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On the Issues

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Blame Sarbanes-Oxley

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An array of stimulus factors has failed to generate strong growth in the U.S. economy. That may largely be a consequence of the Sarbanes-Oxley Act and the stock exchange regulations it has spawned, which have altered the composition and dynamics of corporate boards in ways that discourage risk-taking.

It is a bit of a mystery. Although the economy is beginning to show some life—responding finally to aggressive tax cuts, deficits, a weaker dollar, and historically low interest rates—something is missing. Corporate managements do not appear to be reacting with the enthusiasm and confidence usually associated with renewed growth. Business spending, other than for equipment replacement, appears lackluster and tentative, and managements seem reluctant to hire new workers. Despite stimulus in the economy, something is holding back America's usually dynamic corporate sector.

Economists have puzzled about this, citing at various times such possible causes as a lingering fear of terrorism, the uncertainties associated with the Iraq conflict, and worries about deflation. Few, however, have focused on the Sarbanes-Oxley Act, enacted in July 2002 in response to the corporate scandals. More than a year later, it is time this "corporate reform" act and its effect on economic recovery receive some scrutiny.

Unintended Consequences

Sarbanes-Oxley was adopted hastily and without adequate consideration by a Congress panicked about the possibility that the Enron and WorldCom cases had seriously weakened investor confidence.

Most lawmakers probably thought they were voting for a harmless piece of legislation that would simply give the Securities and Exchange Commission (SEC) more authority. But the act went much further than that. Among other things, it placed new emphasis on the role of independent directors on corporate boards, requiring that all the members of the important audit committees of public companies be composed solely of independent directors, and encouraging the New York Stock Exchange (NYSE) and Nasdaq to require that all listed companies be governed by boards of directors on which independent directors form a majority.

In effect, because virtually all the largest companies in the U.S. economy are listed on the NYSE or Nasdaq, this was a wholesale change in the governance of American corporations, putting significantly more authority into the hands of independent directors and correspondingly reducing the power of corporate managements. Although many who supported the act viewed this as a healthy reform, it may have had unintended consequences—a reluctance of managements to take the risks and make the investments that had previously brought the economy roaring back from periods of stagnation or recession.

The independent directors of a company are part-timers. No matter how astute in the ways of business and finance, they know much less about

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the business of the companies they are charged with overseeing than the CEOs and other professional managers who run these enterprises day to day. Unfamiliarity in turn breeds caution and conservatism. When asked to choose between a risky course that could result in substantial increases in company profits or a more cautious approach that has a greater chance to produce the steady gains of the past, independent directors are very likely to choose the safe and sure. They have little incentive to take risk and multiple reasons to avoid it.

Most large corporations have always had board majorities that were not part of the corporation's management. In the best boards, these directors considered themselves both as sounding boards for and auditors of management, but not the ultimate decision-makers on matters of risk and reward. Management's judgments concerning these key issues were always paramount, because management was expert in the complexities of the corporation's business.

A Brake on Growth?

By requiring independent directors to form both the entire membership of audit committees and a majority of corporate boards, Sarbanes-Oxley and the stock-exchange regulations it spawned may have dramatically changed this relationship. It is important to recall that this new role was conferred on independent directors in the wake of the Enron and WorldCom failures because of a sudden flurry of distrust of corporate managements.

Given this background, it would not be surprising if independent directors—as a majority now specially constituted by law and regulation—interpreted their mandate as authority to take a more active voice in the assessment of company risk than had been true in the past. And also managements, aware of the same background, might now believe that they must share more responsibility for risk assessment with less knowledgeable and more conservative independent directors.

Unfortunately, the SEC has furthered this trend. In proposing to ease the way for shareholders to put issues on the agenda of corporate annual meetings, SEC chairman William Donaldson commented, "It's a real, necessary companion piece to a much bigger picture that I see: a shift, a correct shift, away from a dominance by corporate executives and back to the board." This remark is fully in tune with the underlying concepts of the Sarbanes-Oxley Act and encapsulates the effect the act seems to have had. The problem is, if the main economic actors in our economy—the corporations traded on the NYSE and Nasdaq—are now to be controlled by committees of the risk-averse and timid, we may all face a future of limited economic growth.