disclosure, which largely tracked much of the contents of SOX.

1.2. SOX Did Not Mandate Control Systems

SOX did not mandate control systems, nor require any particular change in their use or design. Rather, controls are voluntarily self-imposed as a matter of common sense and best practices by most businesses and are required by state corporate law for all companies, and by the FCPA for public companies. Most organizations, for example, limit how much money any single employee is authorized to spend on behalf of the organization, without getting formal approval from senior authorized agents, such as a

[7] John C. Coates and R. Glenn Hubbard, Competition in the Mutual Fund Industry: Evidence and Implications for Policy, 33 J. Corp. L. 151 (2008).
[8] E. H. Kim and Y. Lu, Corporate governance reforms around the world and cross-border acquisitions, 22 J. Corp. Fin. 236–253 (2013).

board; likewise, many organizations require two signatures by two employees for larger expenditures. In our modern computer era, many controls are embedded in technology, controlling who has access to corporate data and who can initiate changes in books and records, and through what process. Without controls, businesses (and their investors) are exposed to greater risks of theft, fraud and both public and private corruption, as characterized the Watergate era and seems on the rise again today.

1.3. SOX Never Imposed a "One Size Fits All" Approach

The U.S. has never imposed "one size fits all" regulation in securities law; that generalization includes SOX. The Sarbanes-Oxley Act does not apply to private companies, for example, even if owned indirectly by millions of Americans through pension funds and other intermediaries. Smaller public companies have never been required to obtain attestations from their auditors about their control disclosures,[9] and emerging growth companies – those going public for the first time – enjoy generous exemptions as well. Standards governing auditor attestation of control disclosures have since 2007 permitted risk-based approaches, allowing for significant variation in the design and operation of controls.

Even large, mature public companies covered fully by section 404 of that Act may have control system weaknesses, as long as they disclose them. Companies are not required to do what audit firms think is necessary for an effective control system. If companies inform investors, they may (and often) do choose to accept the risk of theft and fraud in order to save money on more expensive controls. The value of the law is to set an overall baseline for disclosures by the largest public companies about control

[9] The SEC increased the size of exempt small and mid-size companies from the full requirements of SOX in 2020, over the objections of many investors. https://tinyurl.com/29n7fzk6; see note 5 supra.

systems. As noted above, most private companies adopt controls voluntarily, and many choose to have their auditors perform a SOX-equivalent attestation on the effectiveness of their controls, in order to assure lenders and investors as to the reliability of their financial statements, reducing their cost of capital.[10]

1.4. <u>The PCAOB Responded to the Enron Era of Failed Self-Regulation</u>

The creation of the PCAOB by President Bush and Congress through SOX was bipartisan and nearly unanimous. The reason for that near unanimity was that it followed a decade of deteriorating accounting and auditing outcomes for US public companies. Restatements, earnings management, and fraud all rose in the period during which the audit profession's only overseers were largely toothless self-regulatory bodies, backed sporadically by the underfunded and overtasked SEC. The culmination of this deterioration was a host of accounting failures, including Enron and WorldCom, which resulted in massive bankruptcies and investor losses.[11] What set this era apart was that financial failures were not limited to small or under-resourced companies, but included large companies. The PCAOB was created to fix this broken system, with its main tasks being to register, set standards for, inspect, investigate, and discipline public company

[10] E.g,, Robert P. Bartlett III, Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-private Decisions, 76 U. Chi. L. Rev. 7 (2009); Alexey Lyubimov, Larry Davis, & Greg Trompeter, The Impact of the Sarbanes–Oxley Section 404(b) Exemption on Earnings Informativeness, 24 Int'l J. Audit. 3 (2020).

[11] Losses of between 10% and 30% are typically experienced by owners of companies revealing financial frauds, and of course shareholders can be wiped out in the event of bankruptcy. See Patricia M. Dechow et al., Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC, 13 Contemp. Acct. Res. 1, 27 (1996) (stock price declines upon revelation of fraud average 9% of market capitalization); Karpoff, J. M., Lee, D. S., & Martin, G. S. (2008). The cost to firms of cooking the books. J. of Fin'l and Quant. Anal., 43(3), 581–611 (average decline of 38% upon revelation of fraud). Worse for investors generally, fraud has spillover effects on other companies, dragging down the stock prices (and raising the cost of capital) for innocent but similarly situated companies. Eitan Goldman, Urs Peyer, Irina Stefanescu, Financial Misrepresentation and Its Impact on Rivals, 41 Fin. Mgt. 915-945 (2012).

audit firms. Last year, the PCAOB reported its staff inspected over 230 audit firms and reviewed over 900 audit engagements, including in mainland China and Hong Kong.

1.5. Brokers Were Brought Within the PCAOB by the Madoff and Stanford Scandals

As those affected will never forget, Bernard Madoff and Leland Stanford orchestrated massive Ponzi schemes uncovered in 2008 and 2009, losing investors billions of dollars. One investor lost over $1 billion and committed suicide – consistent with a body of research finding that suicides increase significantly in response to large capital market frauds. A key factor in many older Ponzi schemes (including the Madoff scheme) was the use of brokers audited by under-resourced firms not registered with the PCAOB. In 2010, Congress extended the requirement to have PCAOB-inspected auditors to broker-dealers. While Ponzi schemes never go away, none has endured long enough to reach the Madoff/Stanford scale since the requirement of PCAOB-inspected audits of brokers.

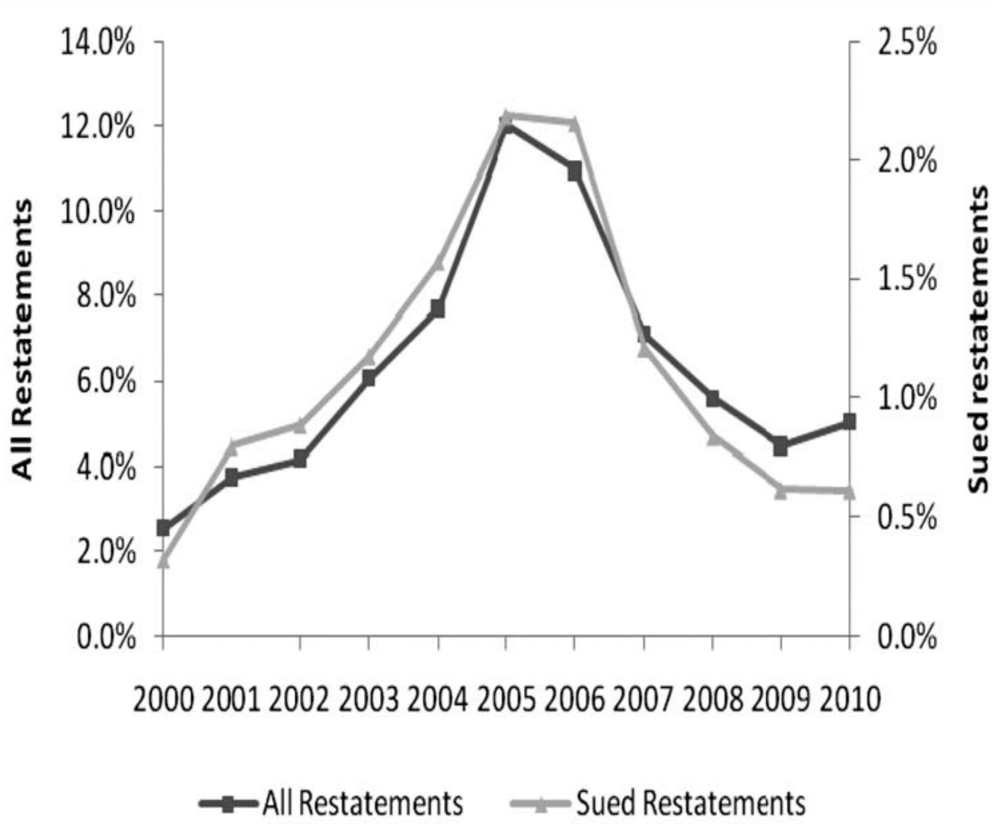
1.6. China-based Auditors Were Permitted to be Inspected

The PCAOB has played a vital role in protecting investors in companies cross-listed into the US from countries – such as the People's Republic of China (PRC) – that historically had weak auditors and posed acute investment risks. Congress unanimously approved the Holding Foreign Companies Accountable Act in 2020, a bipartisan law to improve foreign accounting and auditing, through the mechanism of PCAOB oversight of foreign auditors, backed by the threat of delisting. The HFCAA has worked. In 2022, the PRC accepted PCAOB inspections of PRC auditors as the first and only regulatory body with such access. Unwinding the HFCAA's accomplishments would expose US investors to heightened risks of fraud and abuse.

2. Effects of SOX

In this section, I briefly summarize research on some of the effects of SOX:

- A survey by the Financial Executives Research Foundation in 2005 found that 83% of large company CFOs agreed that SOX had increased investor confidence, and 33% agreed it had reduced fraud.
- A survey by the GAO in 2013 found that 80% of all companies viewed auditor attestation under SOX 404(b) as benefiting the quality of a company's controls, 53% viewed the requirement as benefiting their company's financial reporting, and 52% reported greater confidence in the financial reports of other section 404(b)-compliant companies.
- Restatements of financial statements by companies subject to SOX initially grew, as audits increased in quality, and then fell, as companies began to maintain better financial controls and financial reporting quality improved, as shown in the accompanying figure (from Coates and Srinivasan, supra note 2).



- Quoted bid/ask spreads in the stock markets were widening prior to the passage of SOX, reflecting the effect of scandals on market liquidity and the willingness of dealers to expose themselves to potential adverse selection in trades. After SOX, spreads fell significantly, consistent with a return to greater market confidence and lower costs of capital for all firms.
- Compliance costs initially rose, as companies spent more on audits and internal controls to avoid negative market responses from disclosures of widespread control weaknesses. After the initial ramp-up in expenditures, however, costs began to decline, on an inflation-adjusted basis, particularly after 2007, when the PCAOB's revised audit standard (AS5) permitted companies and audit firms to use a variety of cost-savings measures in implementing and making disclosures

about financial controls. Costs have continued to increase in nominal terms since the post-2007 period, but not in excess of inflation or overall increases in professional service costs generally.

More generally, there is no serious debate that the PCAOB has improved the linchpin of the US financial system, public company auditing. By setting standards for auditing, and by inspecting audit firms, it has augmented auditing practices and improved the reliability of financial reporting. That, in turn, has improved capital market liquidity and lowered the cost of capital.[12] The PCAOB's role has not been a "fix it once" task – accounting practices and the requirements for effective auditing evolve over time, in tandem with changes in business practices, technology, and financial risks and opportunities. Nothing suggests that now is an appropriate moment for the PCAOB's work to be brought to a sudden end.

Finally, it is sometimes claimed that SOX has impeded initial public offerings in the U.S. The data disprove this: 2021 – with SOX long in place – was the historical peak for IPOs.

[12] Hollis Ashbaugh-Skaife, Daniel W. Collins, William R. Kinney Jr, Ryan Lafond, The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity, 47 J. Acc'g Res. 1-43 (2009) ("we find that firms with internal control deficiencies have significantly higher idiosyncratic risk, systematic risk, and cost of equity. Our change analyses document that auditor-confirmed changes in internal control effectiveness (including remediation of previously disclosed internal control deficiencies) are followed by significant changes in the cost of equity that range from 50 to 150 basis points.").

Whatever the net costs and benefits are of SOX overall, the law has not impeded primary capital formation in a detectable way. It is worth noting, too, that surveyed chief financial officers of companies considering going public did not identify SOX as a major deterrent.[13]

3. Compliance Costs of SOX

As a final point about compliance costs, it is of course true that disclosure laws – like all laws – generate compliance costs. Companies must dedicate employee time to the disclosures, lawyers must assist in reviewing them to minimize the risk of enforcement or litigation, and external auditors charge higher fees to attest to disclosures about financial controls. Yet, as noted above, compliance costs fell due to the PCAOB's adoption of AS5 in 2007, and after adjusting for inflation, audit fees remained nearly flat from 2012 to 2021, and either were flat or declined in 2022 and 2023. Companies of course paid more, due to inflation – so you will no doubt read or hear that compliance costs are continuing to rise. And audit fees are not the only component of compliance

[13] James C. Brau and Stanley E. Fawcett, Initial Public Offerings: An Analysis of Theory and Practice, 61 J. Fin. 399 (2006).

costs under SOX. But there is no evidence that SOX compliance costs have been rising at any faster rate than the money supply in the overall U.S. economy.

More importantly, it is simply a mistake to assume that – if SOX were repealed, for example – companies would stop making control-related disclosures. Investors (and lenders) would continue to expect them, and continue to expect companies to have control systems, and to be able to credibly say they are in control of their assets and that their financial statements are reliable. No doubt compliance costs would fall somewhat without SOX, but along with that drop would come an increase in capital costs, due to an increase in the risk that investors' money would be stolen or misused. When it comes to the basic foundations of capitalism, there has never been such a thing as a free lunch.