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MEMO: UPCOMING SUPREME COURT DECISION IN SARBANES-OXLEY CASE
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The following information was released by the Competitive Enterprise Institute:

by John Berlau

MEMO

TO: Friends of CEI

FROM: John Berlau, Director of CEI's Center for Entrepreneurs and Investors

DATE: June 15, 2010

SUBJECT: Upcoming Supreme Court decision in Sarbanes-Oxley case

The Supreme Court is expected to hand down its decision soon in a major case involving the massive and costly Sarbanes-Oxley Act of 2002, Free Enterprise Fund v. Public Company Accounting Oversight Board. The Court could issue its ruling as early as this Thursday, and will definitely hand it down by the end of June when its session closes.

The case, in which Competitive Enterprise Institute attorneys serve as co-counsel, mounts a constitutional challenge to the Public Company Accounting Oversight Board (PCAOB), the accounting regulatory body created by the law. We argue that the way in which the PCAOB board members are appointed violates the Appointments Clause of the U.S. Constitution. Namely, that PCAOB officers, who wield a great deal of regulatory power over businesses and industry-wide accounting practices, are "principal officers of the United States" who must be appointed by the President, with advice and consent of the Senate or by an agency head, as required by the Appointments Clause.

This requirement was intended by the Framers to instill a high level of accountability for officials who wield such vast powers. Although the PCAOB is a striking constitutional anomaly - a case of an independent agency (Securities and Exchange Commission) appointing an equally powerful independent agency - it's a case that will also potentially change, for the better, how other government officials and regulatory bodies are answerable to the American people.

The immediate impact of this case, if our challenge is upheld, will be on U.S. entrepreneurs and investors who have been impacted negatively by this law. This memo sets forth three main points on the importance of this case.

I. Sarbanes-Oxley (Sarbox, SOX) has permanently reduced the number of companies going public, permanently increased the size of companies going public, and had a permanent negative effect on job creation and economic growth.

Much of the early criticism of Sarbanes-Oxley -- hotly disputed by the law's defenders -- was that it was causing foreign firms to stop listing initial public offerings (IPOs) of their stock in the U.S., forcing them to go to London instead. A running joke attributed to London's socialist mayor Ken Livingstone and others is that London should build a statue of Senators Sarbanes and Oxley for bringing in so much business. The law's defenders insisted that this was the inevitable effect of foreign countries getting more competitive; however, this argument failed to answer the question as to why firms were choosing not to do dual listings in the U.S. and London, as they had in the past. Or why companies like British Airways and Air France were actually deregistering from U.S. exchanges. In fact, only one foreign airline, Ireland's Ryanair, is now listed in the U.S.

But more importantly, and often overlooked, is a fact not much in dispute: the absolute number of IPOs since Sarbox has decreased dramatically and never recovered.

According to a 2009 Renaissance Capital report, IPO issuance in 2008 and 2009 is lower than any period since the 1970s, when business creation struggled against inflation, high interest rates and the Vietnam War. Also, data compiled by Jay Ritter of the University of Florida show the number of U.S. IPOs was lower in every year after SOX was enacted in 2002 (2003 to present) than in every year of the decade from 1991 to 2000, including the early '90s recession years. For instance, in the post-SOX boom year of 2006, there were 162 U.S. IPOs. Yet in 1991, a year when the U.S. was mired in recession but did not have SOX, there were 295 U.S. IPOs.

The sheer size of companies going public has also increased, in large part because a company needs to be pretty big to afford the accounting costs that have shot up fourfold as a result of SOX, according to a summary of research in the Sarbanes-Oxley Compliance Journal. According to Business Week, the median market cap (as measured by number of shares times share price) for a company doing an IPO was $52 million in the mid-'90s. Today, it has shot up $227 million. Google had a $1 billion market cap when it went public in 2004. And Facebook still hasn't gone public, despite having an estimated market cap of nearly $10 billion. By contrast, in 1981, Home Depot went public with just four stores. Home Depot co-founder Bernie Marcus told Investor's Business Daily that his firm could never have gone public and raised money for growth had SOX been in effect.

This illustrates the devastating effect of the law in holding back present and future economic growth. Budding Home Depots and Microsofts can no longer go public to raise money for growth. They must wait until they are as big as Google to go public

to lock in their gains. But this lack of an ability to issue equity because of SOX means that firms are ever more dependent on financing through debt, especially difficult considering the current credit crunch.

No matter what kind of business an up-and-coming firm engages in -- whether it's oil drilling or "green tech" -- there are only two basic mechanisms they can use to raise capital to finance their growth: debt and equity. To expand their businesses with money they don't have, entrepreneurs can both borrow money from banks and issue bonds - debt transactions with contractual obligations to pay creditors a fixed amount on a certain date. Or they can issue shares of stock with no obligatory payouts but with an ownership interest in any future prosperity of the firm.

Recent studies have shown that debt and equity don't always move together, and can be substitutes, rather than compliments, as forms of financing. They also show that in some instances, equity issuance can even be countercyclical and increase during bad economic times. This fact gives hope that increased equity issuance could lessen the severity of a recession and get the economy back on its feet much sooner. But this will only happen if - and this is a crucial if -- there are not undue policy barriers to companies going public. Evidence suggests that we were able to recover more quickly from the early '90s recession because of an actual increase in companies -- from Starbucks to Cisco -- issuing IPOs. But SOX forecloses that possibility and makes for a longer recovery.

2. By enforcing Sarbox's mandates, the PCAOB has focused on trivial risks, not only driving up costs for companies, but missing the bigger picture such as the Lehman Brothers off-balance sheet accounting.

The PCAOB has stretched Sarbox's requirement that auditors "attest" to a company's internal controls over financial reporting in the law's Section 404 to require a full-blown audit of trivial items that could only remotely effect a financial statement. This has turned the law into the "Accountants Full Employment Act" and the reason the Big 4 accounting firms lobby so hard against even minor rollbacks in Congress, such as the exemption from Section 404 that passed in the House version of the financial regulation bill.

Under PCAOB Accounting Standard 2 (later revised as Accounting Standard 5), accountants had to scrupulously examine trivial items with little relevance to shareholders, such as who has the office keys and how many letters are in an employee passwords.

According to John Battelle's book The Search, considered a definitive history of Google Inc., Sarbox was "hell for a company like Google, which made its money literally pennies at a time, from millions upon millions of micro-transactions." Battelle reports that Sarbox compliance significantly delayed Google's IPO. "According to engineers involved in the work, Google had to significantly restructure its advertising report system from the ground up." If this was difficult for a company like Google, imagine what a burden it is to smaller companies.

The PCAOB's interpretations of Section 404 governing "internal controls" over auditing costs public companies $35 billion a year, according to the American Electronics Association. University of Rochester economist Ivy Zhang found that the law has cost the American economy $1.4 trillion in direct and indirect costs.

Almost as important is that Zhang and other researchers have found that Sarbox has had no quantifiable benefits in fighting fraud. The PCAOB has done little or nothing about telling accountants how to handle accounting for the off-balance sheet entities at issue in Enron that resurfaced with Lehman and other companies. Countrywide Financial, now charged by the SEC with accounting fraud, actually won an award for its Sarbox compliance from the Institute of Internal Auditors in 2007.

3. Despite widespread denunciation of phantom Bush-era deregulation, regulatory relief from Sarbox has widespread bipartisan support.

See the quotes from Nancy Pelosi, John Kerry, and others below. Also, 101 House Democrats voted for an amendment to the financial regulation bill to exempt smaller public companies from Sarbox internal control audits.

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