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Goodbye to Reforms of 2002

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It took just five weeks after the WorldCom accounting scandal erupted in 2002 for Congress to pass, and President George W. Bush to sign, the Sarbanes-Oxley Act. That law required public companies to make sure their internal controls against fraud were not full of holes.

It took three more years for Bernard Ebbers, the man who built WorldCom into a giant, to be sentenced to 25 years in prison for his role in the fraud.

Mr. Ebbers will be 85 years old before he is eligible for release from prison. He may be freed, however, before the law is ever enforced on the vast majority of American companies. A Congressional committee voted this week to repeal a crucial part of the law. Other parts are also under attack.

Sarbanes-Oxley was passed, almost unanimously, by a Republican-controlled House and a Democratic-controlled Senate. Now a Democratic Congress is gutting it with the apparent approval of the Obama administration.

The House Financial Services Committee this week approved an amendment to the Investor Protection Act of 2009 — a name George Orwell would appreciate — to allow most companies to never comply with the law, and mandating a study to see whether it would be a good idea to exempt additional ones as well.

Some veterans of past reform efforts were left sputtering with rage. “That the Democratic Party is the vehicle for overturning the most pro-investor legislation in the past 25 years is deeply disturbing,” said Arthur Levitt, a Democrat who was chairman of the Securities and Exchange Commission under President Bill Clinton. “Anyone who votes for this will bear the investors’ mark of Cain.”

Those who favored the amendment saw it differently. They were simply out to help small businesses, which would be burdened by having to report on whether they maintained acceptable financial controls, and to have auditors check on whether those controls did work.

They also suggested that more foreign companies would list their securities in the United States if they were spared that onerous requirement. No one seems to have asked if investors really would benefit from making it easier to invest in companies that fear such an audit.

There are other threats to Sarbanes-Oxley as well.

The law set up a long-overdue system of regulating the accounting industry, which had proved time and again that it was incapable of effective self-regulation. The Public Company Accounting Oversight Board has done a credible job, but a month from now the Supreme Court will hear a case that could drive it out of existence.

The Sarbanes-Oxley law also took steps to reinforce the independence of the Financial Accounting Standards Board, which writes accounting rules in the United States. By giving the board a secure source of financing, legislators said they were protecting it from the threats of the companies that had previously made donations to keep the board functioning.

But this Congress has made clear that independence for the accounting rule writers can go too far — particularly if the rules force banks to reveal the horrid mistakes they previously made.

This year, a subcommittee of the House Financial Services Committee held a hearing at which legislators sought no facts but instead threatened dire action if the chairman of the financial accounting board did not promptly make it easier for banks to ignore market values of the toxic securities they owned. The board caved in, which may be one reason why banks are reporting fewer losses these days.

But the board's retreat was not enough to satisfy the banks. The American Bankers Association is now pushing Congress to give a new systemic risk regulator — either the Federal Reserve or some panel of

regulators — the power to override accounting standards. The view of the bankers is that the financial crisis did not stem from the fact that the banks made lots of bad loans and invested in dubious securities; it was caused by accounting rules that required disclosure when the losses began to mount.

The amendment approved this week dealt with Section 404 of Sarbanes-Oxley, which has become a rallying cry for opponents of regulation. Some Democrats seem to think that passing it will be seen as pro-business, and thus help to protect vulnerable Democrats who in 2008 won seats previously held by Republicans. The sponsor of the amendment, Representative John Adler of New Jersey, is one such legislator.

Section 404 was adopted with little controversy in 2002, and for good reason. It simply mandated that public companies report on the effectiveness of their internal financial controls, and that auditors render an opinion on them.

Since the law already required companies to maintain effective controls — and had done so since 1977 — it seemed unlikely that would increase costs much for any company that was already in compliance. And it was crystal clear that controls either did not exist, or were evaded, at WorldCom and Enron.

Unfortunately, when those Section 404 audits began to be conducted for the largest companies, they were costly. Partly, that was caused by badly designed and overly cautious audits conducted by inexperienced auditors. Experience reduces costs to some extent, and in 2007, the Securities and Exchange Committee and the accounting oversight board adopted reforms to make the audits much less expensive.

The section has never been enforced for most companies. The S.E.C. repeatedly delayed the effective date for companies with market capitalizations under \$75 million, as lobbying grew bolder and legislators like Senator John Kerry, the Democratic presidential candidate in 2004, opposed enforcement of the law. Mr. Bush's last S.E.C. chairman, Christopher Cox, avoided making a decision by ordering one more study that would arrive after he was gone.

That study showed that Section 404 costs had come down significantly, and last month the S.E.C. under its new chairwoman, Mary L. Schapiro, announced that in the middle of 2010 — eight years after the law was passed — all public companies would have to start complying.

It took just one month for the House committee to vote to gut Sarbanes-Oxley. It voted to exempt those companies worth less than \$75 million, and asked for a study on whether companies worth less than \$250 million should be allowed to stop complying with the law.

In doing so, it turned aside a plea from Ms. Schapiro, whose opinions carry far less importance in this Congress than those of lobbyists who claim to represent small business.

The Supreme Court case, to be heard Dec. 7, is on the somewhat arcane question of whether it was legal for Congress to require that the members of the oversight board be appointed by the S.E.C. rather than by the president or someone directly responsible to him, like the secretary of the Treasury.

If the Supreme Court rules that the board is illegally appointed, Congress could quickly act to save it by changing the appointment process. But who can be confident that this Congress would want to save the reforms of 2002?

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