

**THE IMPACT OF SARBANES-OXLEY
ON MID-CAP ISSUERS**

**Marc Morgenstern
Peter Nealis
*Kahn Kleinman, LPA***

**Copyright © 2004
Marc Morgenstern and Peter Nealis
Portions of this article may be used for
other programs and publications.**

Table of Contents

I. *INTRODUCTION*. 1

II. *THE PERCEIVED BENEFITS OF BEING PUBLIC*. 4

III. *COSTS OF BEING PUBLIC AFTER SARBANES-OXLEY*. 5

IV. *STAGGERED COMPLIANCE DEADLINES--LEVELING THE PLAYING FIELD?* 10

V. *DISPROPORTIONATE COSTS OF SARBANES-OXLEY TO SMALLER ISSUERS*. 14

VI. *PRIVATE COMPANIES: THE INDIRECT COSTS*. 16

VII. *CONCLUSION*. 18

Tables

Table 1: Comparison of Compliance Obligations of Different-size Issuers 12

Table 2: Annual Costs of Sarbanes-Oxley Compliance 15

THE IMPACT OF SARBANES-OXLEY ON MID-CAP ISSUERS

Marc Morgenstern
Peter Nealis*

Kahn Kleinman, LPA

I. INTRODUCTION.

The Sarbanes-Oxley Act of 2002 (the “Act” or “Sarbanes-Oxley”)¹ and its implementing regulations have significantly increased the costs and regulatory burdens associated with being a public company. The stated (and arguably well-intentioned) goal of the Act was to restore investor confidence in the public marketplace after the emotional and financial devastation stemming from Enron and other public company scandals.² The outrageous executive and board conduct that triggered Sarbanes-Oxley violated numerous federal corporate and securities statutes. Vigorous civil and criminal enforcement of the wrong-doing could have occurred and (more importantly) should have occurred. It remains a fair question, therefore, whether the Act was the appropriate legislative response and whether it can achieve its self-enunciated goal.³

*Mr. Morgenstern (morgenstern@kahnkleinman.com) is the Managing Partner of Kahn Kleinman, LPA (Cleveland, Ohio). Mr. Morgenstern has served on the Executive Committee of the SEC’s Small Business Capital Formation Forum for more than 20 years. Mr. Nealis (pnealis@kahnkleinman.com) is an associate with Kahn Kleinman.

This article is dedicated to the life and memory of Mr. Morgenstern’s nephew, Peter Benjamin Morgenstern-Clarren (1981-2004), a gifted artist, musician, and linguist. The world is a lesser place without him.

Copyright © 2004 Marc Morgenstern and Peter Nealis. Portions of this article may be used for other programs and publications.

¹ P.L. 197-204, 116 Stat. 745 (codified at various sections of 11, 15, 18, 28, and 29 U.S.C.).

² *Id.* at Preamble (“An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws”).

³ See Foley Lardner LLP, *The Cost of Being Public in the Era of Sarbanes-Oxley* (May 19, 2004) (presentation at 2004 National Directors Institute) available at <http://www.foley.com> (last visited August 29, 2004) [hereinafter “Foley Lardner Study”] (reporting that 53% of executives surveyed believe the Act has not made investors more confident, and 56% believe the SEC has not been effective in enacting the regulations required by the Act); Anthony Lin, *One Year After Sarbanes-Oxley Act, Many Officers See Need, But Grumble Nonetheless*, NEW YORK LAW JOURNAL, Volume 230 (July 31, 2003) (reporting that “top executives and their lawyers are giving the government high marks for good intentions, but expressing frustration with the results”); *but see* Jim Quigley, *Sarbanes-Oxley One Year Later: Is it Working?* (September 8, 2003) available at <http://www.deloitte.com> (last visited June 19, 2004) (remarks before New America Foundation and stating “I am here to tell you that Sarbanes-Oxley is working”).

Improved investor confidence in the marketplace would presumably benefit all public issuers to some extent.⁴ The Act was not designed to (and does not) create benefits for any individual company. Overall, however, a reasonable observation is that large-cap companies most benefit from (and are dependent on) broad confidence and liquidity in the equity markets. By their nature and capital structure, such companies have a high percentage of institutional shareholders (such as pension funds and mutual funds) that are acutely sensitive to, and increasingly militant about, corporate governance. With limited exceptions,⁵ the Act does not distinguish between different-sized companies; large-cap, mid-cap, and small-cap are subject to the same compliance and disclosure rules.

Quantifiable Sarbanes-Oxley compliance costs have proven to be significantly higher than originally estimated by the Securities and Exchange Commission (“SEC” or the “Commission”). In addition, there are non-quantifiable (but nonetheless substantial) costs companies incur resulting from diversion of management time and focus.

Ultimately, the paramount question isn’t whether the Act accomplished some good. Clearly, it has re-invigorated board processes and in many ways improved financial statement

⁴ See Jesse Eisinger, *Corporate Regulation Must Be Working — There’s a Backlash*, THE WALL STREET JOURNAL (June 16, 2004), at 61 (“The absurd aspect of this backlash against [the Act] is that companies are finding out that tightening their internal controls is good for business.”).

⁵ See Part IV *infra*. One of the distinctions drawn by the SEC has been between “small-business issuers” and all other issuers. A “small-business issuer” is defined by the SEC to mean any entity that: (1) has annual revenues of less than \$25,000,000; (2) is a U.S. or Canadian issuer; (3) is not an investment company; and (4) if a majority-owned subsidiary, has a parent corporation that is also a small-business issuer. See 17 C.F.R. §228.10(a)(1) (emphasis added). An entity is not a small-business issuer if the aggregate market value of its outstanding equity securities held by non-affiliates is \$25,000,000 or more. *Id.* The definition of “small-business issuer” is extremely rigid, and appears to apply only to a relative handful of “family-controlled,” “pink sheet,” and other thinly traded stocks. Small-business issuers are such a limited class that they generally fall outside the scope of this Article, which focuses on small and mid-cap issuers. The disclosure requirements for small-business issuers are set forth in Regulation S-B, 17 C.F.R. §228.10 *et. seq.* Of the S-B rules requirements generally, which purport to (but do not) provide significant relief and lowered costs to small issuers, Richard Leisner from the Trenam Kemker law firm once trenchantly observed that “S-B is nothing more than S-K Lite.”

transparency and disclosure.⁶ The central question, however, for legislation is: (1) whether the imposed cost is proportional to the aggregate benefit, and (2) whether the scope of a statute is overbroad so that significant inequities are established for an identifiable subclass of the affected population.

The SEC has a difficult, sometimes conflicting, dual statutory mandate: protecting investors while simultaneously facilitating capital formation.⁷ The Commission has acknowledged its obligation to analyze the cost-benefit and also the anti-competitive impact of SEC-promulgated rules.⁸ Congress, unfortunately, is not subject to the same restraints. The emotionally-charged cauldron of political hysteria that created the Act has begun to subside. It is now necessary and appropriate to examine the Act's benefits, weigh them against the costs, and adjust and modify Sarbanes-Oxley based on actual experience.

An ongoing theme through the years has been the disproportional financial burden imposed on smaller issuers by compliance with the Securities Exchange Act of 1934 (the "Exchange Act") and other regulatory sources. As most lawyers, accountants, and companies know, it takes approximately the same amount of managerial involvement and professional costs to prepare a 10-Q or an 8-K for a \$10 billion issuer or a \$500 million company. A corporate Code of Ethics or Whistle Blower Policy is the same length, and requires the identical legal and

⁶ See *Eisinger, supra*; *Quigley, supra*; see also *Business Roundtable CEO Survey Shows Better Corporate Governance*, SECURITIES REGULATION AND LAW (March 15, 2004).

⁷ See The Small Business Investment Incentive Act of 1980, 15 U.S.C. § 775(c) (now contained in Section 19 of the Securities Act); see also Section 2(b) of the Securities Act, 15 U.S.C. §77(b)(b); Section 3(f) of the Exchange Act, 15 U.S.C. 78c(f); Section 2(c) of the Investment Company Act, 15 U.S.C. 80a-2(c). Section 23(a)(2) of the Exchange Act also requires the SEC to consider the anti-competitive effects of its rules. See 15 U.S.C. §78(W)(a)(2).

⁸ See SEC Release 33-8238, *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* (August 14, 2003) ("We are sensitive to the costs and benefits imposed by our rules, and we have considered the costs and benefits of our amendments.") Certain Sarbanes-Oxley related rules (such as the new off-balance sheet disclosure requirements) constitute "collections of information" within the meaning of the Paperwork Reduction Act of 1995. That Act requires the SEC to review the need for such collection as well as its estimated burden. See 44 U.S.C. §§3506, 3507.

business analysis, regardless of issuer size. Not surprisingly then, smaller issuers bear a disproportionate financial and time burden to comply with Sarbanes-Oxley compared to their larger public brethren.

Anecdotally, there seem to be two common reactions outside of the large-cap universe. First, issuers seek to minimize compliance costs through improved information technology or superior use of human capital, either internally or through outsourcing. Second, companies analyze whether the benefits of being public continue to justify the substantially increased aggregate financial, operational, and disclosure costs. More companies are considering withdrawing from the public marketplace since 2002.⁹ Numerous small and mid-cap public companies that have been sold since the passage of Sarbanes-Oxley have indicated in their Merger Proxy statements that increased compliance costs and the level of required disclosures were among the factors considered by their boards of directors in determining whether to sell the company.¹⁰ If there is a statutorily-induced exit of smaller public companies, and a reduced desire to go public, the Act is ultimately self-defeating.

II. THE PERCEIVED BENEFITS OF BEING PUBLIC.

A useful beginning to a cost-benefit analysis would be to re-examine why companies go public. What are the perceived benefits? Historically, the primary motivation for going public was to achieve liquidity¹¹ for certain investors, obtain “cheap” capital for the company, and create a non-cash currency (i.e. stock) for growth and acquisitions. Other common reasons

⁹ 21% of companies surveyed in one study considered going private or selling the company as a result of the Act. See Foley Lardner Study, at 10.

¹⁰ See, e.g., Definitive Merger Proxy Statements filed by Odd-Job Stores, Inc., Royal Appliance Mfg. Co., Rainbow Rentals, Inc., OfficeMax, Inc., and Cole National Corp.

¹¹ See Paul Castor and Christy Lomenzo Parker, *Going Private: Business and Procedural Considerations in Seeking Relief from Reporting and Corporate Governance Requirements*, at 2-3 (March, 2003) (copy on file with the authors).

include employee attraction and retention through the use of equity compensation plans¹², and enhanced corporate image and prestige. The primary cost of accessing the public marketplace was the transactional costs incurred in the initial public offering (“IPO”), compliance with the ongoing integrated disclosure requirements of the Exchange Act, and observance of the applicable rules for the self-regulatory organizations to which the issuer was subject, such as the New York Stock Exchange or Nasdaq (“SRO’s”).

Arguably, none of the benefits of being a public company are enhanced as a result of complying with the corporate governance and financial disclosure requirements of the Act.¹³ Sarbanes-Oxley costs must therefore be considered as if there were virtually no offsetting direct benefit to any individual issuer as contrasted with evaluating whether there are benefits to the marketplace as a whole.¹⁴ If issuer costs are increased, and benefits are not, then the cost/benefit ratio of being public has been unfavorably altered, at least from the perspective of each individual issuer.¹⁵

III. COSTS OF BEING PUBLIC AFTER SARBANES-OXLEY.

Sarbanes-Oxley represents an unprecedented incursion by the SEC and Congress into the substantive operational and corporate governance activities of public companies; conduct historically regulated by the states and the SRO’s. The Act mandates greater financial statement

¹² See Lisa Yoon, *Study: Stock Options Less an Option* (August 22, 2002) available at <http://www.cfo.com> (last visited June 27, 2004).

¹³ *Castor and Parker, supra*, at 2-3 (noting that many of the reasons for staying public are no longer appropriate in light of today’s economic and regulatory climate).

¹⁴ See Marc Morgenstern, *Sarbanes-Oxley; A Law of Unintended Consequences*, SMART BUSINESS NEWS (June 2004) (noting that there is no “offsetting revenue” associated with compliance with the Act).

¹⁵ Some companies looking to grow quickly and access public markets have used “reverse merger” transactions to merge into the shell of a non-operating public company. See Ellen C. Rosen, *An Often Risky Route for Going Public*, THE NEW YORK TIMES, at C7 (April 29, 2004). “If you do a reverse merger, however, you may have none of [the benefits of an IPO] but you walk straight into the Sarbanes-Oxley requirements, and the compliance costs can cost anything from \$500,000 to \$2 million annually.” *Id.* (quoting Marc Morgenstern).

transparency,¹⁶ markedly greater personal liability (civil and criminal) for chief executive and chief financial officers, and largely dictates the composition, role, and skill sets of the board of directors. This is at significant variance to the SEC's traditional emphasis on disclosure rather than corporate substance or conduct.

What is most jarring are provisions like Section 402 of the Act that prohibit all loans to directors and executive officers and management (regardless of purpose or amount).¹⁷ Loans are a component in an issuer's compensation approach. Loans of a certain minimum size or purpose have historically been identified by each company as being material enough to require board approval. Loans that are small enough and conceptually identifiable as a class (routine advances for travel and entertainment) may have been determined by a company as not requiring board approval. In the latter case, management must comply with appropriate internal processes in granting loans exempt from individual board approval.

The board's role is procedural and substantive. Loans should be authorized (or rejected) by the board exercising its reasonable business judgment. Corporate process should work so that loans requiring board approval or knowledge, based on the company's internal rules and corporate and SEC disclosure, are, in fact, approved or rejected – thereby fulfilling the board's substantive and oversight role. The SEC's role, by contrast, should focus on disclosure. The Commission must determine when, how quickly, with what level of detail, and in what format, issuers should disclose the existence of a loan and its corporate consequences. With material facts relating to a loan disclosed, informed investors can then determine whether they want to

¹⁶ Perhaps the major disclosure modification was the creation of the Off-Balance Sheet rules, that dramatically increased the integration of off-balance sheet liabilities into a public company's financial statements and disclosure documents, as well as requiring additional quantification of liabilities. SEC Release No. 33-8182, *Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations* (January 28, 2003). For a discussion of these complex rules, see Marc Morgenstern, *Off-Balance Sheet Disclosures in MD&A*, THE REVIEW OF SECURITIES and COMMODITIES REGULATION (January 28, 2004).

¹⁷ See 15 U.S.C. §78m(k)(1).

invest. What is deeply disturbing at a conceptual and philosophical level is that because of Sarbanes-Oxley, Congress and the SEC have directly regulated corporate conduct by restricting an issuer's substantive ability to choose how to compensate its employees. Congress might just as logically have prohibited public companies from granting six-week vacations to senior management because Congress believes it's "excessive."

Flat prohibition of loans has had mischievous consequences presumably in unintended ways. A prominent example is a widely-shared concern of companies advancing defense-costs to directors and officers pursuant to corporate charter and contractual obligations. These pre-existing obligations, relied on by directors and others in performance of their past duties, may not be enforceable if the advance is characterized as a loan.¹⁸ Routine loans made to employees for re-location costs are also now outlawed, putting public companies in high-cost housing states at a disadvantage to their private competitors when attracting out-of-state key employees.

In originally implementing the Act and its accompanying regulations, the SEC estimated the additional paperwork and compliance burdens of each initiative passed pursuant to the Act. The SEC's official view was that disclosure of "off-balance sheet arrangements" in Management's Discussion and Analysis would roughly translate into an increased annual cost to each issuer of \$10,000.¹⁹ Empirical data has shown the actual costs have been significantly higher. According to the Foley Lardner Study, the estimated average "cost of being public" for

¹⁸ In October, 2002, in an unusual display of professional solidarity and concern, several major national corporate law firms issued a position statement arguing that such advances should not be treated as personal loans. See *Sarbanes-Oxley Act – Interpretive Issues under §402 – Prohibition of Certain Insider Loans* (October 16, 2002 available at <http://www.ffhsj.com>) (last visited June 16, 2004).

¹⁹ See, e.g., SEC Release No. 33-8182, *Final Rule: Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations* (January 28, 2003) (basing its estimate upon the assumption that each company would require approximately 37 hours in company-personnel time per year to comply with the Act). This estimate was refuted by commentators, at least one of which estimated the annual cost for a large multinational company to be about \$2 million. *Id.* at note 169 (referencing a comment letter by Pfizer, Inc.).

fiscal year 2004 is \$2.86 million.²⁰ This is a \$1.62 million (or 130%) increase over the comparable costs for fiscal year 2001, prior to the 2002 enactment of the Act.²¹ Another survey estimates annual compliance costs as approximately \$740,000 to \$1 million, depending on company size.²²

Companies incur other, non-quantifiable, costs in addition to the direct personnel hours that served as the basis for the SEC's cost estimates:

- **Personal liability.** Through new substantive requirements, increased penalties, and an increased emphasis on enforcement, Sarbanes-Oxley enhanced the risk that corporate officers and directors will be subject to personal civil and criminal liability. Many corporate officers and directors are now too fearful of personal liability to take business actions with risks; potentially stifling innovation and progress.²³ An overly-cautious atmosphere of excessive risk-aversion has been created in public corporate board rooms.
- **Director and Officer's ("D&O") Insurance.** With increased responsibilities and accountability for directors and officers, D&O coverage has become more difficult to obtain and more expensive.²⁴
- **Director Compensation.** As required by the SEC, the SRO's have enacted new rules requiring that listed company boards and board committees consist of a specified number of "independent" directors.²⁵ The consequence is an increased demand for independent directors to sit on public company boards, especially former or current CFO's and accountants. Companies bear added cost in the form of increased director

²⁰ See Foley Lardner Study; see also Inc.com, *Sarbanes-Oxley Has Some Publics Thinking Private* (May 20, 2004), available at <http://www.inc.com/criticalnews/articles/200405/sarbanes.html> (last visited June 20, 2004). This is an increase of approximately 130% from the results of the survey for 2002, which showed an average cost of \$1.24 million. *Id.*

²¹ See Foley Lardner Study (observing an increase of approximately 130% in costs related to the Act from 2001 to 2004).

²² *The Costs of Complying with Governance Rules*, CORPORATE INSIGHT (Spring 2004), at 5 (citing to Wall Street Journal Article citing study by Financial Executives International).

²³ See Morgenstern, *Sarbanes-Oxley; A Law of Unintended Consequences*, *supra* ("This cautious environment minimizes risks rather than maximizing rewards."); Alix Nyberg, *Sticker Shock: The True Cost of Sarbanes-Oxley Compliance*, CFO, at 51 (September, 2003) available at <http://www.cfo.com> (last visited June 28, 2004) ("One CFO says that the growing threat of personal liability makes managers too fearful to take a risk that could lead to innovations.").

²⁴ See Morrison & Foerster LLP, *D&O Insurance: What You Must Know to Minimize Your Potential Personal Liability*, available at <http://www.mofo.com> (last visited June 19, 2004). See generally Steven R. Smith, *The Sarbanes-Oxley Act: How Will it Affect D&O Insurance Coverage?*, 91 ILL. B.J. 128 (2003).

²⁵ See SEC Release 34-48745, *NASD and NYSE Rulemaking: Relating to Corporate Governance* (November 4, 2003); see also, e.g., Nasdaq Rule 4350(c)(1); Nasdaq Rule 4200(15) (defining "independent director").

compensation²⁶ and fees paid to executive search firms that are hired to conduct the corporate search for independent directors and qualified “Financial Experts²⁷”.

- **Audit and legal expenses.** Given the Act’s enhanced requirements regarding financial accounting, controls, and disclosure, it is hardly surprising that accounting and legal fees have already increased and continue to increase following passage of the Act.²⁸ Studies indicate that audit fees have increased on average by more than 20% between 2002 and 2003, translating into an increase of between \$89,000 and \$170,000 for small and mid-cap companies.²⁹
- **Controls Software.** Many companies are using information technology (“IT”) to assist in designing and implementing the financial disclosure controls required by Section 404 of the Act. Because compliance with Section 404 of the Act is an ongoing effort, companies believe their IT costs associated with the Act will be ongoing as well. According to one study, respondents said they expect to spend \$480,000 on software, consulting services, and employee training in advance of the Section 404 compliance deadlines.³⁰
- **Outsourcing.** Many organizations (particularly small issuers) find it necessary to outsource compliance with the “whistle blower” provisions of the Act. Retaining a third party helps ensure independence, achieve broader coverage, and compensate for a lack of internal expertise and staff availability.³¹
- **Lost productivity.** Last, and clearly not least, is the diversion of time and energy away from operations, sales, and profitability. The Act has forced high-level company management initially to focus on satisfying the Act’s requirements, and subsequently demonstrating to their boards that compliance has been achieved.³² This cost is impossible to quantify and probably varies dramatically from issuer to issuer. The Foley Lardner study estimates that lost productivity for public companies has increased from

²⁶ See Foley Lardner Study (observing an increase in annual director fees of 16-19% from fiscal year 2002 to fiscal year 2003 for small to mid-cap companies).

²⁷ See Tamara Loomis, *Sarbanes-Oxley Burdens Small Companies*, THE NEW YORK LAWYER (December 19, 2002), available at <http://www.nylawyer.com> (last visited June 19, 2004) (reporting that “public companies are also finding themselves shelling out hard-earned cash to pay executive search firms to find directors for their boards”).

²⁸ See Quigley, *supra* (“True, [the Act] can be an expensive proposition—for our clients, for us, and for the business community as a whole. There is no question about that. There are additional reporting requirements, and more extensive disclosure and control systems put in place to meet them.”).

²⁹ See Foley Lardner Study, at 6 (noting that audit fees increased by an average of 24% between fiscal year 2002 and fiscal year 2003).

³⁰ See Thomas Hoffman, *Users Struggle to Pinpoint IT Costs of Sarbanes-Oxley Compliance* (November 21, 2003), available at <http://www.computerworld.com> (last visited June 28, 2004).

³¹ See Hernan Murdock, *Early Warning System*, INTERNAL AUDITOR at 57 (August 1, 2004), available at 2003 WL 15748493.

³² See Morgenstern, *Sarbanes-Oxley; A Law of Unintended Consequences*, *supra* (“Less easily measured is the cost of management time diverted from operations and sales to statutory compliance. . . . Time spent installing systems and meeting with professionals hurts profitability.”); Nyberg, *supra* (“[E]xecutives may find that fitting compliance duties into their schedules gives them less time for strategic development.”).

\$46,000 in 2001 prior to enactment of the Act to \$160,000 for fiscal year 2003—a 247% increase.³³

The costs of the Act have increased each year.³⁴ Certain costs (including software installation and development of disclosure controls) decline after the first year of implementation. Other costs (such as outside auditor fees) are likely to remain the same or increase.³⁵ Significantly, Section 404 (which requires stringent internal accounting rules) does not become effective for most companies (other than “accelerated filers”³⁶) until fiscal years ending on or after April 15, 2005.³⁷ Because these controls are not yet widely-implemented, current studies don’t fully account for the associated major costs. Actual costs of Section 404 implementation, however, are expected to be (and have thus far proven to be) significantly higher than the SEC’s estimate.³⁸ Act-related costs are not “one-time events,” they are difficult to quantify and predict, and we anticipate they will continue to increase for the near future.

IV. STAGGERED COMPLIANCE DEADLINES--LEVELING THE PLAYING FIELD?

Sarbanes-Oxley does not generally distinguish between small entities and other companies. Following this statutory guidance, the SEC similarly decided to not exempt smaller

³³ See Foley Lardner Study, at 14.

³⁴ See Foley Lardner Study, at 7 (observing a 35% increase from fiscal year 2002 to fiscal year 2003).

³⁵ *The Costs of Complying with Governance Rules, supra*, at 5.

³⁶ A company that is an “accelerated filer,” as defined in Exchange Act Rule 12b-2, as of the end of its first fiscal year ending on or after June 15, 2004, must begin to comply with the management report on internal control over financial reporting disclosure requirements in its annual report for that fiscal year. See SEC Release 33-8238, *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* (August 14, 2003).

³⁷ The SEC has estimated the average annual cost of implementing Section 404 to approximate \$91,000 per company. See SEC Release 33-8238, *supra*.

³⁸ An example is Forest City Enterprises, Inc. (NYSE: FCE) a mid-cap company that expensed approximately \$1.5 million in consulting fees directly relating to compliance with Section 404(a) of the Act. See Forest City Enterprises, Inc. 10-K for Fiscal Year Ended January 31, 2004, available at <http://www.sec.gov> (last visited June 26, 2004); see also Foley Lardner Study (observing that companies expect section 404 compliance to constitute a significant portion of their audit fees for fiscal year 2004).

issuers as it implemented Sarbanes-Oxley regulations.³⁹ The Commission opined that “the informational needs of investors in small entities are typically as great as the needs of investors in larger companies.⁴⁰” Regrettably, they seem to have forgotten to mention that the costs may also be as great. The only notable exception to this principle is that the SEC exempted Small Business Issuers from the tabular disclosure of contractual obligations in their MD&A disclosures.⁴¹

The SEC has repeatedly recognized that small issuers will have more difficulty meeting its new requirements.⁴² The primary SEC response to the disproportionate burden imposed by the Act upon smaller companies has been to stagger (or delay) compliance deadlines based upon the market capitalization of the company. In some cases, Accelerated Filers are required to comply with the Act’s initiatives at an earlier date than other companies. These are U.S. issuers that, among other requirements, have an aggregate market value of common equity held by non-affiliates of \$75 million or more⁴³. Unfortunately, the broad definition of Accelerated Filer encompasses most mid-cap issuers (*i.e.*, companies having equity values of between \$2 billion to \$10 billion), small-cap issuers (*i.e.*, equity values between \$300 million to \$2 billion), and even micro-cap issuers (*i.e.*, equity values below \$300 million).⁴⁴

³⁹ See, e.g., SEC Release 33-8182, *supra* (“Because Section 401(a) of the Sarbanes-Oxley Act does not distinguish between small entities and other companies, we do not believe it is appropriate to exempt small entities from the requirement to discuss off-balance sheet arrangements.”).

⁴⁰ *Id.*

⁴¹ *Id.* (“[W]e were able to further ease the regulatory burden on small entities by excluding small-business issuers from the tabular disclosure requirement about contractual obligations.”).

⁴² See, e.g., SEC Release 33-8177, *Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002* (March 3, 2003) (“Recognizing that smaller businesses may have the greatest difficulty attracting qualified audit committee financial experts, small-business issuers must comply with the audit committee financial expert disclosure requirements in their annual reports for fiscal years ending on or after December 15, 2003.”).

⁴³ See Exchange Act Rule 12b-2.

⁴⁴ See KeyBanc, *The Micro-Cap Trap*, at 1 (copy on file with the authors) [hereinafter KeyBanc Report].

“Small Business Issuers⁴⁵” are afforded extra time initially to comply with certain requirements of the Act. After entry into the periodic reporting system, however, the reporting obligations are generally the same.

Table 1 summarizes selected compliance deadlines by reference to issuer’s market capitalizations.⁴⁶

TABLE 1

Comparison of Compliance Obligations of Different-size Issuers

<i>ITEM</i>	<i>REQUIREMENT</i>	<i>COMPLIANCE DATE (ACCELERATED FILERS)</i>	<i>COMPLIANCE DATE (SMALL BUSINESS ISSUERS)</i>	<i>COMPLIANCE DATE (ALL OTHER ISSUERS)</i>
Accelerated Filing ⁴⁷	Reduced filing deadlines for Accelerated Filers to 35 days for 10-Qs and to 60 days for 10-Ks.	Fiscal year ending December 15, 2003	N/A	N/A
Accelerated 8-K Disclosures ⁴⁸	Ten additional items included as reportable items on Form 8-K. Filing deadline reduced to four <u>business</u> days for most items.	August 23, 2004	Same	Same
Audit Committee Financial Expert ⁴⁹	Required disclosures regarding audit committee financial expert.	Fiscal years ending on or after July 15, 2003	Fiscal years ending on or after December 15, 2003	Same as Accelerated Filer
Audit Committee Criteria ⁵⁰	Exchange rules mandated by SEC regarding structure/composition of audit committee.	Earlier of first annual meeting after January 15, 2004 or October 31, 2004	July 31, 2005	Same as Accelerated Filers
Audit Fees ⁵¹	Enhanced disclosure regarding audit-related fees.	Fiscal years ending after December 15, 2003	Same	Same

⁴⁵ See note, 2 *supra*.

⁴⁶ Adapted from Table of “Key Compliance and Effective Dates for Sarbanes-Oxley Provisions.” See COMPLIANCE WEEK (April, 2004), at 27; see also Lowenstein Sandler PC, *Updated Sarbanes-Oxley Chart; Updated Nasdaq Requirements* (September 23, 2003), available at <http://www.lowenstein.com> (last visited June 16, 2004).

⁴⁷ See SEC Release No. 33-8128, *Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports* (November 15, 2002).

⁴⁸ See SEC Release No. 33-8176. *Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date* (March 16, 2004).

⁴⁹ See SEC Release No. 33-8177, *Final Rule: Disclosure Required by Section 406 and 407 of the Sarbanes-Oxley Act of 2002* (March 3, 2003).

⁵⁰ See SEC Release No. 33-8220, *Standards Relating to Listed Audit Committees* (April 9, 2003).

⁵¹ See SEC Release No. 33-8183, *Strengthening the Commission’s Requirements Regarding Auditor Independence* (January 28, 2003).

ITEM	REQUIREMENT	COMPLIANCE DATE (ACCELERATED FILERS)	COMPLIANCE DATE (SMALL BUSINESS ISSUERS)	COMPLIANCE DATE (ALL OTHER ISSUERS)
Audit Partner Rotation ⁵²	Required rotation of audit partners involved in audit.	Generally first fiscal year after May 6, 2003	Same	Same
Disclosure Controls ⁵³	Required maintenance and evaluation of internal financial controls.	Fiscal year ending after November 15, 2004	Fiscal year ending after July 15, 2005	Same as Small Business Issuers
Equity Compensation Plans ⁵⁴	Stockholder approval of equity compensation plans. ⁵⁵	June 30, 2004	Same	Same
Independent Directors ⁵⁶	Exchange rules mandated by SEC regarding independent directors and structure/composition of compensation and nominating committees.	Earlier of first annual meeting after January 15, 2004 or October 31, 2004	July 31, 2005	Same as for Accelerated Filers
Nomination Process/ Communications ⁵⁷	Enhanced disclosure regarding director nominations and stockholder communications to board.	January 1, 2004	Same	Same
Non-GAAP Financial Statements ⁵⁸	Reconciliation of pro forma information to GAAP (Regulation G).	March 28, 2003	Same	Same
Off-Balance Sheet Disclosures ⁵⁹	Additional MD&A disclosures regarding off-balance sheet arrangements.	June 15, 2003	Same	Same
Tabular disclosure of contractual obligations. ⁶⁰	Tabular disclosure of terms of existing contractual obligations as part of MD&A disclosure.	December 15, 2003	N/A	Same

As part of implementing the requirements of the Act, the SEC has enacted regulations requiring SRO's to enact certain corporate governance and other rules regulating companies

⁵² *Id.*

⁵³ See SEC Release Nos. 33-8392 (February 24, 2004) and 33-8238 (June 5, 2003), *Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*.

⁵⁴ See SEC Release No. 34-48108, *Order Approving NYSE and Nasdaq Proposed Rule Changes* (June 30, 2003).

⁵⁵ The new exchange rules primarily apply to only new plans. Existing plans generally do not have to be approved unless "materially revised." *Id.*

⁵⁶ See SEC Release No. 34-48745, *NASD and NYSE Rulemaking: Relating to Corporate Governance* (November 4, 2003).

⁵⁷ See SEC Release No. 33-8340, *Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Board of Directors* (January 1, 2004).

⁵⁸ See SEC Release No. 33-8176, *Conditions for Use of Non-GAAP Financial Measures* (January 22, 2003).

⁵⁹ SEC Release No. 33-8182, *Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations* (January 28, 2003).

⁶⁰ *Id.*

listed on their exchanges. Although the substantive listing requirements and the applicable compliance dates for each exchange are generally similar, modest differences between the new rules are causing some issuers to engage in “exchange shopping.”

V. *DISPROPORTIONATE COSTS OF SARBANES-OXLEY TO SMALLER ISSUERS.*

Most requirements of the Act and its regulations are applicable to issuers of all sizes. The costs, and practical and financial consequences, appear disproportionately harsh to smaller issuers. While the actual costs of legal and outside accounting fees may be the same, the fiscal consequences are more significant for micro, small, and mid-cap issuers as a percentage of their revenues and net income.

In addition, smaller cap issuers generally have more limited financial staffs (frequently with less public company experience) than larger issuers; micro-caps sometimes have only a single financial officer and no internal staff. Chief financial officers of such companies routinely play multiple roles in finance, administration, and operations. These issuers may find that management spends a disproportionate amount of time on SEC disclosure and compliance rather than operations and profitability.

Through no fault of the Commission, smaller issuers are at an inherent compliance disadvantage. For example, exchange rules now require each listed issuer to have directors specifically determined to be “independent” on their board and “financial experts” on their audit committees.⁶¹ With limited resources available to them, and a finite number of qualified directors, smaller issuers will be less capable of recruiting, compensating, or retaining necessary talent. Empirical data supports the unfortunate reality that costs of locating and retaining

⁶¹ See, e.g., SEC Release No. 34-48745, *NASD and NYSE Rulemaking Relating to Corporate Governance* (November 4, 2003); NYSE Listed Company Manual, Section 303; NASDAQ Rules 4200 and 4350.

directors actually increases as company size decreases. This depressing statistic further highlights certain intrinsic problems smaller companies face in complying with the Act.⁶²

Costs associated with Sarbanes-Oxley compliance increase slightly along with the size of the issuer.⁶³ This increase, however, does not correspond proportionately to company size as measured by revenues rather than market capitalization. One study has compared compliance costs by company revenues as follows:⁶⁴

TABLE 2
Annual Costs of Sarbanes-Oxley Compliance

<i>Company Size By Annual Revenues (in Dollars)</i>	<i>Annual Compliance Costs (in Dollars)</i>	<i>Company Hours Expended on Compliance</i>
25 to 99 million	740,000	3,080
100 to 499 million	780,000	5,100
500 to 999 million	1,000,000	6,900

As Table 2 indicates, the Act’s compliance costs remain relatively constant as company size increases, particularly for companies with revenues in the \$25-499 million range. Many costs (*e.g.*, increased disclosure, one-time cost of software implementation and installation, or D&O Insurance premiums) remain relatively constant regardless of company size.

The foregoing cost analysis has issuers (and prospective IPO candidates) questioning the value of being public. A natural reaction of the soaring Act-related costs would be more companies avoiding the Act’s requirements either by: (1) deregistering the company’s securities, or (2) through the more dramatic act of “going private” through an MBO, LBO, or outright sale

⁶² Foley Lardner Study, at 8 (observing a 15% increase for S&P 500 companies, but a 19% increase for small-cap companies).

⁶³ See Foley Lardner Study (comparison between companies with revenue over and under \$1 billion); *The Costs of Complying with Governance Rules*, *supra*, at 5. According to the Foley Lardner Study, the annual cost of being public for fiscal year 2003 jumped from \$2.86 million for companies with annual revenues under \$1 billion, to \$7.4 million for companies with annual revenues of \$1 billion and over.

⁶⁴ *The Costs of Complying with Governance Rules*, CORPORATE INSIGHT (Spring 2004), at 5 (citing to Wall Street Journal Article citing study by Financial Executives International).

to a competitor; thus effectively escaping Sarbanes-Oxley's expense and requirements. While not uniform, some data suggests that the frequency of going-private transactions has increased following Sarbanes-Oxley.⁶⁵ More companies are considering the possibility of going private. Twenty-one percent (21%) of companies recently surveyed were considering going private,⁶⁶ approximately a 50% increase from the same study conducted in 2003.⁶⁷

VI. PRIVATE COMPANIES: THE INDIRECT COSTS.

The focus of this Article is the impact of Sarbanes-Oxley on public companies. An important, and apparently inadvertent impact of the Act, however, is the ripple effect that has occurred among private entities and non-profit institutions.⁶⁸

Because of the view that all or certain requirements of the Act should represent "standard operating procedure," many key business partners now require private companies to comply with all or a portion of the Act. For example, lenders are now requiring that companies comply with Sarbanes-Oxley "type" financial statement presentations and officer certificates as a condition to financings.⁶⁹ Insurers are increasingly requiring compliance with the corporate governance

⁶⁵ See Grant Thornton LLP, *Post Sarbanes-Oxley: Number of Public Companies Going Private Increases 30 Percent* (December 15, 2003), available at <http://www.grantthornton.com> (last visited June 28, 2004) (noting a 30% increase in going private transactions during the 16 months immediately preceding enactment of the Act compared to the 16 months immediately following enactment); David A. Stockton et al., *Going Private: the Best Option?*, NATIONAL LAW JOURNAL (June 23-30, 2003) (citing study by FactSet Mergerstat indicating that going private deals as a percentage of mergers and acquisition transactions increased by approximately 23.7% from 2000 to 2002); see also Stephen Pounds, *Software Firm Grabs the Bootstraps*, PALM BEACH POST (December 29, 2003) (noting that 95 U.S. companies went private during the 12-month period ending in July, 2003, compared to 75 U.S. companies for the previous 12-month period); but see Marc Morgenstern and Peter Nealis, *Going Private: A Reasoned Response to Sarbanes-Oxley?* (paper presented at the Practising Law Institute Advanced Securities Workshop on August 12, 2004) (discussing why fewer companies are going private than might be expected); Gregory R. Samuel and Sally A. Schreiber, *Going Private Transactions*, 40-SPG TEX. J. BUS. LAW 85, 88 (2004) (observing that the number of going private transactions decreased from 2002 to 2003).

⁶⁶ Foley Lardner study at 10; see also Inc.com, *Sarbanes-Oxley Has Some Publics Thinking Private*, *supra*.

⁶⁷ *Id.*

⁶⁸ See Robert Half International Inc., *The Impact of Sarbanes-Oxley on Private Business: Are the New Rules Giving Rise to a Universal Standard?* (July 2003) (copy on file with the authors). Certain provisions of the Act (such as the whistle blower and anti-fraud provisions) explicitly apply to all companies, public or private.

⁶⁹ See Andrew G. Humphrey, *The Effects of Sarbanes-Oxley on Private Companies*, available at <http://www.fauger.com> (last visited June 14, 2004).

provisions of the Act as a prerequisite to granting D&O coverage. Regional CPA's recommend or require audit committees for private companies and non-profit institutions. The venture community and sophisticated private equity investors are obtaining covenants that portfolio companies will comply with certain operational and corporate governance provisions of the Act.

Additionally, some states are in the process of developing "mini-Sarbanes-Oxley legislation" applicable to both private companies and non-profit institutions.⁷⁰ While the Act is not yet the statutory standard for private companies or non-profits, we can reasonably posit that judicial decisions will increasingly compare corporate and non-profit board process and conduct to Sarbanes-Oxley as the benchmark for best practices and community standards. In the process, the boundaries for implied civil liability may be extended.

In response to this environment, many private companies are developing more rigorous corporate governance and financial reporting infrastructure at an earlier stage in their development.⁷¹ In moderation and proportion that's probably good. It's easy to envision, however, that instead of concentrating on running and growing fledgling businesses, management may spend valuable time and effort on "compliance" with the Act. Because of the increased time and resources expended on the Act that could have otherwise been devoted to corporate growth and development, the Act is expected to increase the time period for early stage venture-backed companies to accomplish an IPO by an average of at least 1-2 years.⁷²

⁷⁰ In 2003, 14 State legislatures proposed accounting reform or other business-related legislation based on issues raised by the Act. See AICPA, *The State Cascade – An Overview of State Issues Related to the Sarbanes-Oxley Act*, available at <http://www.aicpa.org> (last visited June 24, 2004). See Geoffrey R. Morgan, *With State Legislatures Trying to Extend Concepts of Sarbanes-Oxley, Let's Not Get Too Comfortable Just Yet*, *Viewpoint* (Volume 1, No. 19, 2003), at S53. With respect to non-profits, see Office of New York State Attorney General, *Attorney General Spitzer's Proposed Reforms to State Corporate Accountability Laws* (March 12, 2003) available at <http://www.oag.state.ny.us> (last visited June 24, 2004).

⁷¹ See Ernst & Young LLP, *2002: Year in Perspective, Venture Capital Insights*, available at <http://www.ey.com> (last visited June 19, 2004) (noting that "we are likely to see a shift in the required timeframe for infrastructure investments to a period of between 18 months and three years before an IPO").

⁷² *Id.*

Many private companies' long-term liquidity strategy involves either an IPO or a sale to a public company. Some conservative (or prophetic) advisors suggest that such private companies comply with Section 404 now; well before an IPO or even the penumbra of a liquidity event is remotely contemplated. Their concern is that Section 404 requires substantial time to create and implement the appropriate software and procedures. They want to ensure that the company is positioned to be acquired by a public company or conduct an IPO, and that non-compliance with Section 404 will not prevent or delay such a transaction.

VII. CONCLUSION

The SEC's response to concerns voiced over the disproportionate impact of the Act upon small issuers has been modest, and may be characterized as the institutional equivalent of "So what?"⁷³ The Act itself does not distinguish on the basis of issuer size. This approach, however, ignores the practical reality that a vibrant and competitive public marketplace requires participation by issuers of all sizes.⁷⁴ Small companies grow to become large companies. More than 80% of the public marketplace currently consists of smaller issuers.⁷⁵ Large-cap issuers do not spring fully-born from the loins of Zeus.

The overall consequence of an arguably well-intended law may be increasingly costly private and public capital. The current somewhat knee-jerk legislative response to extend the Act's approach and obligations to private companies and non-profit institutions is troubling. More companies are remaining private,⁷⁶ going private or de-registering, or achieving corporate

⁷³ See *Eisinger, supra* (arguing "that there should be a cost. Sarbanes-Oxley cannot be free and still have an impact").

⁷⁴ The SEC is mandated by the Exchange Act to consider the effects on competition when enacting Sarbanes-Oxley regulations. See Exchange Act Section 23(a)(2), 15 U.S.C. §78w(a)(2).

⁷⁵ See KeyBanc Report, *supra*, at 1 (estimating that 84% of public companies can be characterized as "micro-caps").

⁷⁶ Associated Press, *Small Companies are Shying Away from IPOs* (June 23, 2004), available at <http://www.forbes.com> (last visited June 24, 2004).

liquidity through business combinations with competitors rather than an IPO. The undesirable, anti-competitive, and ultimately self-defeating consequence may be a decreasingly vibrant public marketplace. Without a robust public marketplace, there will be nothing for investors to invest in or be protected from.

Sarbanes-Oxley needs to be re-thought with significant sensitivity to its impact on mid-cap issuers, private companies, and the capital markets in general. For Sarbanes-Oxley to achieve its sponsors' enunciated goals, eventually the rules must more sharply differentiate among issuers by market-cap or revenues, and more appropriately allocate costs and benefits. Investor confidence in the equity marketplaces requires profitable companies, with well-balanced boards of directors, that are willing to take risks in order to achieve commensurate equity returns. Risk-averse boards, overseeing decreasingly profitable businesses, and focused primarily on the next quarter and avoiding liability, will neither inspire confidence in the marketplace nor create the vibrant U.S. equity marketplace that is the key to our country's long-term success.