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## **SOXing It to the Little Guy**

**How Sarbanes-Oxley Hurts Small Investors *and* Entrepreneurs**

**By John Berlau\***

Remember 1982, when video games, personal computers, and cordless phones were new—and the companies that made these products were new? If investors could travel back in time, some of them would have fun playing Pac-Man again, but all would love to load up on some of the many great stock bargains around then.

For instance, a new company called Apple Inc. had listed on the Nasdaq stock market in 1980. In 1982, its Apple II personal computer was catching on in offices and even in some homes. But skeptics were saying that computers were changing so fast that this product would soon be overtaken. It certainly was in a few years—by one of Apple's new products: the Macintosh, soon to become known simply as the Mac. And who would have thought that 25 years later Apple's iPod would displace Sony's Walkman as the leading portable music player?

Then there was a regional discount store chain that hadn't yet caught the eye of most brokerage houses and analysts, even though the company had been founded in 1962 and had gone public in 1970. Operating in 14 states, mostly in the South, Wal-Mart Stores Inc. was selling for \$50 per share after its fifth stock split in June 1982. An investment of less than \$5,000 in 1982 would be worth more than \$300,000 today.

And if you didn't bring that much cash aboard the time machine and really wanted some bang for your buck, you could buy the stock of another retailer that had just listed on Nasdaq with little fanfare and whose first store opened only three years earlier. When it

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went public in 1981, in had only four stores to its name. Yet if you had bought 100 shares of this stock the next year, by 2002 your holdings would be worth \$1.6 million.<sup>1</sup> With that chunk of change, you could get a big house when you came back to the future—and fill it with furnishings from Home Depot, the company whose stock had made you so rich.

**Finding Hidden Gems in 2007.** Of course, there are no time machines—at least none yet made by companies that have attracted venture capital. But, in a sense, investors do go “back in time” when they study the histories of Apple, Wal-Mart and Home Depot to find the superstars of the future, what the investor site Motley Fool calls “hidden gems.”

It’s true that, as Motley Fool columnist John Reeves puts it, “for every superstar stock out there, there are dozens of clunkers.”<sup>2</sup> Careful investors are aware of the risks, and still want to take the chance.

But now, a law is robbing investors of their rights to place their money in stocks that carry risk but also have potential for great returns. This law’s prescriptive mandates are making it more difficult for companies of the size that Home Depot, or even Wal-Mart, were in 1982 to raise money in America’s public capital markets. Even if someone were to come back from the future to 2007 with stock market data through 2032, he just might come up empty-handed if looking for growth companies with the successful returns for investors of Wal-Mart and Home Depot.

Why? Because of the Sarbanes-Oxley Act of 2002. Substantial evidence shows that the law, which was intended to protect investors from corporate abuses, is hindering honest firms’ ability to raise capital and the average investor’s capacity to grow wealth. Enacted after major corporate scandals, the law increases penalties for fraud, but it also contains many mandates that unduly restrict legitimate entrepreneurs.

Section 404 forces auditors and executives to sign off not only on the accuracy of a company’s financial statements, but also on its “internal controls,” a vague term which the law does not define. 404 has turned out to be the law’s most costly provision, but contrary to some accounts, is far from the law’s only problem. In Section 301, Sarbox also mandates the one-size-fits-all requirements that only “independent” directors sit on companies’ audit committees, intruding on the cohesiveness and efficiency of different types of boards. And Section 201 prohibits a company’s auditor from performing any other services for the firm, which has caused costly duplication of many accounting tasks.<sup>3</sup>

As a result of these costly rules, it is highly unlikely that today a retailer in Home Depot’s position in 1982 would be able to afford the cost of going public. As Home Depot co-founder Bernie Marcus told *Investor’s Business Daily* last year: “I honestly don’t believe we could...start the Home Depot in today’s legal and regulatory climate.” He worries that today’s public companies “can’t make a decision without a lawyer on one side of you and an accountant on the other side.”<sup>4</sup>

**Sarbox Hits Investors.** Investors should be worried, too. An individual investor cannot build wealth with a company if it doesn't list in a public market while it's growing. Emerging growth companies are also an important part of diversified portfolios. Yet more and more companies are bypassing the markets during their initial growth stages.

Rushed through Congress in the summer of 2002, Sarbanes-Oxley sailed through Congress when members wanted to show they were "doing something" about corporate scandals after the Enron and WorldCom bankruptcies. It passed the Senate unanimously, with only three House Members—Reps. Ron Paul (R-TX), Jeff Flake (R-Ariz.), and Mac Collins (R-Ga.)—voting against it.

But now members of both parties say that the law has had some destructive effects. House Speaker Nancy Pelosi (D-Calif.) said on CNBC last fall that the law has had "unintended consequences."<sup>5</sup> Accountants are scrutinizing items, such as employee passwords for office computers, that have little—if anything—to do with the accuracy of financial statements. Broad rules barring conflict of interest prohibit accountants from giving even simple tax advice to the firms they audit. Qualified people are discouraged from serving on boards of directors. And in terms of costs as a share of revenues, the biggest loads are on smaller companies, Congress's Government Accountability Office has found.<sup>6</sup>

As a result, these companies do not have the same access to the public capital markets that Wal-Mart and Home Depot did in their early years. And individual investors do not have the same opportunity to build wealth with them.

"For most entrepreneurs, the initial public offering used to be the ultimate sign of success," noted an article in *Business Week*.<sup>7</sup> But now, "the increased costs of being public are forcing more entrepreneurs to think at least twice before going that route." According to *Business Week*, in the mid-1990s the median market cap of a company going public was \$52 million. Today, it's \$227 million.<sup>8</sup> This means that average investors are now often shut out of the company's growth to the \$200 million mark.

Some argue that the dearth of initial public offerings and the increase in companies going private is caused not by Sarbanes-Oxley but by the emergence of private equity. This argument is largely circular. Private equity, which used to be utilized primarily for distressed firms, has become an option for growing companies in large part because Sarbox has made going and staying public so expensive. *The Sarbanes-Oxley Compliance Journal* reported recently that "the consensus is that it is roughly four times as expensive to go public today."<sup>9</sup> (That Sarbox compliance would even merit its own journal, as well as several guidebooks, speaks volumes of the law's onerous nature.)

**Big Costs, Little Benefit.** In fact, the total annual costs for all public companies to comply with just the "internal controls" section of Sarbanes-Oxley is \$35 billion per year, according to the American Electronics Association.<sup>10</sup> And money isn't the only cost. A single average public company also devotes 30,700 man-hours to compliance each year.<sup>11</sup>

That is money and time that could be devoted to developing new products, new businesses, and new jobs.

At the same time, researchers are finding very little benefit for investors to justify these enormous costs. In an extensive study of stock prices, University of Rochester economist Ivy Zhang found no quantifiable data to back up the claim that the law has boosted investor confidence.<sup>12</sup> The anti-fraud laws under which Enron and WorldCom executives were convicted existed *prior* to Sarbanes Oxley's enactment. And the law did little to address the real problems of modern accounting statements in using an old system to measure complex modern financial transactions.

The biggest evidence of Sarbox's negative effects, in addition to large companies being bought out by private equity investors, is the number of companies delisting or "going dark." Wharton School economist Christian Leuz found that the number of companies voluntarily delisting from U.S. markets tripled after Sarbox's enactment.<sup>13</sup> Reputable, profitable companies such as animal feed maker Scope Industries and steel tubing supplier Webco left the American Stock Exchange because of Sarbox.<sup>14</sup> They now list on the Pink Sheets venue with "penny stocks" of questionable merit. A profitable company delisting from a stock exchange was virtually unheard of before Sarbox.

**Major Reform Needed.** Unfortunately, while many recognize that Sarbox is a problem, few realize the extent of it. President Bush recently said that the problem is one of implementation and that the law doesn't need to be overhauled, but "fine-tuned."<sup>15</sup>

House Speaker Pelosi seemed to have a better grasp when she expressed a position—surprisingly—slightly to the right of Bush. She has said, "I don't think you need the whole [Sarbox] package." Like the USA PATRIOT Act after 9/11, Sarbox was rushed through Congress and deserves a second look. A few things definitely need to go. One is the requirement that has turned out to be the biggest cost: the audits of a firm's "internal controls" as well its numbers. "Internal controls" have been defined so broadly by regulators and accountants that they have come to encompass things of little relevance to shareholders such as policies for office keys and employee passwords.

The requirement for "independent" directors for audit committees has blocked large shareholders such as venture capitalists from serving on these committees, even if they are not a part of management. But large shareholders are frequently the ones with both the incentive and expertise to keep a sharp eye on company management for the benefit of all shareholders.

The strict ban on auditors performing consulting services should also be tossed. It is especially difficult for small firms to hire several different accounting firms for all their needs. Conflict of interest should be scrutinized, but often it is impractical to avoid it. Doctors have conflicts of interest if they both perform surgery and diagnose patients for surgery referral. Yet until they prove otherwise, we trust doctors because they are in the best position to know what surgery is needed and to perform the needed operation.

**What's Best for Investors?** In the absence of these reforms, or even with them, the best reform to be enacted may be the creation of a venue in which Sarbox and other Securities and Exchange Commission regulations do not apply. This subdivision would be similar to the London Stock Exchange's lightly regulated Alternative Investment Market. Companies in this venue would still be punished for defrauding investors, but investors would be able to choose how many preexisting rules are necessary. If investors favored Sarbox and other rules, they would simply avoid this venue. But I suspect many investors would agree with Motley Fool adviser and columnist Bill Mann:

Naturally, investors want sufficient information to be able to make informed decisions about the companies they own. But if the burden is so great on companies that the 'next Microsoft' is leaving the public exchange rather than expending resources to meet them, that's not necessarily a good outcome.<sup>16</sup>

## Notes

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<sup>1</sup> Calculations by author.

<sup>2</sup> John Reeves, "Discovering the Next Starbucks," *The Motley Fool*, Feb. 3, 2007, <http://www.fool.com/investing/high-growth/2007/02/03/discovering-the-next-starbucks.aspx>

<sup>3</sup> Public Law 107-204, 116 Stat. 745, encodified at 15 U.S.C 7211.

<sup>4</sup> "The Home Depot's Bernie Marcus On Why He Couldn't Do It Today," *Investor's Business Daily*, Jan. 30, 2006, available at

<http://www.legalreforminthenews.com/Reports/IBD%20Bernie%20Marcus%20Interview%201-30-06.pdf>

<sup>5</sup> Transcript of "Kudlow & Company," *CNBC*, Oct. 24, 2006.

<sup>6</sup> "Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies," *GAO 06-361*, Apr. 13, 2006, <http://www.gao.gov/new.items/d06361.pdf>

<sup>7</sup> Jeremy Quittner, "Private Matters," *Business Week Small Biz*, Fall 2004, [http://businessweek.com/magazine/content/04\\_44/b3906607.htm](http://businessweek.com/magazine/content/04_44/b3906607.htm)

<sup>8</sup> *Ibid.*

<sup>9</sup> Thomas Austin, "Successful Private Companies Turning to Alternative Investment Strategies," *Sarbanes-Oxley Compliance Journal*, Jan. 12, 2007, <http://www.s-ox.com/news/detail.cfm?articleID=2248>

<sup>10</sup> "Sarbanes-Oxley Section 404: The 'Section' of Unintended Consequences and Its Impact on Small Businesses," American Electronics Association paper, February 2005, <http://www.aeanet.org/soxreport>

<sup>11</sup> Michael Arndt, "Accounting's Beautiful Losers," *Business Week*, Nov. 10, 2004, [http://www.businessweek.com/bwdaily/dnflash/nov2004/nf20041110\\_0586\\_db038.htm](http://www.businessweek.com/bwdaily/dnflash/nov2004/nf20041110_0586_db038.htm)

<sup>12</sup> Ivy Xiyang Zhang, "Economic Consequences of the Sarbanes-Oxley Act of 2002," AEI-Brookings Joint Center for Regulatory Studies paper, June 2005, <http://www.aei.brookings.org/admin/authorpdfs/page.php?id=1154>

<sup>13</sup> Christian Leuz et al., "Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations," Wharton School research paper, November 2004, <http://knowledge.wharton.upenn.edu/papers/1285.pdf>

<sup>14</sup> Kate Berry, "Low Price Listing," *Los Angeles Business Journal*, Apr. 19, 2004, available at [http://calbears.findarticles.com/p/articles/mi\\_m5072/is\\_16\\_26/ai\\_n6015482](http://calbears.findarticles.com/p/articles/mi_m5072/is_16_26/ai_n6015482); Don Mecoy, "Steel Tubing Manufacturing Company Webco Examines Reverse Stock Split Plan," *Daily Oklahoman*, June 3, 2004, [http://www.amex.com/?href=/newsDetails/CmnNewsDet.jsp?id=XpressFeed\\_NewsDetails\\_1086291956543.html](http://www.amex.com/?href=/newsDetails/CmnNewsDet.jsp?id=XpressFeed_NewsDetails_1086291956543.html)

<sup>15</sup> Greg Robb, "Bush Supports Plans to 'Fine Tune' Sarbanes-Oxley Act," *MarketWatch*, Oct. 23, 2006, <http://www.marketwatch.com/News/Story/Story.aspx?dist=newsfinder&siteid=google&guid={E160D840-1325-45E9-B2EC-9AE364AEF84D}>

<sup>16</sup> Bill Mann, "Your Ownership Is Revoked," *The Motley Fool*, Aug. 4, 2004, <http://www.fool.com/investing/general/2004/08/04/your-ownership-is-revoked.aspx>