Blocking the Boards

SARBANES-OXLEY PREVENTS CORPORATE BOARDS FROM MAKING DECISIONS BASED ON SOLID BUSINESS PRINCIPLES.

The Sarbanes-Oxley Act of 2002 is the most controversial and consequential corporate legislation of our generation. New public company requirements have improved financial statement transparency and disclosure and reinvigorated board involvement. But is the societal cost too great?

The legislation has at least two major flaws. Philosophically disturbing are provisions stripping public company boards from exercising judgment in important substantive areas such as compensation by prohibiting executive loans. Economically counterproductive are compliance costs and disclosure obligations borne disproportionately by smaller public companies, discouraging promising companies from going or remaining public, thereby hindering capital formation.

Sarbanes-Oxley modified the composition, role, and authority of public company boards. While it emphasizes independence, the overwhelming negative consequences are defensive, inward-looking boards and increasingly adversarial relationships between companies and their accounting firms and directors.

The growing perception is that a board's primary function is to serve as the public's "watchdog." Watchdogs have value. But this emphasis corrodes valuable counseling aspects of director and accountant relationships with management. Companies are recruiting CFOs or public accountants as directors, individuals traditionally regarded as good at measuring profit but not at creating it. Have you ever heard an investor say, "Let's get a new CEO with a great accounting background to increase sales and maximize shareholder value"?

The conduct and role of directors are well defined by their fiduciary obligations, reasonable exercise of business judgment, and duties of "care" and "loyalty." To preserve integrity, directors must identify and disclose any self-interest or conflict. Corporate obligations take precedence over self-interest. Actions have to be "prudent," reflecting the same care directors would exercise in making decisions for themselves. The business judgment rule protects a "non-interested" director, exercising reasonable care and good-faith judgment, from liability, as well as promoting rational, fact-based, decision-making processes.

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Consider the impact the legislation has on an otherwise common corporate transaction. Public companies routinely provided executive loans in diverse circumstances. Business reasons ranged from compensation to employee relocation mortgages and indemnification and litigation defense costs — all activities that private companies are permitted to take.

Before Sarbanes-Oxley, a public company board's obligation was to approve or reject a loan based on exercising business judgment. If material, the company would publicly disclose the transaction. Congress could have concluded that executive loans have so much potential for abuse that they are intrinsically material and require prompt disclosure regardless of size or purpose; an approach consistent with the SEC's historical function of creating vibrant marketplaces based on informed investment decisions.

Sarbanes-Oxley, however, prohibits

all loans to directors, executive officers, and management, regardless of purpose, amount, or business judgment.

The danger? If Sarbanes-Oxley represents good public policy, then Congress should further "protect" investors. Ban executive vacations in excess of six weeks. Ban salaries over $250,000. Prohibit other corporate actions and board decisions. By itself, eliminating loans is simply undesirable. As regulatory precedent, it's deeply disturbing. Why isn't more disclosure or better enforcement (or both) the answer rather than the congressional elimination of business judgment?

Prohibiting executive loans and minimizing a board's freedom to analyze and act will not restore investor confidence. What will is profitable, growing companies creating shareholder wealth.

Sophisticated investors value strong boards with diverse and complementary skill sets. There is a delicate tension between directors, who must engage in constructive challenge and constraint, and members of management, who have to execute difficult decisions and maintain strategic focus. Independence has a value; but so does competence. Financial statement understanding is an important skill, but it's only one skill. To prosper, companies need boards with technology savvy, global awareness, and backgrounds in sales, operations, and human resources.

Great boards seek profitability, emphasize sales and growth, analyze risk, and measure and reward success. They make judgment-based decisions through thoughtful processes reflecting undivided loyalty to the corporation. Their skills balance each other's. Board dynamics and interpersonal relationships are productive. Their decisions aren't always going to be right. But if investors want equity returns, then they should demand reform that encourages directors to take proportionate equity risks. You cannot take judgment out of business any more than you can out of life.

Sarbanes-Oxley also grossly inadequately distinguishes between the obligations and compliance costs of issuers of vastly different sizes and human and capital resources. The SEC opined that the "informational needs of investors in small entities are typically as great as the needs of investors in larger companies" but ignored the reality that costs may be equally great, and therefore unbearable. More than 80 percent of public companies are smaller issuers who are entitled to a regulatory environment that is neither operationally crippling nor financially prohibitive. Recent SEC comments have suggested that the SEC is receptive to modifications that "recalibrate" regulations for smaller companies. The statement is too timid and the acknowledgement of the problem inadequate.

The pendulum has swung too far. Risk-averse boards, stripped of decision-making capacity, cannot fulfill their fiduciary obligations. Investors need a reaffirmation not just of a board's right, but rather its obligation, to exercise reasonable business judgments on all corporate governance issues. SEC rules and costs must be significantly reduced so that smaller public companies can operate profitably.

The time for reform, not recalibration, is now.

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