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The Social Construction of Sarbanes-Oxley

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The Social Construction of Sarbanes-Oxley*

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THE SOCIAL CONSTRUCTION OF SARBANES-OXLEY

*Donald C. Langevoort**

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INTRODUCTION

The meaning of the Sarbanes-Oxley Act[1] ("SOX") is still being contested even though it is now nearly five years since its enactment. This is not to say the words and phrases that make up the statutory mandates and implementing regulations are hopelessly muddled. Though there are plenty of ambiguities for lawyers and their clients to worry over, most of the require-

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1. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C. (Supp. III 2003)).

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ments are clear enough as "law on the books" to expect at least formalistic compliance with them. But simply because something is enacted into law does not tell us much about how strongly it will influence economic behavior. At the very least, there is the rational calculus of likelihood of detection and magnitude of sanction. Most of SOX's implementation and enforcement is left to the discretion of the Securities and Exchange Commission ("SEC") and other public agencies.[2] We therefore should estimate what the regulators will do—which will bring into play an interesting mix of external politics and the agencies' own beliefs.[3] Courts, too, will play a role in saying what SOX means when they review the Commission's rules and enforcement actions, as will Congress in its continuing legislative oversight.

Socio-legal researchers tell us, however, that even the coupling between official legal interpretations and social behavior is fairly loose—that absent unusually high rates of detection and prosecution, compliance decisions are based at least as much on the perceived legitimacy of the law and prevailing norms in local context as any deliberate risk calculation.[4] Business people form their own beliefs about SOX independently from official interpretations, and they act accordingly. So do other groups like lawyers, accountants, investors, media, and politicians. These groups' perceptions influence each other as to appropriate corporate governance and behavior.[5] This is more than just a political battle, although the political dimension is surely potent. SOX has a cultural dimension as well, which political muscle alone cannot easily override.

The viewpoints in competition range from the idea that the Act ought to be firmly embraced for stopping a threatened market meltdown by restoring trust between companies and investors[6] to the notion that it is a quack cure for an overblown problem and[7] a $1.4 trillion debacle for investors and the

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2. The main other governmental actors are the SOX-created Public Company Accounting Oversight Board ("PCAOB"); the Department of Justice with respect to criminal enforcement, and the Department of Labor with respect to whistle-blower protection. SOX largely avoids creating or expanding any private remedies.

3. A separate article of mine explores this mix inside the SEC. Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 WASH. U. L. REV. (forthcoming 2007) [hereinafter Langevoort, *SEC as a Lawmaker*]. For more jaundiced perspectives, see Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA. L. & BUS. REV. 10, 44–48 (2006); A.C. Pritchard, *The SEC at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073 (2005).

4. *See generally* TOM R. TYLER, WHY PEOPLE OBEY THE LAW (1990); IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION (1992); Neil Gunningham et al., *Social License and Environmental Protection: Why Businesses Go Beyond Compliance*, 29 LAW & SOC. INQUIRY 307 (2004).

5. *See* Gerald F. Davis, *New Directions in Corporate Governance*, 31 ANN. REV. SOC. 143, 158 (2005).

6. *See, e.g.*, Paul Volcker & Arthur Levitt, Jr., *In Defense of Sarbanes-Oxley*, WALL ST. J., June 14, 2004, at A16; David Wessel, *Moving the Market: Corporate Overhauls are Proving to be Effective, Greenspan Says*, WALL ST. J., May 16, 2005, at C3.

7. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

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economy.[8] The more interesting questions are who is debating and why. Rent seeking is palpable, but far from the whole story. The economics and ideology of manager-investor relationships[9] and the United States' law-making competence in the global economy are also in play.

The closer one looks at SOX and its origins in the financial scandals of the early 2000s, the blurrier the picture, which lets commentators see what they want to see and draw inferences accordingly.[10] That is why social construction is so crucial. My aim in this paper is to illuminate the social nature of SOX's diffusion into practice. I will leave to the reader the judgment about whether this has been or will be good or bad, and for whom. If I seem to challenge SOX's critics more than its supporters, it is because the critics have been more venomous than is fair. Venom aside, the bite still deserves attention.

A reasonable concern is that we should not worry about something as fuzzy as social construction. We can observe how SOX has influenced behavior since its adoption, and that is what is important—not what self-interested parties say or think about the law. Numerous empirical studies in law, accounting, and finance have tested SOX's effects. These studies, however, are preliminary—because the rule-making process takes time, many of the Act's mandates did not go into effect until very recently, and implementation of certain provisions for some affected parties is still being delayed.[11] They also suffer from their own methodological challenges, because the events surrounding SOX were very noisy. Quite apart from the legislation itself, political attitudes and investor expectations also shifted in response to the financial reporting scandals.[12] Determining whether reactions were

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8. HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED, HOW TO FIX IT 5 (2006). The $1.4 trillion figure comes from Ivy Xiying Zhang's study trying to measure the stock market effects of SOX-related events, a difficult task that has actually led to many different estimates. Ivy Xiying Zhang, Economic Consequences of the Sarbanes-Oxley Act of 2002 (2005), http://w4.stern.nyu.edu/accounting/docs/speaker_papers/spring2005/Zhang_Ivy_Economic_Consequences_of_S_O.pdf; *see infra* note 13.

9. On unpacking corporate law and economic ideology, see Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1 (2004).

10. *Cf.* Joseph A. Grundfest, *We Must Never Forget That It Is an Inkblot We Are Expounding: Section 10(b) as Rorschach Test*, 29 LOY. L.A. L. REV. 41 (1995) (making a similar point about another important event in securities regulation, the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)).

11. This is particularly so for what has turned out to be the most controversial part of the legislation, the requirement in SOX section 404 that auditors independently attest to management's assessment of the company's internal controls. The SEC has delayed the applicability of section 404's requirements to smaller issuers and foreign companies, and is revising its interpretive guidance. *See infra* note 113. On the interpretive contest over section 404 prior to these most recent changes, see Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting* Corporate Law*'s "Duty of Care as Responsibility for Systems"*, 31 J. CORP. L. 949, 965–70 (2006) [hereinafter Langevoort, *Internal Controls*].

12. Related to this is definitional uncertainty. SOX, for the most part, merely amends the Securities Exchange Act of 1934, so that in referring to SOX what I really mean is all of post-SOX securities regulation. In turn, post-SOX securities regulation has its own definitional ambiguity, plausibly including not only SEC and PCAOB regulation but also important aspects of federal criminal law, state securities law (e.g., New York's Martin Act as aggressively enforced by Eliot

to the legislation itself or these other effects is hard.[13] Finally, we cannot assume that first reactions to any law will necessarily be sustained: there can be an overreaction in the first instance that calms as the interpretation of the law shifts both officially and unofficially.

To this end, Part I will take a close look at the legitimacy of SOX by examining the two plausible stories of SOX's origins and considering the early post-SOX evidence on its costs and benefits. There is no clear-cut answer to the question of how much SOX benefits investors; both positive and critical positions are plausible. Costs have been far greater than expected, but more from SOX's implementation than from the legislative text. Before turning to how and why implementation has occurred that way—which to me is the central question of interpretation—Part II considers whether there is an alternative interpretation of SOX that explains its motivations and likely long-term effects. This raises the possibility that SOX's most important effects may be less about investor protection than about renegotiating the boundary between the public and private spaces in big corporations, a much deeper ideological issue. The legislation may reflect a political instinct that incentive structures in modern public corporations generate risks that require public (not just investor) accountability to be legitimate. I suggest the "independent" director, currently seen largely as an investor advocate, is being pushed toward becoming a "public" director whose main assignment is to keep risks and rewards in a socially acceptable balance. Part III then turns to the various interpretive communities debating SOX's meaning, anticipates how they are likely to respond, and considers the resulting behavioral impact of their criticism or praise. In Part IV I predict, consistent with neither enthusiasm nor harsh criticism of the legislation, that the interpretive pluralism will gradually moderate both costs and benefits, slowly tilting toward the "public values" account described in Part II. Part V addresses the most specific criticism of SOX, involving so-called going-dark transactions and the impact on foreign issuers. I conclude by connecting SOX to larger questions about how law becomes part of social and economic practice.

Spitzer, see Jonathan R. Macey, *Wall Street in Turmoil: State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117 (2004)), and the corporate governance reforms by the stock exchanges that came out of the same political turmoil. *See* Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 SEC. REG. L.J. 370 (2002). Because all of these affect perceptions and behavior in ways that are hard to disentangle, my definition of post-SOX securities regulation is deliberately capacious.

13. *See* Reena Aggarwal & Rohan Williamson, Did New Regulations Target the Relevant Corporate Governance Attributes? (Feb. 12, 2006), http://www.ssrn.com/abstract=859264. There have been numerous efforts to test stock price reaction to SOX's adoption as an indication about how the market viewed the reform effort. *E.g.*, Pankaj K. Jain & Zabihollah Rezaee, *The Sarbanes-Oxley Act of 2002 and Capital-Market Behavior: Early Evidence*, 23 CONTEMP. ACCT. RES. 629 (2006); Zhang, *supra* note 8. An interesting effort to elide the noise problem focuses on the stock price reactions for foreign companies subject to the Act as opposed to those not subject to it. *See* Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross Listed in the US* (Univ. of Texas Law Sch., Law and Econ. Research Paper No. 55, 2005), *available at* www.ssrn.com/abstract=876624.

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I. ORIGINS

By most accounts of the recent corporate accounting scandals, Enron by itself would have produced little more than marginal, mainly symbolic shifts in federal regulation. But the political dynamic changed in June 2002 when the WorldCom scandal led to an even bigger corporate implosion. Political sentiment became angrier, and Democrats were prepared to make these twin scandals—which by now had produced widespread loss of jobs and billions in financial losses for investors—a major campaign issue in the fall elections. The House and Senate quickly agreed to cooperate on a hybrid bill—although for procedural reasons the Democrat-controlled Senate handled most of the work—and SOX was enacted by the end of July. The November elections produced gains for the Republicans, including taking control of the Senate. In hindsight, this suggests either that the Republicans acted prudently in taking away the Democrats' edge by their show of bipartisan cooperation or that they badly overestimated the electoral significance of the scandals and compromised in an unnecessary panic.

Few would quarrel with the basics of this story. In terms of the legitimacy of the legislation, however, the story has two plausible interpretations. One interpretation—now heavily emphasized by SOX's critics—argues that it demonstrates undue haste on difficult issues of financial regulation, resulting in a defective legislative product. But one could just as easily say that key legislators seized a moment when the public's attention was sufficiently focused so that normal partisan obstructionism and special-interest domination were briefly displaced. Which of these two interpretations prevails will tell us something about how SOX is ultimately understood.

This Part considers two related criticisms of the legislative process meant to undermine SOX's legitimacy. Section I.A examines the claim that Congress grossly overestimated the benefits SOX's reforms would generate; Section I.B examines the claim that Congress ignored the costs as well.

A. *Misunderstanding Benefits*

Roberta Romano, a vocal critic of SOX, provides the most sophisticated academic exploration into SOX's origins.[14] Romano focuses on a handful of provisions in the legislation that come closest to the substance of corporate governance as opposed to securities disclosure. Her most potent claim is that with respect to director independence and nonaudit services, a large amount of empirical work had been done by financial economists testing whether there were grounds to believe that a change in regulation would produce better outcomes (e.g., superior returns for investors), and that the weight of the research was that it would not. This leads her to conclude that

14. *See* Romano, *supra* note 7, at 1523. Romano's article has generated a number of critical responses. *E.g.*, John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 J. ECON. PERSP. 91, 105-11(2007); James D. Cox, *The Role of Empirical Evidence in Evaluating the Wisdom of the Sarbanes-Oxley Act*, 40 U.S.F. L. REV. 823, 831–43 (2006); Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 334-37 (2006).

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SOX was careless legislation, paying no heed to available data about whether the changes were likely to produce better outcomes in corporate behavior or to the question of what costs the changes would generate, thereby precluding any serious cost-benefit assessments.

Romano further argues that, contrary to the suggestion of many, Congress was not simply putting up window dressing to appease an angry public. That strategy, she says, would have led Congress to make changes that generate few benefits but also few costs. SOX has real costs, predictable at the time and amply demonstrated since then.[15] The more plausible reading, then, is that "norm entrepreneurs" committed to the reforms *fooled* Congress into thinking that these were really beneficial changes. These norm entrepreneurs seized the odd political moment to persuade the Senate Democrats to swallow their medicine. Romano fingers former SEC chair Arthur Levitt and his former Chief Accountant Lynn Turner as her chief culprits. She both explains and criticizes their actions as emotional responses to political battles against accountants during their tenures at the SEC, leading them to dig in their positions despite the acknowledged absence of empirical support for their ideas.[16]

To be sure, Romano is focusing on only a small handful of provisions to draw generalizations about SOX ("quackery," she calls it) and the quality of the law-making process. If she is right in the generalizations, however, she certainly casts a dark cloud over SOX's legitimacy. If something akin to her story triumphed among key constituencies in politics, law, and business, the normative power of the law would be severely undercut. The SEC might not enforce the law vigorously, either because of external political pressure or because key actors at the Commission themselves come to doubt the regulation. So, too, in the courts. And compliance in the business community would be grudging and ritualistic in ways unlikely to cause meaningful change from the status quo.

With respect to the empirical case, Romano's assessment is well crafted. It should, however, be put in perspective. Of the four issues she surveys (executive loans, executive "certification" of financial statements, nonaudit services, and director independence), it is hard to disagree with her analysis of the outright ban on loans to executives.[17] On the other hand, the SEC quickly committed to construe the ban narrowly with respect to certain kinds of loans (executive relocation, advancement for litigation expenses) that it would be senseless to disrupt. The SEC thereby reduced the untoward effects of the ban. The main residual effect has been to preclude loans for financing executives' purchases of company stock, to which we shall return

15. Romano, *supra* note 7, at 1587–91.

16. *See id.* at 1568–85.

17. *Id.* at 1561. As Romano points out, this was a last minute amendment by Senator Schumer of New York. *Id.* Only one witness in the hearings had suggested a ban; the more plausible suggestions involved greater disclosure with respect to loans.

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in Part II.[18] As to the requirement that senior executives "certify" their SEC filings, the SEC already had the ability to sanction executives who signed financials aware of their inaccuracy, so this could easily be seen as a window dressing.[19] Few benefits, then, but little additional cost. In fact, the certification requirement was actually a Republican proposal, which the SEC was planning to implement after Enron even without legislative authority.

The other two issues, nonaudit fee bans and independent director requirements, deserve a closer look. While the weight of empirical research has failed to find a significant correlation between nonaudit fees and audit quality generally,[20] there is empirical evidence linking the two when corporate governance indicators are otherwise poor (i.e., managerial control is high).[21] There is also evidence indicating that audit quality did decline in the late 1990s,[22] a period of rapid growth in the marketing of nonaudit services by public accounting firms.[23]

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18. *Id.* at 1539–40. Romano is harshly critical of this because of the benefits associated with greater equity ownership by officers and directors.

19. *See* 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, 45 (2002). When the White House included officer certification on its list of responses to the scandals, critical analysis into its merits simply ceased. To be fair, there is much concern with the certification as it applies to internal controls, the most controversial of SOX's requirements, *see supra* note 11 and *infra* notes 38–43 and accompanying text; this concern, however, is more about the controls requirement than certification itself. While the economic value of certification may seem small, its psychological impact may be great. To the extent that executives think of certification differently from the way they had approached SEC filings before, there might actually be measurable effects from what otherwise seems ritualistic.

20. Mark L. DeFond & Jere R. Francis, *Audit Research After Sarbanes-Oxley*, 24 AUDITING: J. PRAC. & THEORY 5, 14–16 (Supp. 2005). Prior research here is fairly sketchy because of an absence of data: nonaudit fees in the United States were not subject to mandatory issuer disclosure until an SEC mandate in 2000. Most of the research, then, relies on post-2000 results,and was work in progress in 2002. Congress was apparently aware of a well-publicized study by Frankel and his colleagues that purported to show a relationship between nonaudit fees and levels of abnormal accruals and earnings management. Richard M. Frankel et al., *The Relation Between Auditors' Fees for Nonaudit Services and Earnings Management*, 77 ACCT. REV. 71 (Supp. 2002). Since then, that study has been criticized for its methodology and its results called into doubt.

21. David F. Larcker & Scott A. Richardson, *Fees Paid to Audit Firms, Accrual Choices, and Corporate Governance*, 42 J. ACCT. RES. 625 (2004).

22. *See* Joseph V. Carcello, *Discussion of Audit Research After Sarbanes-Oxley*, 24 AUDITING: J. PRAC. & THEORY 31, 32 (Supp. 2005) (citing, e.g., Marshall A. Geiger & K. Raghunandan, *Going-Concern Opinions in the "New" Legal Environment*, 16 ACCT. HORIZONS 17 (2002)). There was also evidence of increasing numbers of restatements of company financials. *See* Coates, *supra* note 14, at 92-93.

23. The more plausible inference from this particular evidence is that the decline was mainly a reaction to a reduction in the liability threat faced by auditors as a result of the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), and the Private Securities Litigation Reform Act (PSLRA) of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.). If so, the logical response might have been to restore aiding and abetting liability for auditors or amend the PSLRA to increase the liability threat. But for a mix of substantive and political reasons Congress would not revisit its restrictions on private litigation and thus those possibilities were taken off the table. *See* John W. Cioffi, *Irresistible Forces and Political Obstacles: Securities Litigation Reform and the Structural*

More importantly, the nonaudit fee ban was a small part of a larger package of audit reforms in SOX that included, among other things, control of the auditor-company relationship by the board's audit committee as well as increased supervision of auditing and accounting through the creation of the Public Company Accounting Oversight Board ("PCAOB").[24] The failure to find a significant correlation between nonaudit services and declining audit quality might only indicate there are other conflicts dominating the nonaudit fee issue. Audit scholars have pointed to other possibilities, including agency cost issues in terms of local office or individual audit partners' total income (audit and nonaudit fees) being concentrated in particular clients,[25] and psychological biases in the form of cognitive dissonance.[26] If they are correct, then the critique is less damning: even if one particular strategy regarding nonaudit fees might have been misdirected, the effort—and overall structural approach in the legislation—might still be justified. Congress may have been shooting with a scattergun, in other words, but it was firing at what appeared to be a real threat and might reasonably have hoped that some shot would strike the target.

With respect to post-SOX audit quality generally, the results are positive, but too preliminary to be firm. Measures of earnings management and abnormal accruals appear to be down since 2002.[27] Of course we cannot necessarily give SOX credit for this because, as noted earlier, we might have expected higher quality accounting and auditing even in the absence of statutory reform simply because the marketplace demanded it or regulators credibly threatened to use their preexisting authority more aggressively. But something seems to have worked. In this light, SOX's accounting and auditing provisions as a whole do not look quite so ill considered.

With respect to independent directors, Congress's intervention was small—insistence on an audit committee of independent directors (a move the stock exchanges had already largely made) and on disclosure of whether at least one member of the audit committee had financial expertise. If we expand our definition of SOX to include all those exchange reforms,[28] the

Regulation of Corporate Governance 41 (Comparative Research In L. & Political Econ. Research Paper Series, Paper No. 7/2006), *available at* http://www.ssrn.com/abstract=902648.

24. James D. Cox, *Reforming the Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurements*, 81 WASH. U. L.Q. 301, 321–23 (2003).

25. DeFond & Francis, *supra* note 20, at 15. *See also* Anwer Ahmed & Scott Duellman, Auditor Independence, Corporate Governance and Abnormal Accruals 23 (Oct. 2005), http://www.ssrn.com/abstract=887301. For survey evidence, see Mark W. Nelson et al., *Evidence from Auditors about Managers' and Auditors' Earnings Management Decisions*, 77 ACCT. REV. 175, 192 (Supp. 2002).

26. *E.g.*, Max H. Bazerman et al., *The Impossibility of Auditor Independence*, 38 SLOAN MGMT. REV. 89, 90 (1997); Nelson et al., *supra* note 25, at 189–98.

27. Carcello, *supra* note 22, at 33; Daniel Cohen et al., Trends in Earnings Management and Informativeness of Earnings Announcements in the Pre- and Post-Sarbanes Oxley Periods (Feb. 1, 2005), http://www.ssrn.com/abstract=658782; *see also* Marshall A. Geiger et al., *Recent Changes in the Association between Bankruptcies and Prior Audit Opinions*, 24 AUDITING: J. PRAC. & THEORY 21 (2005); Coates, *supra* note 14, 106-07.

28. *See supra* note 12.

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insistence on director independence is more extensive. It requires, for instance, an independent majority on the board, the independence of key committees, and procedures for forming independent directors as a distinct working group.

Legal, business, and finance scholars have spent a great deal of effort over the last two decades assessing whether changes in corporate governance correlate with good or bad outcomes; director independence is probably the most studied of these aspects.[29] Researchers have yet to find strong evidence that a greater percentage of independent directors produces better operating income or stock price returns.[30] The common explanation for this failure is that entrenched insiders can populate the board with formally independent, but functionally loyal, outsiders, or with outsiders insufficiently informed or motivated to upset the status quo. In addition, it is fairly well accepted that governance mechanisms can be substitutes for each other, so that examining one possibility (such as director independence) will not pick up alternative mechanisms (such as high-powered incentive contracts for executives) even in good governance settings.

A separate research program seeks correlations between governance measures such as independence and the likelihood of fraud or other financial irregularities at the firm. Because formal determinations of fraud are rare, researchers choose rough proxies for fraud, such as the bringing or settlement of an SEC enforcement action or private class action, an earnings restatement, or abnormal accruals. Although the empirical evidence is conflicting, many researchers have concluded that good governance practices and fraud are negatively related.[31] Some of these results relate specifically to the audit committee—Congress's main interest as well. Work by April Klein, for example, finds evidence of less earnings management as the percentage of independent directors on the committee goes up, though not necessarily to 100% (although she finds evidence of greater earnings

29. For a good summary of the research, see Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921–23 (1999).

30. *See, e.g., id.* Recently, there has been support for the idea that *entrenched* boards correlate with poorer performance. *See, e.g.*, Lucian A. Bebchuk & Alma Cohen, *The costs of entrenched boards*, 78 J. FIN. ECON. 409, 410 (2005); Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003). This remains an ongoing project, with some researchers convinced that more refined empirical work can find more substantial correlations between good governance structures and returns to shareholders. For a discussion, see Aggarwal & Williamson, *supra* note 13. The proliferation of institutional investor services that rate corporate governance characteristics for individual firms, such as Institutional Shareholder Services, Inc., is based on the assumption that this relationship either has or will be demonstrated. *See infra* note 78.

31. *E.g.*, Mark S. Beasley, *An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud*, 71 ACCT. REV. 443, 445 (1996); April Klein, *Likely Effects of Stock Exchange Governance Proposals and Sarbanes-Oxley on Corporate Boards and Financial Reporting*, 17 ACCT. HORIZONS 343, 354 (2003); Hatice Uzun et al., *Board Composition and Corporate Fraud*, 60 FIN. ANALYSTS J. 33, 41 (2004). As with all statistical studies, causation cannot automatically be inferred even from clear-cut correlation. Good governance practices may be chosen by high-performing firms as a symbol of quality even if they do not produce the quality, and correlations in settings where adherence to a governance standard is voluntary may not be replicated where adherence is mandatory.

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management when a company changes the composition of the committee away from 100%).[32] On earnings restatements, Agrawal and Chadha find no significant relationship with respect to audit committee independence generally, but do find one when there is financial expertise among independent audit committee members.[33] Although this evidence fails to prove that requiring 100% independence plus financial expertise on the audit committee has value, there is at least a circumstantial case for favoring independent audit committees.

Here again, note the systemic nature of Congress's response. It is plausible to think, for example, that observed deficiencies with respect to independent directors result not so much from blind loyalty to the CEO but from an inability to determine when the CEO is not telling the truth about the company or is otherwise unfit to serve.[34] Many SOX provisions tweak the system to help directors compensate for this: financial expertise on the audit committee is encouraged; auditors are subject to closer regulatory scrutiny and directed to speak directly to the audit committee rather than through management; internal controls are improved; lawyers have to report misconduct directly to the board. It is possible these systemic changes give more information to the board so that independent directors will address emerging problems earlier. Even assuming that wholly independent audit committees in and of themselves produced no measurable benefits in the past, it would not necessarily mean that independence might not interact with other changes in a way that produces benefits.

B. *The Cost Problem and the Debate over Internal Controls*

The foregoing shows that Congress had more of a basis for expecting benefits from these SOX changes than critics suggest. That is not an insignificant point with respect to its perceived legitimacy, especially since measures such as audit quality seem to have improved since 2002. But expected benefits are not enough to justify legislation, and I have not yet said anything about the expected costs of the SOX reforms. The costs of a ban on nonaudit services are obvious to the accounting firm (lost income) and may spill over into the firm's ability to attract and retain professional talent.

32. April Klein, *Audit committee, board of director characteristics, and earnings management*, 33 J. ACCT. & ECON. 375, 376 (2002); *see also* Biao Xie et al., *Earnings management and corporate governance: the role of the board and audit committee*, 9 J. CORP. FIN. 295, 314 (2003). *But see* Jean Bedard et al., *The Effect of Audit Committee Expertise, Independence, and Activity on Aggressive Earnings Management*, 23 AUDITING: J. PRAC. & THEORY 13, 14 (2004) (finding significant effects when 100% of the audit committee members are independent).

33. Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J.L. & ECON. 371, 374 (2005). Carcello points out that this study was done with 2000–01 data, by which time independent audit committees had become the norm because of New York Stock Exchange reforms and "best practices" understanding, so that testing the effects of independence was difficult. Carcello *supra* note 22, at 35.

34. *See* Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 308–12 (2004) [hereinafter Langevoort, *Corporate Thermostat*].

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There is also a loss of possible synergies from bundling audit and related services, which might lower the costs to issuers of obtaining useful consulting, technology, and related services. With respect to independent directors on the audit committee or boards generally, there are the costs of attracting additional directors and compensating existing directors for the additional workload, compensation or increased insurance premiums for additional legal risk, and possibly more subtle costs in terms of trust and interpersonal relationships.[35]

The problem, however, is that there is no good scientific mechanism for quantifying benefits or costs, much less netting them out. Congress made no serious effort to look deeply at costs, so the risk that it made a poor judgment as to trade-offs is serious.[36] But the poor judgment is not self-evident, either. This is where only post-SOX evidence can be of help, and it is too early to pass judgment. It appears that director fees and insurance premiums have gone up,[37] but audit quality apparently has also.

The larger point here is that SOX compliance costs are more a matter of how the legislation is interpreted and enforced than what Congress said in the statutory text. The best example is section 404, SOX's most controversial provision, which mandates an audit of the issuer's internal controls system and management's evaluation thereof. By all accounts, this has been extremely costly in terms of additional fees paid to audit firms, not to mention internal resources spent on controls systems. Post-SOX empirical research has identified significant benefits as well: marketplace actors seem to find the new information about internal control deficiencies useful.[38] Netting out is hard here, but there is widespread skepticism—which I share—that the balance was well struck initially, especially for smaller firms. The resulting burden is said to be a major reason why the rate of companies ceasing to be public companies post-2002 has risen,[39] and why foreign companies are more reluctant than before to voluntarily assent to U.S. regulatory authority.[40]

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35. *See* James S. Linck et al., Effects and Unintended Consequences of the Sarbanes-Oxley Act on Corporate Boards (May 16, 2006) (Am. Fin. Ass'n 2006 Boston Meeting Paper), *available at* http://www.ssrn.com/abstract=902665. In prior work, I have cautioned about the more subtle costs. Donald C. Langevoort, *The Human Nature of Corporate Boards: Laws, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001) [hereinafter Langevoort, *Human Nature*].

36. *See, e.g.*, Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes Oxley Act: A Morality Tale for Policymakers, Too*, 22 GA. ST. U. L. REV. 251, 255 (2005).

37. Linck et al., *supra* note 35, at 5.

38. *See, e.g.*, Hollis Ashbaugh-Skaife et al., The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital (April 13, 2006), http://www.ssrn.com/abstract=896760.

39. *See* William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private"*, 55 EMORY L.J. 141 (2006). *But see* Coates, *supra* note 14, at 108.

40. *See infra* Part V.

I have explored the cost-benefit problem under section 404 in some depth elsewhere[41] and do not want to repeat a complicated story. The statutory text was extraordinarily ambiguous, leaving a great deal of discretion to the SEC and PCAOB as to what it demands. After all, public companies have been required to have "reasonable" systems of internal control in place since the late 1970s,[42] and auditors have long taken some account of the control environment in doing their audit. section 404 could have been seen as a minor and not terribly expensive tweaking of this, or as something much more. Plainly, we have gotten much more. But this is because accountants, lawyers, and consultants captured the meaning of the statutory text early on in ways that—whatever the merits of the interpretation otherwise—have generated large rents for their professional activities, aided by extraordinarily open-ended PCAOB pronouncements that the SEC approved. The regulators are now backing off that breadth with remarkable alacrity.[43] This is an interpretive story that I seek to generalize in Parts III and IV.

II. Is SOX Just About Investor Protection?

By its terms, SOX is about investor protection and should be evaluated as such. But it is entirely possible that deeper instincts about the modern corporation as a politically accountable institution played a role in its adoption. An important theme in stories about Enron and WorldCom was social and economic dislocation, not simply investor losses. The two companies were characterized by rapid growth during which insiders gained control over extensive and important assets. Leveraging their companies' own stock prices as well as the short-term debt and derivatives markets, the insiders took considerable risks to fuel this growth.[44] Subsequent discovery of fraud and misreporting then led quickly to loss of access to capital and then insolvency, which in turn hurt employees, investors, and the communities to which they were connected. Moreover, the fraud itself resulted in misallocation of capital and competitive harm to the relevant markets. By one estimate, WorldCom's misreporting caused more than $7 billion in harm to other telecommunication providers and frustrated key elements of national telecommunications policy.[45]

As many commentators have pointed out, some deception along these lines was not necessarily a bad gamble on behalf of the company's well-

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41. *See* Langevoort, *Internal Controls*, *supra* note 11, at 957–65. *See also* Joseph A. Grundfest & Steven E. Bochner, *Fixing 404*, 105 Mich. L. Rev. 1643 (2007).

42. Securities Exchange Act of 1934, 15 U.S.C. § 78m(b)(2)(B)(2000).

43. *See infra* note 113 and accompanying text.

44. *See, e.g.*, Frank Partnoy, Infectious Greed: How Deceit and Risk Corrupted the Financial Markets (2003); David Skeel, Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From 5–6 (2005). Notably, while insider greed may be part of the story, it may have been secondary to competitiveness. *See* Baruch Lev, *Corporate Earnings: Facts and Fiction*, 17 J. Econ. Persp. 27, 36 (2003).

45. J. Gregory Sidak, *The Failure of Good Intentions: The WorldCom Fraud and the Collapse of American Telecommunications After Deregulation*, 20 Yale J. on Reg. 207, 235 (2003).

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diversified investors,[46] especially those who bought into the company earlier rather than later. Had the game continued with a streak of good luck, as it might have for either company, stockholders as well as insiders would have been winners as their firms cemented dominant positions in rapidly expanding, lucrative markets. The downside risk, however, was allocated very unequally. Diversified investors (including insiders who had cashed out or hedged their company stock and options holdings) faced far less risk than employees, undiversified investors, and creditors—and employees with retirement assets heavily tied up in company stock were particularly exposed.

SOX responded to the resulting carnage. Notably it refused shareholders any more governance power, either in terms of voting rights (e.g., greater shareholder access to the corporate ballot, so that directors would be more subject to shareholder control)[47] or private litigation. This absence is strange if one thinks the scandals were manifestations of classic agency cost problems, but perfectly consistent with the idea that the scandals were the result of over-heated incentives that investors are unlikely to check.

A palpable theme in much of SOX is discomfort with those over-heated incentives and insistence on more public accountability, so that large business corporations meet standards resembling those commonly expected of public and quasi-public institutions. The exercise of dominion over crucial assets, the opportunities for wealth extraction, and the ability to impose risk on others give sufficient cause to insist on internal standards and procedures that are typical of contemporary "good government" initiatives familiar in administrative law and other public law subjects[48]—transparency, accountability, and openness to external voices. In this sense, SOX is less about redistributing private power as diffusing it through more checks, balances, and sunlight. Implicit is a connection to the precautionary principle—counter-balancing the high-powered incentives that can incline managers to be strong risk-seekers. Enron and WorldCom showed that hidden risks of this sort can be very dangerous, and a natural response is to say that they should be constrained by more robust deliberative procedures.[49] Shareholders may benefit from this too, but that benefit is not the sole measure of its efficacy.

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46. *See, e.g.*, William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1326–27 (2002). As I and others have repeatedly suggested, there was no doubt an element of hubris in the placing of these bets, but hubris may be something of a survival trait in intensely competitive environments. *See* Langevoort, *Corporate Thermostat*, *supra* note 34.

47. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (calling for such reforms).

48. *E.g.*, Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543 (2000).

49. *E.g.*, CASS R. SUNSTEIN, LAWS OF FEAR (2005). On application within the SEC, see Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style and Mission*, 2006 U. ILL. L. REV. 975, 1007–1010. There is a close relationship here between this notion and "corporate social responsibility," where firms risk being penalized in various markets if they act in a way inconsistent with their social license. *See* Gunningham et al., *supra* note 4, at 320–21; Cynthia A. Williams & John M. Conley, *An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct*, 38 CORNELL INT'L L.J. 493, 533–36 (2005).

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To me, this public accountability reading would explain a number of features of the legislation. The new quasi-public regulation of the accounting profession (substituting for the prior system of self-regulation in audit standard setting) is explicitly designed to address the public interest.[50] The statutory language creating the PCAOB says that its authority and structure extend beyond investor protection;[51] in one of its earliest important pronouncements the new Board drew from this language to state that the intended beneficiaries of its work are "the board of directors, management, employees, investors, lenders, customers, and regulators,"[52] thereby signaling that it did not intend to make shareholder value the sole measure for accounting's contributions. The insistence on auditor independence from nonaudit income sources discussed earlier is in part a declaration that auditors are unlikely to internalize their public audit responsibilities if audit work is just a loss leader for the marketing of other product lines.

The ban on executive loans[53] fits this account, as the most notorious use of company loans was to leverage senior executives' purchase of more company stock. As Romano notes, such leveraging is a good thing insofar as stock ownership more closely aligns executive and shareholder interests. But like all leveraging, it also adds risk—there is also more incentive to avoid candor that could lead to a stock price decline and to try to gamble one's way out to avoid defaulting on a loan.[54] Perhaps Congress was reacting to too tempting an incentive structure.

SOX's most controversial innovation, requiring an ongoing implementation, evaluation, and audit of the company's system of internal controls, fits this account as well.[55] This requirement opens up the internal architecture of the firm,[56] creating better sight lines so that more people (including public auditors) can more easily observe and verify the movement and positioning of assets and information. Insofar as corporate reporting obligations are now far more attentive to risk taking, the internal architecture must encompass

50. On the tension between public interest and shareholder demand models of accounting regulation, calling for greater emphasis on the former, see William W. Bratton, *Shareholder Value and Auditor Independence*, 53 DUKE L.J. 439, 485 (2003).

51. Sarbanes-Oxley Act of 2002 § 101(a), 15 U.S.C. § 7211(a) (Supp. III 2003) (establishing the PCAOB "in order to protect the interests of investors and further the public interest").

52. PCAOB, AUDITING STANDARD NO. 2: AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMING IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS App. ¶ E-5 (2005). As discussed below, the PCAOB has proposed rescinding Auditing Standard No. 2 and replacing it with an entirely new, less-demanding standard. *See* PCAOB Rulemaking Docket Matter 021, Rel. 2006-007 (Dec. 19, 2006), *available at* http://www.pcaob.org/Rules/Docket_021/index.aspx.

53. Securities Exchange Act of 1934, § 13K, 15 U.S.C. § 78m(k) (Supp. III 2003).

54. *See* Michael C. Jensen, *The Agency Costs of Overvalued Equity and the Current State of Corporate Finance*, 10 EUR. FIN. MGMT. 549, 552–53 (2004).

55. Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (Supp. III 2003); *see also supra* notes 39–44 and accompanying text.

56. Langevoort, *Internal Controls*, *supra* note 11, at 969; Larry Catá Backer, *Surveillance and Control: Privatizing and Nationalizing Corporate Monitoring After Sarbanes-Oxley*, 2004 MICH. ST. L. REV. 327.

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this as well—bringing internal controls over financial reporting even closer to other forms of enterprise risk management, such as legal compliance and operational controls. This is about openness and transparency, and it is not just tied to what current shareholders or future investors would demand.

This interpretation can also be seen in directors' obligations. Boards generally, and the audit committee in particular, are given a long list of new tasks to perform—for example, overseeing and evaluating the relationship with the independent auditor, monitoring whistle-blower incentive and protection programs, and discussing internal controls with management. These tasks are likely to crowd out the more traditional role of giving an external perspective to the CEO about business strategy[57] and perhaps take away time otherwise spent working to assure that managerial behavior aligns with shareholder wealth maximization.

The emphasis on independent directors makes more sense in this light, too, a subject to be explored later on. The not-so-subtle message from SOX is that independent directors bear special responsibility for promoting more transparency inside and outside the company, starting at the top.[58] The companies' auditors and attorneys are then enlisted to aid the directors in this task through mandatory "reporting up" obligations with respect to observed illegalities and other problematic behaviors.[59] Again, the fact that Congress chose not to give shareholders greater power in the election process is consistent with an emerging conception of the "public" director. Recall the earlier discussion of the research that suggests independent directors do not necessarily create additional firm value, but may tolerate less fraud and illegality. If so, they are already acting to some extent as "public" directors; SOX simply strengthens this role. Along the same lines, more independent directors appear to create value for debtholders, a more risk-averse class of investors.[60] These results seem hard to explain at first, but fit with an account in which independent directors are meant to be speed bumps for otherwise risky behaviors.

The foregoing may sound simply like a restatement of a common theme in the corporate governance literature, in which corporate social responsibil-

57. *See* James D. Westphal, *Collaboration in the Boardroom: Behavioral and Performance Consequences of CEO-Board Social Ties*, 42 ACAD. MGMT. J. 7, 10–11 (1999); Langevoort, *Human Nature*, *supra* note 35, at 802–03.

58. Langevoort, *Internal Controls*, *supra* note 11, at 954–57. For a discussion of new expectations regarding securities law compliance, see Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 BUS. LAW. 1375 (2006).

59. As to lawyers in particular, this connection is well made in Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517 (2003), and Geoffrey C. Hazard, Jr. & Edward B. Rock, *A New Player in the Boardroom: The Emergence of the Independent Directors' Counsel*, 59 BUS. LAW. 1389 (2004). *But see* Robert Eli Rosen, *Resistances to Reforming Corporate Governance: The Diffusion of QLCCS*, 74 FORDHAM L. REV. 1251, 1277–92 (2005) (describing how in-house lawyers resist bringing directors into the compliance decision-making process).

60. Robert Anderson et al., *Board characteristics, accounting report integrity and the cost of debt*, 37 J. ACCT. & ECON. 315, 317 (2004).

ity and the public/private distinction have long been debated.[61] But even if no more than a familiar theme, it is still worth noting because most commentators have assumed that contemporary American corporate and securities law has rejected that model, not embraced it. Though there are echoes here, my reading of SOX is more modest than the unabashedly progressive goals that typically animate calls for more social responsibility. Legislation of that character would either redistribute power to identifiable non-shareholder groups or make managers more accountable to them, but SOX does neither. Its public values relate to process more than substance.

Similarly, this reading differs from the common theme that accountants and directors are enlisted as "gatekeepers," charged by law with monitoring responsibilities to assure legal compliance.[62] While there is again an overlap, my reading modifies the idea of gatekeeping. First, it is not tied strictly to a legal compliance standard, but rather deals more comprehensively with operational risk. Second, gatekeeper theorists have not explicitly recognized the conflict in roles stemming from such an orientation; to the contrary, the implicit assumption is often that gatekeeping is at least consistent with a shareholder protection strategy.[63]

Early post-SOX evidence is consistent with a caution-inducing account. In a particularly interesting study, Cohen, Dey, and Lys suggest that SOX has altered both the compensation structure and risk-taking incentives for corporate executives, leading to less-risky investment decisions regarding research and development and capital expenditures.[64] That makes sense intuitively, particularly if either the volatility or financial reporting issues raised by more aggressive projects increase the legal risk to both company and form-certifying executives. Accounting also appears to have become

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61. The public/private distinction has been emphasized by a number of legal scholars in assessing the financial scandals. *E.g.*, David A. Westbrook, *Corporation Law After Enron: The Possibility of a Capitalist Reimagination*, 92 GEO. L.J. 61, 108–10 (2003); Douglas M. Branson, *Corporate Social Responsibility Redux*, 76 TUL. L. REV. 1207, 1212–14 (2002). I am not claiming that SOX is the first time the law has tried to push this boundary. In the 1970s, for example, there was a strong effort to bring more integrity and accountability to public firms, but the effort was sidetracked by a number of developments in the early 1980s—the free-market politics and ideology of the Reagan administration, and the booming takeover market as the preferred method of corporate discipline. Though a thorough exploration is beyond the scope of this paper, one can see much in SOX that is a revival of those earlier efforts. *See, e.g.*, Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79 (2005).

62. *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004).

63. The conceptual tension between current and future shareholders in defining securities law "compliance" is underappreciated by corporate law scholars. *See* Steven Schwarcz, *Temporal Perspectives: Resolving the Conflict Between Current and Future Investors*, 89 MINN. L. REV. 1044 (2005); Langevoort, *Internal Controls*, *supra* note 11, at 960–62.

64. Daniel A. Cohen et al., The Sarbanes-Oxley Act of 2002: Implications for Compensation Structure and Risk-Taking Incentives of CEOs (July 8, 2005), http://www.ssrn.com/abstract=568483. One effect is the shift from aggressive accounting to actual business choices that have the desired effect on reported earnings without raising the same risk of legal sanction. John R. Graham et al., *The economic implications of corporate financial reporting*, 40 J. ACCT. & ECON. 3, 47–50 (2005) (documenting willingness of executives to forego potentially valuable investment decisions to achieve desired reporting results).

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more conservative,[65] which is of mixed value to equity investors but consistent with broader conceptions emphasizing the disciplinary nature of both accounting and auditing.[66] Some sixteen percent of financial companies now have a "chief risk officer," a position unknown just a few years ago.[67]

I am not saying that a public-accountability reading of SOX is closer to its actual intent (whatever that means) than an investor-protection reading. If I am right about social construction, however, what was intended is less important than what something comes to mean. SOX plants some seeds that, if climatic conditions turn out right, could grow to change the landscape at the boundary between what is considered public and private in corporate governance. Readers will no doubt disagree about whether what sprouts will be flowers or weeds. We have already addressed some of the social costs of SOX-type initiatives and will turn shortly to others. Dampening risk-taking and innovation hardly counts as an obvious virtue in the modern economy. As critics of stakeholder-oriented theories have long pointed out, the more open-ended the articulation of what corporate governance is supposed to accomplish in serving public goals, the less discipline it exerts on managers who try to justify self-serving behaviors in utilitarian terms.[68] At the very least, however, thinking more broadly about what SOX might be trying to accomplish puts the legislation in a considerably different light and moves any discussion of its legitimacy (or measuring its efficacy) in a very different direction.

III. The Contest Over SOX's Meaning and Legitimacy

Part I aimed to show that SOX's origins and early history leave open the possibility of multiple interpretations of its meaning and legitimacy. SOX may have been a hasty and ill-considered overreaction, a needed reform accomplished at the brief moment when it was possible, or something in between. Part II described a way of thinking about SOX that differs from the standard investor protection-oriented account.

But stories about statutory origins and early histories tend to fade in importance—or be revised in collective memory—as regulation is implemented, interpreted, and enforced. The ongoing political and social

65. Gerald J. Lobo & Jian Zhou, *Did Conservatism in Financial Reporting Increase after the Sarbanes-Oxley Act? Initial Evidence*, 20 Acct. Horizons 57, 71 (2006).

66. *See* Bratton, *supra* note 50, at 445–46; Lawrence A. Cunningham, *Finance Theory and Accounting Fraud: Fantastic Futures versus Conservative Histories*, 53 Buff. L. Rev. 789, 793–94 (2005) (describing the tension between accounting's interest in conservative presentation and finance's interest in forward-looking value). For further discussion of this issue see *infra* text accompanying notes 89–92.

67. The Conference Board, *Corporate Directors May Not Be Providing Sufficiently Robust Enterprise Risk Oversight*, June 6, 2006, http://www.conference-board.org/utilities/pressDetail.cfm?press_ID=2893 (last visited January 16, 2007).

68. For this reason, single-minded focus on shareholder wealth maximization is seen by many as the now-dominant paradigm for corporate governance around the world. *See generally* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L.J. 439 (2001).

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construction of SOX will ultimately determine its impact on doing business. While it is much too early to say for sure how SOX will fare in this regard, it is possible to think about which interests will compete to influence both regulatory choices and perceptions of SOX's legitimacy. Hence, this Part will describe a stylized negotiation about SOX and its meaning (metaphorically, not in terms of a formal game-theoretic model) among key participants—corporate executives, institutional investors, the securities industry, accountants, auditors, lawyers, regulators, the media, and corporate employees. This will necessarily require generalization about these participants, whose beliefs and attitudes are far more dispersed than I suggest, but this generalization should improve clarity and traction. The goal is simply to imagine the interaction in the many ways it might play out, and we begin by considering what each brings to the table.

A. *Corporate Executives*

Let me start with a hypothesis: corporate executives generally do not think of themselves as working directly for corporate shareholders, but for "the corporation" as an abstract and inchoate (i.e., socially constructed) institution. That is, they see all company stakeholders as essential suppliers of inputs or purchasers of outputs whose expectations and demands have to be managed successfully for the firm to succeed. But senior management does not feel normatively beholden to them.[69] Even the board of directors is more a mechanism for gaining external resources than a locus of normative authority,[70] although managers certainly respect its formal power. Managers believe they deserve autonomy and control over the institution as long as they respect basic legal and business norms and keep their constituents satisfied.

This, of course, is not the received legal model of the firm, which to most commentators privileges the shareholders as the group closest to being its owners, and by all accounts makes the managers fiduciaries to the company's shareholders. I admit it is an open question whether managers actually think of themselves as normatively (rather than legally) bound to shareholders; some scholars think so, with some disagreement among those who do regarding whether the normative bond exists because the law demands it or because American capitalism has thoroughly internalized the notion of shareholder primacy.[71] My anecdotal observations, however, con-

69. I will leave to the side the question of whether, as orthodox economists predict, their behavior is largely self-serving and opportunistic, or whether their identity is shaped by the company's culture. *See* George A. Akerlof & Rachel E. Kranton, *Identity and the Economics of Organizations*, 19 J. ECON. PERSP. 9, 19–22 (2005); Donald C. Langevoort, *Opening the Black Box of "Corporate Culture" in Law and Economics*, 162 J. INSTITUTIONAL & THEORETICAL ECON. 80, 84 (2006).

70. *See* Amy Hillman & Thomas Dalziel, *Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives*, 28 ACAD. MGMT. REV. 383, 385 (2003); *see also* Davis, *supra* note 5, at 153.

71. *See, e.g.*, Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1662 (2001).

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vince me that management considers itself a distinctive "in-group" and considers investors, like other stakeholders, an "out-group,"[72] albeit one that can exercise a powerful set of rights if and when it can overcome its collective action problems. The respect ostensibly paid to shareholders invokes the rhetoric of fiduciary obligation but is otherwise just the savvy handling of a potentially powerful constituency.

If this is right, then we should assume that, on average, managers consider SOX an intrusion and resent nearly all of it. They may embrace it publicly because their investors and regulators expect them to, but see it as functional only insofar as it lowers the cost of capital to their firms. To managers who believe the capital markets are largely efficient, this means complying to the extent that investors value the changes positively—but only to that extent (and they would have felt forced to respond to shifting capital marketplace demands even without SOX, and thus still resent its straightjacket). To those with less faith in market rationality, the work will be more in the form of impression management.[73] In either case, a fairly dim story about SOX's origins would suit these beliefs, although managers of companies who see their firms as superior might be less critical to the extent that SOX might help expose the inferiority of "lemon-like" competitors and help bond their own credibility among investors. No doubt the degree of criticism will also vary depending on how costly compliance is, which therefore will make managers of smaller companies more harshly critical than those of larger ones.

B. *Institutional Investors*

The standard account of developments in corporate governance and transparency, pre-SOX at least, was largely about the influence of institutional investors. The growth in their size and sophistication combined with the emergence of mechanisms and the disappearance of obstacles for coordinating their behavior have made institutional investors increasingly formidable players in corporate governance.[74] To be sure, successful exercise of investor power has been uneven and episodic—many institutional investors remain conflicted and unwilling to oppose management, so that activists rarely expect an easy majority of votes. But most regard the trend as moving toward more shareholder power rather than less, especially insofar as managers fear large-scale institutional shareholder selling as much or more than votes in opposition. The available evidence, in turn, suggests that greater institutional holdings correlate with "better" governance practices and

72. *See* James D. Cox & Harvey L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 L. & CONTEMP. PROBS. 83, 99–108 (1985). As discussed *infra*, text accompanying notes 117 and 118, it is useful to see managers as trying to make the board see itself as part of this in-group.

73. *See* James D. Westphal & Edward J. Zajac, *Decoupling Policy from Practice: The Case of Stock Repurchase Programs*, 46 ADMIN. SCI. Q. 202, 204 (2001).

74. *See generally* MICHAEL USEEM, INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA (1996).

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higher quality disclosure,[75] although it may also increase the temptation for corporate executives to commit fraud when they fear more certain punishment for poor performance.[76]

As noted in Part II, SOX does not affect this balance directly; Congress was careful, perhaps curiously so, not to enhance shareholders' political power inside the corporation. The SEC sought to create easier shareholder access to the ballot a year after SOX, but even this mild effort was rebuffed,[77] with Congress certainly offering no support for change. Nor did SOX do much to enhance private rights of action under the securities laws, which institutions increasingly control as lead plaintiffs.

Thus we have to treat institutional investor influence as largely exogenous; its evolution will not, directly at least, be affected by SOX or its interpretation. Presumably, most institutional investors will embrace those SOX reforms that they believe will generate positive marketplace value, though how rationally they will evaluate these reforms is the subject of some debate.[78] Their main interest is in aligning managerial behavior closer to shareholder wealth maximization, and they presumably would be uncomfortable with SOX reforms that distract board members too much from their monitoring task or otherwise impose heavy compliance costs. The ambiguity about how well SOX does this probably leaves them somewhat ambivalent about many of the reforms.

One segment of the institutional investor community has a different set of preferences, however. Public pension funds and labor-managed private funds have become very vocal activists, which some commentators view as attentive to constituencies whose interests diverge from share price maximization.[79] Here we find investor groups that could well construe SOX in the "public" rather than purely "investor" terms discussed in Part II. Such investors are willing to encourage size as much as efficiency, or prudence rather

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75. *See* Brian J. Bushee & Christopher F. Noe, *Corporate Disclosure Practices, Institutional Investors, and Stock Return Volatility*, 38 J. ACCT. RES. 171, 172 (Supp. 2000).

76. *See* David Denis et al., *Is there a dark side to incentive compensation?*, 12 J. CORP. FIN. 467, 483 (2006); Langevoort, *Corporate Thermostat*, *supra* note 34, at 307–08. While widely assumed, the specific link between options-based compensation and the propensity to commit fraud is far from clear. *Compare* Daniel Bergstresser & Thomas Philippon, *CEO incentives and earnings management*, 80 J. FIN. ECON. 511, 513 (2006) (finding evidence of correlation) *with* Merle Erickson et al., *Is There a Link Between Executive Equity Incentives and Accounting Fraud?*, 44 J. ACCT. RES. 113, 116 (2006) (finding a lack of persuasive evidence); *see also* Joseph P. O'Connor, Jr. et al., *Do CEO Stock Options Prevent or Promote Fraudulent Financial Reporting?*, 49 ACAD. MGMT. J. 483, 483 (2006) (suggesting that the incentive effects of stock options vary depending on other conditions).

77. Pamela Atkins, *SEC Access Proposal Seen as Dead; Some Shift Focus to Requiring Majority Vote*, 37 SEC. REG. & L. REP. (BNA) 230, 230 (Feb. 7, 2005).

78. An interesting subject is the diffusion of "good governance" beliefs within the institutional investor community and whether these are well-grounded beliefs, a marketing innovation by the new "corporate governance industry," or simply the product of mimetic diffusion. For a criticism of the functionality of these beliefs, see Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. (forthcoming 2007), *available at* http://www.ssrn.com/abstract=902900.

79. *See, e.g.*, Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

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than the aggressive risk-taking that employees, retirement savers, and the general public might find threatening. To these, greater normative emphasis on controls, ethics, and law-abidingness might be appealing even if their effect on profitability or share price value is unclear.

C. *The Securities Industry*

The securities industry (investment banks, brokerage firms, the stock markets, etc.) has substantial political power in Washington and is the one group often said to come closest to effecting "capture" of the SEC.[80] Its political interests fall somewhere in between those of managers and institutional investors; it is anxious to generate depth, trading volume, and deal flow, and hence supports the core attributes of securities regulation in fighting its seamy underside. Wall Street is strongly committed to the "investor confidence" story because it benefits from widespread public participation in the securities markets. At the same time, domestic industry players face strong competition from abroad and hence reasonably fear regulatory arbitrage—economic activity moving to a less-preferred venue simply to avoid regulatory costs.[81] Given the rapid globalization of finance, U.S. listings of foreign issuers will be affected by SOX's interpretation, as could decisions by domestic companies about whether to go public in the first place. Hence, the securities industry is very concerned about both the perception and reality that SOX is unduly costly because of the impact on its transactional business. It has to walk a fine line to push Congress or the SEC to make accommodations without being so vocally critical of SOX that it feeds perceptions that U.S.-style regulation is dysfunctional. It is thus likely to take the public position that SOX is good but needs adjustment at the margins.[82]

Perception is an important point here. If the stock market prices investor protection mechanisms with precise efficiency, Wall Street's interest would largely coincide with wealth-maximizing institutional investors. But if public investors from time to time become insufficiently sensitive to governance or transparency problems as opposed to more alluring "stories" and invest

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80. *E.g.*, Jonathan R. Macey, *Positive Political Theory and Federal Usurpation of the Regulation of Corporate Governance: The Coming Preemption of the Martin Act*, 80 NOTRE DAME L. REV. 951 (2005).

81. This concern is diminished to the extent that securities industry institutions become global, as nearly all investment banks are. Still, geographic concentration of power in New York City leads to natural concern about the U.S. being perceived as unaccommodating to capital raising and transactional activity. For a report prepared at the direction of New York City's mayor, Michael Bloomberg, and Senator Charles Schumer that plays upon this theme by calling for modifications of the way SOX has been implemented, see SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP, *available at* http://www.ci.nyc.ny.us/html/om/html/2007a/pr021-07.html.

82. *See, e.g.*, Bob Greifeld, *The View From Nasdaq*, WALL ST. J., July 30, 2004, at A10. Wall Street's foreign competitors have precisely the opposite incentive: to portray SOX (and U.S.-style securities regulation generally) in the worst possible light, accurately or not. In many ways, U.S.-based market participants are fighting distorted perceptions of U.S. regulation and litigation that harm those same markets as they influence issuers and managers to avoid them.

readily without demanding adequate compensation for the residual risk, Wall Street is probably less likely to support such protections and instead join in the opportunism.[83]

D. *Accountants and Auditors*

Of all the groups that have been enriched by SOX, accounting firms seem to be the winners. That is ironic because of how much responsibility for the financial scandals was placed on accountants, and of course there are significant costs to the profession as well—the replacement of self-regulation with the PCAOB and the loss of nonaudit income due to the independence rules. But auditing was plainly promoted in regulatory importance, and public issuers have no choice but to be audited.[84] As noted earlier, the required auditing of internal controls has increased revenues substantially, and presumably profits as well. The highly concentrated nature of the industry, made more so by the demise of Arthur Andersen, limits issuers' opinion-shopping ability.[85]

One would expect, then, for the accountants to be strong SOX supporters, at least with respect to those provisions that move greater company resources to Generally Accepted Accounting Practices ("GAAP") compliance and audit procedures. This has certainly been the case both overtly and subtly, as in the gradual expansion of the scope of enterprise risk management as part of the internal controls function—accomplished by the accounting industry's semi-independent Committee of Sponsoring Organizations of the Treadway Commission ("COSO").[86] This can rightly be called rent-seeking behavior, though not in the purely opportunistic sense.[87] SOX privileges GAAP and auditing in many ways, and the profession has official public support for re-imagining itself as a more powerful, conservative voice in corporate governance. We saw earlier that this is having its intended effects. Audit quality seems to have improved, and accounting results have become more conservative. Accountants are thus likely to tell the SOX story as a success even though they might chafe under portions of it.[88]

When considered alongside general managerial opposition to SOX reforms, the auditors' favorable telling of the SOX story sets up the most tension we have observed thus far. The outcome of the negotiation between

83. *See* Paul G. Mahoney, Commentary, *Is There a Cure for "Excessive" Trading?*, 81 VA. L. REV. 713, 716 (1995).

84. *See* Cox, *supra* note 24.

85. *See* Theodore Eisenberg & Jonathan R. Macey, *Was Arthur Andersen Different? An Empirical Examination of Major Accounting Firms' Audits of Large Clients*, 1 J. EMPIRICAL LEGAL STUD. 263, 264–65 (2004).

86. *See* Conference Board, *supra* note 67.

87. *See* Langevoort, *Internal Controls*, *supra* note 11, at 966–68.

88. Although this discussion identifies accountants as the interested actors, there actually is a broader "compliance" industry of consultants, software and information technology specialists, and the like with similar interests. On the latter, see Kris Maher, *Career Journal: Sarbanes Oxley Is Boon for Slew of Consultants*, WALL ST. J., Aug. 19, 2003, at B1.

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managers and auditors will depend on who captures the interpretation of these SOX provisions most effectively and garners support from other constituencies. Though it is too early to speculate about the outcome beyond substantial early success for the auditors in terms of post-SOX audit revenues, we might reflect briefly on some of the possible subtle consequences of greater auditor primacy. As noted earlier, conservative financial reporting is comforting to creditors, shareholders, and others who see it as a disciplinary or monitoring tool. How well investors do under a highly conservative regimen depends on balancing this comfort against the corresponding loss in accuracy.[89] By definition, conservative GAAP reporting on average understates the true economic value of the firm, which can never be fully captured within a rigorous framework of rules or principles of general applicability. How much, if at all, conservative reporting deprives investors of useful information is controversial,[90] but to the extent that it does, aggressive interpretations of SOX will reflect that cost. This is an important part of the internal controls debate, too. Investment in internal controls may well have a positive payoff in the capital markets to the extent that it exposes weaknesses that relate to material aspects of the business.[91] But if the investments are skewed toward the labor-intensive but less important aspects of the business—which might be the most profitable strategy for the auditors to encourage—the likelihood that it will generate such payoffs is reduced.

To the extent that auditors gain bargaining power, managers may have to negotiate and compromise in other ways as well. They may, for instance, acquiesce in the labor-intensive work in return for less attention to more sensitive issues, such as managerial risk-taking.[92] We might also see managers select independent directors to serve on audit committees who have greater financial or accounting expertise as counterweights to the external auditors.[93] That is an important compromise, however, because by changing the character and identity of the independent directors, the interests and attention of the board begins to shift, and some control is lost. There is evidence, for example, that having greater accounting expertise on the audit committee correlates with greater conservatism in financial reporting,[94] and

89. *See* Cunningham, *supra* note 66, at 790.

90. Anil Arya et al., *Are Unmanaged Earnings Always Better for Shareholders?*, 17 ACCT. HORIZONS 111 (Supp. 2003).

91. *See supra* note 38.

92. Section 404's internal controls obligation as initially articulated may have this effect because it concentrates on assuring that routines are well constructed but does not do quite as well at assuring that surveillance resources target sensitive risks with respect to senior managers gaming the system. *See* Langevoort, *Internal Controls*, *supra* note 11, at 972–73; Michael G. Alles & Srikant Datar, *How do you stop the books from being cooked? A management control perspective on financial accounting standard setting and the section 404 requirements of the Sarbanes-Oxley Act*, 1 INT'L J. DISCLOSURE & GOVERANCE 119, 132 (2004).

93. *See* Linck et al., *supra* note 35, at 38.

94. Gopal V. Krishnan & Gnanakumar Visvanathan, *Does the Sox Definition of an Accounting Expert Matter? The Association Between Audit Committee Director's Expertise and Conservatism* 4 (Dec. 1, 2005), http://www.ssrn.com/abstract=866884.

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having greater financial expertise correlates with reduced misreporting risk.[95] Whether these seemingly beneficial outcomes carry heavy costs as well (e.g., resistance to value-added projects because the accounting issues posed are too risky, or loss of strategic advice) is an open question.

E. *Lawyers*

Lawyers have the most control over the interpretation of SOX: they are the ones who, in the first instance, describe it, wrestle with its ambiguities, and guide clients through the initial rounds of compliance. The profession's collective inferences as to SOX's meaning and legitimacy are bound to have a substantial influence on other interpretive communities.

Lawyers, of course, are a diverse bunch, so generalization here is particularly challenging. But we can make some predictions. First, sociological evidence shows that corporate lawyers do tend to identify with their clients' needs and interests, an essential survival trait in a competitive market for high-end legal services.[96] On the other hand, their economic power comes from their expertise in managing legal risk in complex environments. The more serious the threat and the more complex and difficult the law is, the greater the need for legal expertise and hence the greater the rents.[97] In this respect, SOX was a gift to corporate lawyers—economic and political circumstances heightened the perceived risk, and SOX layered sets of complicated new regulations on issuers. Moreover, many of the reforms (new audit committee responsibilities, internal controls obligations, disclosure enhancements such as the revised Management Discussion and Analysis report) have resulted in work that is ongoing rather than a one-time adjustment to new mandates, making SOX particularly lucrative for corporate lawyers.[98] In the manager-lawyer negotiation to control a given transaction or obligation, SOX increases the lawyer's bargaining power because it is unclear how much is necessary and how much is inflated.

Because lawyers benefit from SOX compliance efforts, I predict that the legal profession's internal construal will be expansive, albeit with a public display of sympathy for the difficulties "well-meaning business people" (i.e., their clients or potential clients) face in adjusting to the uncertainties of the new regime. As with accountants, lawyers can see much in SOX that resonates with legitimate concerns: precautionary procedures, routines, and checks and balances are the stuff lawyers learn to value. In general, they will be comfortable with an assessment of SOX as bolstering the need for good

95. *See* Agrawal & Chadha, *supra* note 33, at 374.

96. *See* ROBERT L. NELSON, PARTNERS WITH POWER (1988). In-house counsel play a somewhat different role because of their closer identification with management. For a good study of in-house lawyer reaction to SOX's effort to bring directors into compliance decisions, see Rosen, *supra* note 59, at 1277–92.

97. *See* Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375 (1997).

98. *See, e.g.*, Rosen, *supra* note 59, at 1258 ("The real story is that the corporate bar has been made stronger and richer by SOX.").

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preventive maintenance inside the company, which constant change amid competitive pressures otherwise causes well-meaning issuers to defer. And state-of-the-art SOX compliance can help the client distinguish itself from lesser firms. All of these are ways savvy lawyers can finesse the difficult task of enhancing their power without alienating their client-managers, who are presumably much more skeptical.

Also, as with accountants, managers may well promote lawyers in importance because of their skills and contacts as intermediaries with regulators. It is perhaps not surprising that Linck and his co-authors report that, post-SOX, the largest percentage of new corporate directors were lawyers.[99] That, too, is interesting because the lawyer's natural attention and interest will be to attend to legal risk, giving more support to compliance and internal controls. We might assume that lawyers would also be more sensitive to shareholder interests because that is the legal model of the firm. But I would guess that most elite corporate lawyers share managers' beliefs about the normative structure of business management, albeit with more sensitivity to legal risk and the need to satisfy shifting regulatory expectations. If anything, I would argue that a shift toward greater lawyer involvement in corporate governance would come closer to the alternative interpretation of SOX offered earlier: diffusing managerial autonomy in favor of more emphasis on process and deliberation.

F. *Regulators*

The key to how SOX will be interpreted initially is largely in the hands of the regulators, primarily the SEC and the PCAOB. Although the initial rule-making is largely done, interpretation and enforcement is only beginning. And it is clear that the latter process dominates the message sent to other interpretive communities and establishes the level of legal risk. The regulators have the ability to turn the heat up or down fairly quickly with respect to any statutory provision or rule. A good example of this is the internal controls requirements in place before section 404. It is commonly assumed that the financial scandals leading to SOX involved widespread control failures that justified the new regulations. Yet since 1978, public companies have been obligated by both statute and SEC rule to have "reasonable" systems of internal controls in place and to respect internal controls procedures. If the assumption about control failures is right, this largely failed as effective regulation, and the reason is that the SEC was not diligent about enforcement; in fact, it signaled so early on.[100] By the late 1990s, issuers showed relatively little sensitivity to the need for particularly

99. Linck et al., *supra* note 35, at 43.

100. *See* Langevoort, *Internal Controls*, *supra* note 11, at 953. To be sure, the funding structure of the PCAOB (based on fees charged to issuers) may lead to less political sensitivity and more consistent enforcement of audit-related obligations. *See* Coates, *supra* note 14, at 99-100.

rigorous controls on financial reporting. Check-the-box-style compliance was enough. SOX could have the same fate if the regulators so choose.[101]

To predict the SEC's likely attitude to SOX enforcement, one needs a tractable theory of administrative behavior tied to the Commission's unique incentive structure, a daunting task beyond our current knowledge. My impression, which I have sketched out more fully elsewhere, is that the SEC is quite responsive to external pressures.[102] But that does not translate easily into a dark capture story because the most powerful external constituencies actually value its core work in mandating disclosure and prosecuting fraud (i.e, there is a plausible economic theory behind its work). As such, the SEC uses its enforcement ability to adjust demands with an eye toward keeping the U.S. capital markets attractive as well as reasonably honest. It is not always prescient in its choices, but it is disciplined by external forces when it wanders too far off the mark.[103]

So the initial assumption that the SEC would be a fervent SOX enthusiast, imperialistically embracing its expanded role in corporate governance, is probably wrong. It will use SOX moderately (and aggressively when scandals reoccur), but in general it will stay close to a "common law" pattern of mixed messages—regularly reminding issuers and investors of its presence but backing off if key interests become too provoked.

That said, the SEC is likely over the long run to ally with accountants and lawyers in valuing process and caution as the major accountability themes of SOX, in addition to its unusual interest in optimal transparency. Because lawyers and (to a far lesser extent) accountants dominate the SEC staff, those professions have a strong influence on internal agency perceptions, which mediate political pressures that business interests exert. Historically, the SEC has seen its mission as protecting investors, albeit with a "lawyer's bias" to construing investor needs in a way that privileges regulation over non-regulation. An interesting question is whether this concentration on investor needs still exists, or whether the SEC, too, is shifting its beliefs so that public accountability is being promoted more prominently than enhancing shareholder wealth. If the latter, then the SEC, too, may promote a public-interest interpretation of SOX's meaning and legitimacy.

G. *The Media*

Many analyses of the key groups contesting SOX's meaning would stop with the foregoing. I would argue, however, that two remaining forces are

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101. At the international level, a good bit of evidence underscores that the way securities regulators enforce the law is more important to capital marketplace participants than what the law on the books says. *See, e.g.*, Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2002); Laura Nyantung Beny, *Do Insider Trading Laws Matter?: Some Preliminary Comparative Evidence*, 7 AM. L. & ECON. REV. 144 (2005).

102. *See* Langevoort, *SEC as a Lawmaker*, *supra* note 3.

103. *See* John C. Coates, IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531 (2001).

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also key to SOX's social construction and may gradually tip its balance: the media and corporate employees. The media is important in ways that have been under-appreciated by corporate law scholars. Although orthodox finance theory might suggest otherwise, bad publicity can have a negative effect on the stock price of a given issuer regardless of whether it conveys new information[104] and may also have an effect on investor sentiment generally. Bad publicity can also damage the company's social license with customers, employee morale, and access to public resources.[105] Directors may react to press coverage because they lack inside knowledge of the company and hence may find media criticism of insiders credible.[106] Perhaps more importantly, directors are particularly sensitive to preserving their own reputation and elite status and want to avoid embarrassing criticism of their own behavior.[107] The media also affects regulatory choices. The SEC gets many of its cases because of media reports, and it is acutely sensitive to media blame if it is perceived as lax in its appointed tasks.[108]

The question, then, is whether the media will be an independent source of SOX interpretation and push some vision of it. The plausible generalization here is yes, perhaps powerfully so. Reporters covet scandal and happily ignore hindsight bias to speculate about who knew what and when, who could have foreseen and prevented the harm, and so on. Post-SOX, the financial media seized on both the themes of reform (accountability and transparency) and its specific initiatives (e.g., director independence, internal controls) in making assessments. Management and boards are subject to intense criticism when it appears they have fallen short on any dimension.

I predict that the media's interpretive preferences tend toward the public accountability rather than shareholder primacy version of SOX. That is, investor harm is not privileged over harm to other stakeholders in the aftermath of scandal, nor is there much sensitivity to the costs of too much caution for the diversified shareholder. The media is the strongest promoter of the precautionary principle that harms should have been prevented, and SOX is about prophylactics. Obviously, this leads to mixed messages about SOX. When new scandals arise, the "why didn't SOX work" question is pointedly raised, which is potentially damaging—especially if read in conjunction with episodic (presumably management-inspired) coverage of the costs SOX generates. But this does not easily play into a strategy of less regulation and more managerial autonomy. Norms entrepreneurs committed to an expansive vision can comment that someone hadn't gotten the message

104. Gur Huberman & Tomer Regev, *Contagious Speculation and a Cure for Cancer: A Non-event that Made Stock Prices Soar*, 56 J. FIN. 387 (2001).

105. *See* Gunningham et al., *supra* note 4, at 330.

106. *See, e.g.*, Kathleen A. Farrell & David A. Whidbee, *Monitoring by the Financial Press and Forced CEO Turnover*, 26 J. BANKING & FIN. 2249, 2273–74 (2002).

107. On "status anxiety" at the company level, see Michael Jensen, *Should We Stay or Should We Go? Accountability, Status Anxiety and Client Defections*, 51 ADMIN. SCI. Q. 97 (2006).

108. *See, e.g.*, Pritchard, *supra* note 3.

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(or that there was political interference, etc.) and that even more accountability-inducing mechanisms or enforcement resources are the answer.

H. *Corporate Employees*

One final group deserves serious consideration as a potentially important post-SOX interpretive community: mid- and lower-level corporate employees.[109] Legal academics in corporate law pay little attention to company employees; by and large, the manager–shareholder relationship dominates academic analysis, with efficiency rather than redistributive consequences the standard metric for assessing optimality. Organization theory pays substantial attention to human resources, and the common assumption is that employee morale, attitudes, and behaviors strongly influence competitiveness and profitability.[110] Employee resistance (or incapacity) can thwart good decisions at the top, making human resource management a key element of business strategy.

This assumption connects to SOX in two ways.[111] One of the important lessons of Enron and WorldCom (and Arthur Andersen) is that employees are substantially at risk from managerial misbehavior and skewed incentives. Presumably, there is greater internal anxiety to being the next Enron. To the extent that SOX's internal controls requirements lead to a more open internal firm architecture, employees may observe more than they did previously. And to the extent that those controls—both embedded in the systems and in more formal SOX-mandated whistle-blower mechanisms—encourage "reporting up" concerns and suspicions, employees may aid enforcement. To be sure, there are inevitably pressures in organizations that deter whistle-blowing, and job mobility may allow some employees to exit rather than assume the risk. But it is not entirely clear these will be so potent if employees with strong ties to the firm fear for their jobs and retirement savings if the spotted misconduct is real, especially as the concern spreads contagiously. If, as suggested above, lawyers and accountants pressure firms to build alternative communications channels to the standard organization chart, the risk to employees from reporting up may be reduced.

The second SOX effect is cultural. Employees may not only sense greater anxiety from the risk of impropriety as a result of media coverage of financial reporting scandals, but may increasingly consider violations of accountability and transparency norms to be illegitimate. Their emotional attachment to the firm triggers resentment when they learn managers unfairly put them at risk. That, too, may make employees more likely to report up in ways that trigger SOX-type governance interventions. And even if it

109. *See* Sally Riggs Fuller et al., *Legal Readings: Employee Interpretation and Mobilization of Law*, 25 ACAD. MGMT. REV. 200 (2000).

110. *See* Akerlof & Kranton, *supra* note 69.

111. On this issue, see Richard E. Moberly, *Sarbanes-Oxley's Structural Model to Encourage Corporate Whistleblowers*, 2006 B.Y.U. L. REV. 1107, and David L. Schwarzkopf & Hugh M. Miller, *Early Evidence of How Sarbanes-Oxley Implementation Affects Individuals and their Workplace Relationships*, 110 BUS. & SOC'Y REV. 21 (2005).

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does not, anxiety and fear increase, which can spread and threaten productivity without setting off formal alarms. The "chatter" itself may provoke suspicions.[112] All this creates disincentives for managers who try to hide selfish or risky behaviors, and increases the pressure on senior management to accept substantive monitoring mechanisms.

We should put employees in the group particularly likely to see SOX's meaning and legitimacy in public rather than investor-oriented terms. True, they may also be shareholders, but in many firms their human capital (and perhaps their retirement savings) are concentrated enough that their interests become more like creditors than investors. Such employees may value the process associated with greater transparency and accountability—and they may be particularly invested in the precautionary principle.

IV. Interpretive Interactions

A. *Pressure Toward Compromise*

As should be clear by now, my argument is that SOX's meaning and perceived legitimacy will be determined by an interaction among all the interpretive communities described in Part III. This interaction occurs in many different venues—political lobbying in Congress and the agencies as well as cultural jockeying in the media about the meaning of SOX. How that interaction will play out is impossible to predict because it will be a feedback process with so many unknown variables.

The future could favor managers if the social construction that SOX was a dangerous ("quack") overreaction prevails. Plainly, managers have powerful political and expressive resources. The most damning critique at their disposal is to link the over-regulation story with loss of competitiveness and off-shore migration of jobs and capital. This well-publicized storyline seeks to enlist employees and taxpayers as allies. Such an alliance has the strength to trump any rent seeking by accountants and lawyers. It also invites rent seeking by managers themselves to the extent that they can cut back even those aspects of SOX that generate value for investors at the expense of managerial autonomy.

SOX compliance could also turn against corporate executives. Were the SEC to act zealously with respect to SOX expansion and enforcement, accountants and lawyers would be all the more empowered and would gain more control over the implementation of SOX. If this implementation were followed by another round of scandals and a market drop, institutional investors, employees, and the press would mobilize, overwhelming managerial resistance to the encroachments. The SOX story could then become a mythic war narrative and provide support for new calls to bolster SOX.

112. *See* Dennis Wright Michaud et al., *Empowering Board Audit Committees: Electronic Discovery to Facilitate Corporate Fraud Detection* (Apr. 2, 2006), http://www.ssrn.com/abstract=896004; Langevoort, *Internal Controls*, *supra* note 11, at 225–26.

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I doubt, however, that either of these extremes will come to pass. Rather, SOX's meaning and legitimacy will be a story mainly about compromise, disappointing enthusiasts but also giving critics far less meat to chew. The earliest signals have come from the SEC and the PCAOB, which have backtracked quickly on an expansive approach to internal controls reports and audits. This is moderation rather than total abandonment—the SEC will not, for instance, exempt small businesses from section 404's requirements entirely, as called for by its own advisory committee[113]—but it is sensitive nonetheless to managers' arguments and political muscle.[114] As noted earlier, the SEC is attentive to Wall Street's concerns. Brokers and stock exchanges in the United States are understandably nervous about firms exiting the public capital markets or foreign countries becoming more hospitable sites for capital markets. Thus, the regulators are turning down the heat.

Down, probably, but not off. The regulators (and financial media) are still sensitive to the risk of damage from future accounting scandals that seem attributable to political pressure or loss of will. Moreover, the battle against managerial opportunism has become a larger part of the SEC's culture in the last five years; this will be hard to shed quickly without generating resentment within the agency's staff. Most importantly, the legal and accounting professions may not surrender their new power easily, and their influence within the SEC is still extraordinarily strong. Other key interests—institutional investors, the media—will also call the SEC to task if it backs off too far. So SOX should continue to be enforced with cautious moderation.

In such an atmosphere of compromise, the second-level effects will be the most interesting. To the extent that lawyers and accountants gradually

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113. *See* Financial Reporting of Foreign Private Issuers, Exchange Act Release No. 33-8730, 71 Fed. Reg. 47,056 (Aug. 15, 2006) (foreign issuers); Financial Reporting of Non-Accelerated Filers and Newly Public Companies, Exchange Act Release No. 33-8731 (proposed Aug. 9, 2006), *available at* http://www.sec.gov/rules/proposed/2006/33-8731.pdf (smaller companies); Steven Marcy, *SEC Promises More Section 404 Guidance But Rejects Exemption for Small Companies*, 38 SEC. REG. & L. REP. (BNA) 901 (May 22, 2006). Perhaps more dramatically, the SEC and the PCAOB announced a rethinking of how internal controls should be implemented and evaluated in late 2006, backtracking considerably on the expansive approach put in place right after SOX. *See* SEC Rel. No. 33-8762, 71 Fed. Reg. 77635 (Dec. 27, 2006) (proposed interpretive guidance); PCAOB Rulemaking Docket No. 021, Release 2006–007 (Dec. 19, 2006) (proposed rescission of Auditing Standard No. 2), *available at* http://www.pcaob.org//Rules/Docket_021/index.aspx.

114. The Committee on Capital Markets Regulation, comprised of leading business and Wall Street leaders as well as some well-known academics, issued a well-publicized report that made international competitiveness its dominant theme as it called for significant changes to the implementation of section 404 as well as other aspects of securities regulation. *See* Interim Report of the Committee on Capital Markets Regulation (Dec. 5, 2006), *available at* http://www.capmktsreg.org/research/html; *see also* SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP, *supra* note 81. Other examples of backtracking are abundant. For instance, the Commission first proposed a definition of financial expert that was limited to accounting expertise, but reversed course under pressure from the issuer community—thereby expanding it to include former senior executives who were engaged in financial reporting. On risk disclosure relating to the use of derivatives and off-books entities, the Commission proposed a broad reading of the new MD&A mandates but then reversed course when told that it would generate too much disclosure. *See* Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of "May"*, 48 VILL. L. REV. 1245, 1272–76 (2003).

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gain more control over the organizational architecture of SOX compliance—audit committee activities, internal controls procedures, operational and compliance audits, whistle-blower protection programs—managers will lose places to hide. This will be especially noticeable if low- and mid-level corporate employees become, as I suggested earlier, more sensitive to risk created by managerial misbehavior. The question then becomes whether managers will compensate by working that much harder at finding new hiding places, by subtly bribing the accountants and lawyers with controls systems that make it lucrative for monitors to do some kinds of investigative work but not others, or by adjusting to the new constraints.

B. *Contesting the Role of the Independent Director*

Of all the questions relating to the social construction of SOX, the most telling involves the long-running contest to define—or redefine—the role of the independent director in the public corporation. Current scholarship and practice disagree substantially about what directors are supposed to do, and the resulting role conflict has led to a good deal of tension and uncertainty in the boardroom. This has largely been a battle about shareholder primacy.

As noted earlier, SOX does nothing to empower investors in this contest. To the contrary, it adds substantial director workload unrelated to wealth-maximization. As post-SOX research by Linck et al. indicates, board members now have to work more hours, and hence are paid more.[115] Alternatively or additionally, the size of the board might grow so that the effect of the increased workload on any one director is reduced. Larger boards may favor managers and be a net loss for investors because larger boards are less effective at oversight than smaller ones.[116] Even if boards remain small, displacement might cause the same effect: if the tasks to which the directors pay attention are a smaller part of the overall scope of real economic activity, executives may focus on good cosmetic appearances where directors are forced to look and preserve their autonomy where directors are not looking. More work may also mean less attention to strategic issues that best inform an evaluation of the CEO and his or her team.[117]

The bigger question here concerns directors' attitudes and focus of attention. The weak spot in the independence movement has always been that a company's senior management dominates the selection of independent directors, which means management can select for certain attitudes and preferences. My sense is that, to the extent feasible, managers prefer directors who not only share elite bonds and have useful external contacts, but who share the ideology that all stakeholders, including shareholders, are

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115. Linck et al., *supra* note 35, at 4.

116. *See id.* at 28, 43; *see generally* David Yermack, *Higher market valuation of companies with a small board of directors*, 40 J. FIN. ECON. 185 (1996).

117. *See* Tom Kirchmaier & Mariano Selvaggi, *The Dark Side of "Good" Corporate Governance: Compliance-Fuelled Book-Cooking Activities* 2–3 (FMG, Discussion Paper No. 559, 2006), *available at* http://www.ssrn.com/abstract=895362.

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external claimants to be bargained with or managed—that is, that the corporation's best interests are not identical with shareholder's expressed interests. Implicitly, this privileges management's voice in articulating those best interests. Like managers, independent directors so chosen can learn to act out the rhetoric of fiduciary obligation to satisfy investor audiences but in fact have little constraint except as needed to assure that the necessary resources (capital, labor, regulatory approval) remain stable. They can do this without any guilt because institutional stewardship—rather than serving the pecuniary interests of a particular group—has a great deal of normative appeal.

Little or nothing in SOX alters this directly. Stock exchange rules do now require an independent nominating committee to take charge of the selection of new directors, and an SEC rule unrelated to SOX requires procedures for listening more closely to investor preferences on director selection.[118] But if the social and ideological ties with respect to management are strong enough initially, this shift alone will have little effect—the hierarchy will still reproduce. Without more than formalistic structural changes, then, we would expect SOX to have little positive effect on director attitudes and perhaps be a net loss for the reasons stated earlier. We would also expect similar resentment toward SOX from independent directors who share management's ideology—SOX increases workload, arguably increases legal risk, and distracts them from their preferred tasks.

As we saw in Part II, however, it is possible to construe SOX not in terms of the familiar dichotomy between managerialism and shareholder wealth maximization but as insisting on something of a "third way"—the infusion of public process values into the large corporation.[119] Independent directors are plainly the main agents conscripted to this task. SOX gives independent directors greater de jure control over transparency.[120] So much of the new workload is related to audit and disclosure issues. Under this reading, the resulting "distraction" is exactly what was intended; transparency, for the benefit of audiences well beyond the company's current shareholders, becomes a social priority. The slightly more subtle message is that independent directors are also to be conduits for the public's voice in the corporation's governance, especially on matters that might put key stakeholders at risk.

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118. SEC Schedule 14A, Item 7, *available at* http://www.sec.gov/about/forms/sched14a.pdf#search=%22schedule%2014a%22.

119. See Williams & Conley, *supra* note 49, on this "third way" generally.

120. *See* Sale, *supra* note 58. Jeffrey Gordon's work on independent directors suggests that over the last few decades, their dominant role has been to connect internal corporate governance to external stock price signals under conditions that increasingly make stock prices more informed (and hence informative). Jeffrey N. Gordon, *Independent Directors and Stock Market Prices: The New Corporate Governance Paradigm* (Eur. Corp. Governance Inst. Working Paper No. 74/2006, 2006), *available at* http://ssrn.com/abstract=928100. At the same time, he suggests that independent directors can more easily be mobilized to seek greater stock price accuracy and better compliance with law. My claim here is not inconsistent with this, but emphasizes that SOX may be pulling directors away from single-minded attention to shareholder wealth maximization and hence introducing more role conflict than was previously present.

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The implementation of SOX is not the first time outside directors have been asked to play a more public-regarding role, and prior efforts were beaten back.[121] So why would now be any different? SOX does not explicitly require independent directors to do anything more than attend to new tasks, which may mean relatively little without accountability mechanisms to motivate independent directors to pay them more than lip service. After all, neither dominant interest—managers or investors—will acquiesce in more public accountability without external pressure. Managers are adept at lip service and can presumably seek out directors who are just as gifted.[122]

But I think that the set of interests just described can, under the right circumstances, exert pressure in a way that will generate increasing role conflict for independent directors and gradually lead to some redefinition. Accountants and (to a lesser extent) lawyers have an interest, as we have seen, in having independent directors who will advocate for more attention and resources for internal controls, compliance, and other process and transparency-oriented efforts. They will use their expertise over "what the law requires" to get directors' attention and support. As they interact directly and more frequently with the independent directors, as SOX insists, they will repeatedly push this message, muting managements' efforts to control their attention. If, as early evidence suggests, managers feel compelled to bring more lawyers and accountants (or former regulators or other government officials) onto their boards to respond to SOX, this diffusion of control mechanisms will likely be hastened.

The regulators may well aid this diffusion, intentionally or not. As I have suggested, we can expect caution from the regulators in SOX enforcement. And in its role as "investor's champion," the SEC should in theory be hesitant to distract from wealth maximization and risk-taking as governance goals. But as critics have rightly pointed out, bureaucratic incentives are asymmetric—there is pressure to intervene when risk-taking goes bad and causes losses, but no offsetting incentive to reward when risk-taking goes well.[123] The SEC, in other words, has a natural precautionary bias. Even a moderate post-SOX enforcement program is likely to send cautionary signals regarding independent directors' duties, which accountants and lawyers will then amplify.

The media may turn out to be an even more powerful agent in helping turn independent directors into public directors. Putting aside legal accountability, there is now greater reputational risk associated with being a director when things go wrong if, in hindsight, appropriate SOX procedures were not

121. For varying perspectives on the efforts in the 1970s to alter the role of the outside director, see Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982); Karmel, *supra* note 61. That neither regulators nor courts have been inclined to impose liability on outside directors for breaching their duties has plainly softened the effort to conscript directors in any particular direction. *See generally* Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006).

122. *See supra* note 73.

123. *See* Pritchard, *supra* note 3; Stephen S. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 35 (2003).

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followed or red flags were ignored.[124] To the extent that corporate accountability resonates with broad societal (and investor) expectations, the press is unlikely to go easy on elites on corporate boards tainted with scandal, imagined or real. Elites' sensitivity to criticism is high, and as the risk of bad press from SOX deficiencies grows, so does the precautionary pressure. Simply as an illustration of this extra-legal pressure to conform, I would note how frequently boards of non-profit institutions are now called to account when problems arise from not having "SOX-type" governance mechanisms such as good audit practices, independent trustees, and the like.[125] Of course, the bulk of SOX does not apply to non-profits at all, yet such boards have discovered that in the public's mind—or at least the media's—it really does.

For these reasons, I think it is at least plausible that SOX will be a proximate cause for a gradual redefinition of the director's role.[126] To be sure, these effects would probably occur even without SOX, but SOX's legally-enforceable mandates both hasten and constrain the institutional responses to shifting pressures. Changes in the law cause cognitive dislocation, forcing actors out of old habits and prompting them to renegotiate their status and responsibilities.[127] To be clear, I am not predicting a complete shift—the power exerted by executives and wealth-oriented shareholders is too strong, and there is ample room for symbolic rather than real attention to accountability pressures. I leave as an open question where the balance will be struck, but strongly suspect that norms will settle someplace other than where executives or investors would prefer. Transparency can never be confined to the investors' gaze, and accountability takes place in multiple forums: outside the company in courts, elections, and public opinion; inside the company in board compensation and retention as well as employee attitudes and morale. The ability to persuade an audience that concealed risk-taking or misbehavior actually had a positive expected value for investors is minimal in most of these forums, regardless of whether it is true. If so, SOX's institutional infrastructure will more and more prompt directors to act as speed bumps, thereby constraining enterprise risk.

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124. *See* Floyd Norris, *A Heavyweight Board, Light on the Supervision*, N.Y. TIMES, Sept. 1, 2004, at C1 (criticizing the Hollinger board, with reference to SOX's internal controls requirements). *But see* Floyd Norris, *Atmel's Mess: You're Fired. No, You Are*, N.Y. TIMES, Aug. 11, 2006, at C1 (crediting Atmel's independent directors and crediting SOX reforms for enabling the activism).

125. For a discussion of non-profit governance post-SOX, see Lumen N. Mulligan, *What's Good For the Goose is Not Good For the Gander: Sarbanes-Oxley-Style Nonprofit Reforms*, 105 MICH. L. REV. 1981 (2007); Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. DAVIS L. REV. 205 (2004) (describing state attorney general efforts to impose SOX standards as matters of fiduciary responsibility).

126. One might add here that public and labor sector institutional investors might well become part of the pressure toward "publicization." *See supra* text accompanying note 79.

127. *See* Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1161 (2003); Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, J. APP. CORP. FIN. 8, 19 (2002).

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V. Small Issuers, Foreign Issuers, and U.S. Competitiveness

The discussion just concluded raises the strongest practical criticisms of SOX. It is causing small issuers to suffer disproportionately and, in many cases, to exit the public company regime;[128] it deters foreign issuers from cross-listing in the United States or otherwise seeking capital from American investors;[129] it puts U.S. companies at a competitive disadvantage vis-à-vis less encumbered foreign counterparts; and it encourages regulatory arbitrage in the structuring of multinational businesses.[130] Critics of SOX would no doubt react to the idea of SOX as a public law construct by saying such an interpretation would just make this worse.

There is little doubt that SOX was written with companies (and externalities) the size of Enron and WorldCom in mind. Small issuers' compliance costs are relatively larger as a percentage of assets or market capitalization. Linck et al. also show that the cost of attracting and retaining outside directors has increased markedly post-SOX for smaller issuers.[131] The question, then, is the return on investment for SOX compliance, on which there is no compelling data. We do run into the problem that smaller issuers are more susceptible to fraud and manipulation than larger issuers, because their trading markets are thinner and less sophisticated (i.e., less institutional shareholding and analyst monitoring) and because reputational intermediaries such as high-end investment banks and law firms are out of their reach. We might thus expect significant benefits from strict SOX compliance for smaller companies.[132] But even these could be outweighed by the costs, and I suspect they often are.[133]

The critics' evidence here is largely the increasing number of smaller issuers going dark or going private (i.e., deregistering as public companies under the Securities Exchange Act, if not cashing out their public shareholders entirely), which proves the inefficiency of SOX's mandates on these companies. In standard economic theory, this is right: a change in regulation should not lead to exit if the regulation is valued by investors. The cost of capital goes down, making it more attractive to be a public company, not less. That, however, assumes the market is relatively efficient, which is not necessarily true for the smallest companies. An alternative hypothesis is that company insiders value the private benefits of control lost under SOX,

128. *See* Carney, *supra* note 39.

129. *E.g.*, Butler & Ribstein, *supra* note 8, at 71–73.

130. *Id.* at 74.

131. *See* Linck et al., *supra* note 35.

132. Disclosure of material weakness in internal controls is relatively more frequent for smaller issuers. *See* Weili Ge & Sarah McVay, *The Disclosure of Material Weaknesses in Internal Control after the Sarbanes-Oxley Act*, 19 Acct. Horizons 137 (2005).

133. *See* Paul Rose, *Balancing Public Market Benefits and Burdens for Smaller Companies Post Sarbanes-Oxley*, 41 Willamette L. Rev. 707 (2005).

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which they regain by a going-private or going-dark transaction of dubious fairness.[134]

The SEC has shown prompt sensitivity to this question, so some cost reductions are forthcoming. Otherwise, the question devolves into one that the SEC wrestles with repeatedly in the so-called microcap market: what is the right balance for investor protection in settings where other institutional constraints are absent, making regulation particularly costly? Although there are many possible answers (the analysis of which is well beyond the scope of this paper), one is to chill public investment in marginal companies by imposing regulatory costs,[135] thereby forcing such companies to find capital through more sophisticated, less regulated private markets. In some sense, the post-SOX exit of some of the smallest companies may be little more than that, and it is no severe cause for public policy alarm except with respect to the fairness of the transaction that takes the company private.

We might add a comment about the "public" interpretation of SOX. If this interpretation is indeed emerging, there is further reason to expect regulatory burdens on smaller businesses to be lightened. Employment and other effects from small issuer activity are cumulatively significant, but on an individual basis the spillover effects from a single scandal are small and localized. Sustained media attention is unlikely. SOX is concerned with large-scale concentrations of economic power and wealth in managerial hands, where the social consequences of failure are greater. Assuming this, there will be relatively less resistance to interpretations of SOX that deregulate the smaller company.

We can say almost the same thing about foreign issuers. Because externalities from a foreign issuer scandal are felt mainly abroad, the U.S. public is less likely to demand the same transparency and accountability from foreign issuers as from large public companies here. So far as the investor protection goal is concerned, we confront a jurisdictional issue well beyond SOX: what to do when capital markets become sufficiently global that the location of a trading venue becomes arbitrary and basing regulation on trading location becomes impracticable. One might try to wall off U.S. investors from stocks that are not adequately regulated, but that is unlikely to maintain U.S. competitiveness in providing financial services. In the long run, the biggest threat to SOX's meaning and interpretation is the impossibility of imposing it worldwide, so that it will always be susceptible to challenge by countries and cultures that embrace some different vision of corporate governance and transparency. My sense is that Wall Street, at least, will make

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134. *See* Christian Leuz et al., *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations* (Am. Fin. Ass'n 2006 Boston Meetings Paper), *available at* http://www.ssrn.com/abstract=592421 (documenting a large negative abnormal return to going dark transactions). Smaller companies are most likely to exit. *See* Ehud Kamar et al., *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* (U.S.C. Ctr. in Law, Econ. & Org., Research Paper No. C06-5, 2006), *available at* http://www.ssrn.com/abstract=901769.

135. This is evident in the SEC's penny stock rules, making it harder to solicit investor interest with respect to the smallest companies. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1049–50 (5th ed. 2006).

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sure the SEC remains aware of the risk to the domestic financial services industry and that SOX enforcement will be moderated as a result, especially with respect to foreign issuers. But again, the resolution of SOX issues will be subsumed in much bigger debates about the future of transnational securities regulation.

That, in turn, brings us to the opposite side of the coin, the impact of SOX on the world-wide competitiveness of U.S. companies. That, too, is an issue frequently raised by critics. Assuming large foreign companies can escape SOX-type obligations, do they gain an advantage over domestic firms as a result? The impact could come either from compliance costs themselves (which would probably be material only for smaller companies) or from something like a reduced appetite for risk because of increased transparency and accountability to a broader set of constituents. Here again we should remember that the SEC is likely to adopt a relatively moderate course on SOX enforcement because of the compromise of interests noted earlier, and be sensitive to the small issuer concerns. So we shouldn't overstate the fear. Furthermore, companies in most foreign countries face greater public-regarding pressures to avoid risk (albeit through very different governance mechanisms, often including partial state ownership or control).[136] The United States/United Kingdom-style firms' entrepreneurial freedom has been seen as their competitive advantage. However much SOX may be gradually dampening the enterprise risk appetite, it is probably better to say that its effect has been, at most, to bring U.S. firms slightly closer to the international norm—a small, counterintuitive illustration of transnational convergence in corporate governance.

Conclusion

SOX is still a work in progress; it may eventually do much or little, for good or ill. My aim here has been less to make that assessment than to describe the processes by which its meaning will evolve and the interests that will be influential in that social construction. The better we understand these interests, the more we see that compromise is more likely to triumph than either the critics' hostility or the enthusiasts' cheerleading. For that reason, I find myself fairly ambivalent about SOX's ultimate impact.

This point about compromise echoes what we know about the diffusion of other legal innovations. Employment discrimination has been well studied and offers some interesting comparative insights for corporate scholars.[137] In the aftermath of Title VII, employers redesigned internal hiring and promotion structures, instituted training programs, and put grievance procedures into place. Yet many responses were more symbolic

136. *See, e.g.*, Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 Stan. L. Rev. 539 (2000).

137. *See generally* Lauren B. Edelman et al., *The Endogeneity of Legal Regulation: Grievance Procedures as Rational Myth*, 105 Am. J. Soc. 406 (1999); Lauren B. Edelman & Mark C. Suchman, *The Legal Environments of Organizations*, 23 Ann. Rev. Soc. 479, 495–99 (1997).

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than real, leaving in place a sizable amount of managerial autonomy over human resource decisions that allow efficiency-justifications (and perhaps a lingering "taste" for discrimination) to displace fair employment practices.[138]

Second-level effects also took root. Once placed inside the organization, human resource officers and grievance examiners developed a distinct professional identity to make sense of what they were doing, and began bargaining for more resources by construing the law more expansively.[139] In turn, their activities were visible to company employees and others, and so raised internal expectations about fair hiring practices. These expectations were bolstered, of course, by evolving social norms about discrimination and workplace fairness—in many ways, the human resource professionals were portals for the diffusion of external social norms inside the firm. In turn, the resulting organizational practices took on a normative dimension, as courts took note of what was established practice. Gradually and grudgingly, compliance became more embedded, if still far from the hoped-for goal.

SOX is different in many ways, of course, but I think there will be common threads to the stories. Enhanced independent director responsibilities, more expansive external audits, and pervasive internal controls all have the capacity to be symbolic rather than real. Managers will try to capture control of them to reduce their potency—in good faith, probably, extolling trust and nimbleness over formal routines, paperwork, and other distractions from the bottom line. But SOX places new independent directors, auditors, and lawyers, as well as new cadres of internal audit and compliance professionals, in places they did not inhabit before. To the extent that they see an adversarial role as legitimate and important, they may gradually develop a more distinct professional identity, too, and from their new outposts, cause expectations about adherence by management to norms of transparency and accountability to increase among employees, investors, and others. They probably also fear—if the SEC, PCAOB, and financial media are up to the task—that they may increasingly be called to account for their seemingly weak brain or spine if something goes wrong.

The way SOX is eventually understood will influence the extent to which this will be so. Though this understanding rests only partially in the hands of the SEC and PCAOB, their moderation—especially as applied to smaller companies—is essential to cabin too much rent seeking by lawyers, accountants, and others, which both hurts investors and invites a backlash that allows critics to undermine the statute and its origins. SOX's social construction will be a product of the interaction between choices now being made and events yet to come. From among competing stories, the winner will be the one that best comports with shifting economics of investor-

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138. *See* Devon W. Carbado & Mitu Gulati, *The Law and Economics of Critical Race Theory*, 112 YALE L.J. 1757 (2003) (book review); Donald C. Langevoort, *Overcoming Resistance to Diversity in the Executive Suite: Grease, Grit, and the Corporate Promotion Tournament*, 61 WASH. & LEE L. REV. 1615 (2004).

139. *See* Lauren B. Edelman et al., *Legal Ambiguity and the Politics of Compliance: Affirmative Action Officers' Dilemma*, 13 L. & POL'Y 73 (1991).

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manager relationships and social expectations about the obligations of private enterprise. Given the muddled nature of both the expectations and the economics, and assuming that future events are not too far out of the ordinary, my best guess is that SOX's impact on doing business will be a subtle "accountability creep," rather than a dramatic post-SOX epiphany, as part of a long-running narrative about the boundaries and norms of corporate governance in a world that both celebrates and worries about private economic power.

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