THE REEXAMINATION OF SARBANES-OXLEY ACT AND THE UNINTENDED EFFECT ON SECTION 404 IMPLEMENTATION

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This research paper will focus on Section 404 which governs internal controls. It will also include an analysis of the guidance promulgated by the SEC in regards to Section 404. The focus will be on the general criticisms of Sarbanes-Oxley, specifically Section 404. This paper will also address the unintended consequences on the implementation of Sarbanes-Oxley Section 404.

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INTRODUCTION

In 2001, accounting frauds at Enron and WorldCom set into motion a chain of events that would revolutionize the regulation of public companies. As is now common knowledge, the accounting scandals at Enron and WorldCom defrauded millions of investors, employees, and the American public at large. By the time the dust had settled, one of the largest and most reputable accounting firms in the world was forced to close its doors. In response to the frauds of Enron and WorldCom, as well as other large public companies, the Congress passed the Public Company Accounting Reform and Investor Act, better known as Sarbanes-Oxley, on July 29, 2002.¹

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¹ Bob Greifeld, *The View From Nasdaq*, WALL ST. J., July 30, 2004, at A10; Ginger Carroll, *Thinking Small: Adjusting Regulatory Burdens Incurred by Small Public Companies Seeking to Comply with the Sarbanes-Oxley Act*, 58 ALA. L. REV. 443, 443 (2006).

Sarbanes-Oxley “represents the most sweeping and comprehensive overhaul of federal corporate governance law since the securities laws of 1933 and 1934.”²

I. OVERVIEW OF SARBANES-OXLEY

Section 404 of Sarbanes-Oxley³ is undoubtedly the most infamous and widely-debated provision of Sarbanes-Oxley. However, Sarbanes-Oxley also “includes provisions for an accounting oversight board, auditor independence, corporate responsibility, enhanced financial disclosures and corporate and criminal punishments.”⁴ Although many of these provisions have significantly impacted the accounting industry, public companies, and corporate governance in general, we will focus on Section 404 because it imposes the greatest costs on public companies,⁵ and is therefore the most contentious provision.⁶

A. Section 404

Section 404 is often referred to as the internal controls provision.⁷ Generally speaking, internal controls are methods and practices utilized by companies to ensure the accuracy of their financial statements.⁸ They range from bank reconciliations to ensure adequate segregation of duties.⁹

Although Section 404 is currently at the center of a hot economic and political debate, the statute itself is deceptively simple. It authorizes the SEC to promulgate rules compelling companies that are required to file annual reports under 15 U.S.C. sections 78m(a)¹⁰ or 78l(d)¹¹ to prepare an internal control report.¹² The report must:

² Scott Harshbarger & Goutam U. Jois, *Looking Back and Looking Forward, Sarbanes-Oxley and the Future of Corporate Governance*, 40 AKRON L. REV. 1, 3 (2007).

³ Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (2002).

⁴ See generally Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C.).

⁵ William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of “Going Private”*, 55 EMORY L.J. 141, 142 (2006).

⁶ Carroll, *supra* note 1, at 450.

⁷ Harshbarger, *supra* note 2, at 21.

⁸ *Statements and Restatements*, A1 N.Y. TIMES (Mar. 20, 2007); Carroll, *supra* note 1, at 21–22.

⁹ *Id.*

¹⁰ 15 U.S.C. § 78m(a) (2002) (requiring issuers of securities pursuant to Section 12 of the Securities Exchange Act of 1934 to file annual reports); 15 U.S.C. § 78l (2002).

¹¹ 15 U.S.C. § 78o(d) (2002) (requiring issuers who have filed registration statements that have become effective pursuant to the Securities Act of 1933 to file “such supplementary and periodic information, documents, and reports as may be required”).

¹² Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (2002).

(a) (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) Internal control evaluation and reporting

With respect to the internal control assessment required by subsection (a)... each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the board. Any such attestation shall not be the subject of a separate engagement.¹³

At the first glance, it is not readily apparent why such a seemingly innocuous provision has caused such a headache for public companies. However, a closer look reveals that at least part of the problem relates to the fact that Sections (a) and (b) are redundant, in that they require duplicative internal audits by management, as well as external audits performed by certified accounting firms.¹⁴

B. SEC Guidance Regarding Section 404

In June 2003, pursuant to the authority delegated to it in Section 404, the SEC adopted rules requiring all Exchange Act reporting companies to include a report of management, as well as an accompanying auditor's report, in their annual reports.¹⁵ The purpose of the reports is to authenticate the effectiveness of the company's internal control over financial reporting (ICFR).¹⁶ The SEC allowed small public companies a lengthier compliance period.¹⁷

Despite the guidance provided by the 2003 rules, auditors and public companies remained unsure about how to evaluate ICFR, and therefore how to adequately comply with Section 404. The SEC responded by issuing

¹³ *Id.*

¹⁴ Jim DeMint & Tom Feeney, *Common-Sense Changes*, WALL ST. J., May 10, 2006, at A18.

¹⁵ Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 33-8238, 68 FR 36636 (2003).

¹⁶ *Id.*

¹⁷ Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, Exchange Act Release No. 33-809, 17 CFR 210, 228, 229, 240 (2007). The Commission technically exempted non-accelerated filers, which are "smaller public companies with a public float below \$75 million."

further guidance.

1. Guidance for Management of Public Companies

On December 20, 2006, the SEC issued a proposed release containing interpretive guidance for managers of public companies with respect to the required evaluation of ICFR.¹⁸ The interpretive guidance became effective on June 27, 2007. The interpretive guidance set forth two broad principles:

The first principle is that management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner. The guidance describes a top-down, risk-based approach to this principle, including the role of entity-level controls in assessing financial reporting risks and the adequacy of controls. The guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement of its financial statements. The guidance does not require management to identify every control in a process or document the business processes impacting ICFR.

The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. The guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation. This allows management to align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the highest risks to reliable financial reporting (that is, whether the financial statements are materially accurate). As a result, management may be able to use more efficient approaches to gathering evidence, such as self-assessments, in low-risk areas and perform more extensive testing in high-risk areas.¹⁹

Overall, the interpretive guidance provides management with the requisite flexibility to design and implement an evaluation process tailored to the individual needs and nuances of its company.

2. Guidance for Auditors—AS-5

Sarbanes-Oxley created the Public Company Accounting Oversight Board (PCAOB) to “oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.”²⁰ On

¹⁸ Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 33-810, 17 CFR 241 (2007).

¹⁹ *Id.*

²⁰ The Public Company Accounting Oversight Board, <http://pcaob.org/> (last visited Oct. 10, 2007).

December 19, 2006, the PCAOB proposed a new auditing standard, designated AS-5, in order to provide companies guidance on how to comply with Section 404 in the most cost-effective manner.²¹ However, proposed AS-5 was met with some criticism by officials at the SEC.²² The SEC, which has the final say regarding the adoption of audit standards, “didn’t think the AS-5 wording went far enough.”²³

The PCAOB received 175 comment letters in regards to proposed AS-5.²⁴ In addition, the SEC worked with the PCAOB in order to align proposed AS-5 with the SEC’s Interpretive Guidance for Management, thereby addressing the concern that the duplicative requirements of Sections 404(a) and (b) are a substantial contributing factor to the high costs of compliance. The PCAOB addressed many of the issues raised by commentators, as well as the guidance provided by the SEC, in a version of AS-5 that was filed with the SEC on May 25, 2007.²⁵ AS-5 was approved by the SEC on July 25, 2007.²⁶

AS-5 seeks to:

Provide the professional standards and related performance guidance for independent auditors when an auditor is engaged to perform an audit of management’s assessment of the effectiveness of internal controls over financial reporting that is integrated with an audit of the financial statements.²⁷

The SEC has stated that it expects AS-5 to make compliance with Section 404 more efficient and cost-effective.²⁸

II. CRITICISMS OF SECTION 404

Despite the rampant criticism of Section 404, supporters contend that it has made companies more transparent, thereby benefiting investors, and that it has made companies better managed.²⁹ Furthermore, according to audit statistics gathered in 2005 and early 2006, the total number of restatements

²¹ Kara Scannell, *Moving the Market: Softening a Sarbanes-Oxley Thorn—SEC Makes Progress on Tweaking the Rules For Unpopular Provision*, WALL ST. J., Apr. 5, 2007, at C2.

²² *Id.*

²³ *Id.*

²⁴ Public Company Accounting Oversight Board; Order Approving Proposed Auditing Standard No.5, An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements, a Related Independence Rule, and Conforming Amendments, Exchange Act Release No. 34-56152, 72 Fed. Reg. 42141 (2007).

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ Stephen Labaton, *Businesses Seek New Protection on Legal Front*, NY TIMES, Oct. 29, 2006.

has increased since the passage of Sarbanes-Oxley.³⁰ However, while advocates of Section 404 tend to point to this increase as conclusive proof that Section 404 has achieved its intended purpose, the statistics do not reveal whether the misstatements were material.

Although the benefits of Section 404 are not particularly well-documented, countless studies have been devoted to quantifying its extensive costs. According to a study conducted by the American Electronic Association, U.S. companies are spending \$35 billion annually to comply with Sarbanes-Oxley, which exceeds the original federal estimates by more than \$33 billion.³¹ A study conducted by the University of Nebraska concluded that audit fees for large public companies have increased an average of 103% from 2003 to 2004.³² Finally, a study conducted by a Milwaukee-based law firm concluded that the costs of being a public company have tripled since the passage of Sarbanes-Oxley.³³ These studies demonstrate that compliance with Sarbanes-Oxley, and most notably Section 404, is expensive for all public companies. However, the costs of Section 404 compliance are even more overwhelming for small- to mid-sized public companies.

Section 404 imposes disproportionately high costs on small public companies relative to larger public companies.

Specifically, this provision overburdens small public companies because it requires them “to divert their resources, both capital and personnel, to insuring compliance with the securities regulatory system, to the detriment of the pursuit of business initiatives, with potentially modest benefit to investors.” To state it simply, large public companies have more extensive resources at their disposal than small public companies, which allows these large companies to rely on their own personnel to comply with the securities regulations rather than having to outsource operations such as internal auditing, legal work, and compliance. On the other hand, small public companies, “which are required to record, process, disclose and report the same information within the same time periods as large public companies, have fewer internal resources available to them.”³⁴

One commentator estimates that while large public companies might spend an average of 0.06% of sales on Section 404 compliance, small public companies, defined for purposes of this estimate as having less than \$100 million in revenue,

³⁰ Harshbarger, *supra* note 2, at 24.

³¹ Mallory Factor, *Two Cheers for Nancy Pelosi*, A9 WALL ST. J. (Mar. 18, 2006). Although the studies cited to estimate the costs of compliance with Sarbanes-Oxley as a whole, Section 404 is the most costly provision of Sarbanes-Oxley. See Carney, *supra* note 5.

³² Factor, *supra* note 31..

³³ *Id.*

³⁴ Carroll, *supra* note 1, at 453.

might spend approximately 2.55% of sales.³⁵

As a result of the mounting evidence tending to show Sarbanes-Oxley, and notably Section 404, imposes an unequal burden on small public companies, the SEC created the Advisory Committee on Smaller Public Companies, “to examine the effects of Sarbanes-Oxley on small businesses” and to consider how to tailor the regulations to better fit the varying sizes of public companies. The Advisory Committee focused on whether the inability of small companies to effectively segregate duties makes Section 404 ineffective.³⁶ In addition, the Committee attempted to determine whether controls can be implemented by small public companies that will reduce the risk of management override, while still lessening the burdens of Section 404 compliance.³⁷ Finally, the Committee attempted to answer the overriding question of whether regulatory relief, in the form of relaxing the requirements of Section 404, would enhance the competitive position of small public companies in the market.³⁸

As a result of the debate surrounding the disproportionately high costs imposed by Section 404, the SEC has repeatedly deferred the effective date of Section 404 compliance for small public companies. Currently, small public companies do not have to include a management report on ICFR until they file their returns for the fiscal year ending on or after December 15, 2007.³⁹ In addition, small public companies do not have to include an auditors report attesting to ICFR until the company files its return for the fiscal year ending on or after December 15, 2007.⁴⁰

III. THE UNINTENDED CONSEQUENCES OF SARBANES-OXLEY

It is highly doubtful that when Senator Sarbanes and Representative Oxley sponsored Sarbanes-Oxley they intended for the excessive costs of compliance to push public companies to “go private”, or domestic companies to go overseas. However, many critics of the legislation believe that such consequences, whether intended or not, are very real. Essentially, Sarbanes-Oxley has caused public companies to engage in regulatory arbitrage. Regulatory arbitrage, which is perhaps best known in the context of securities regulation, essentially means that rational companies will seek out a regulatory regime that imposes the “optimal amount of regulation—

³⁵ Harshbarger, *supra* note 2, at 21.

³⁶ Carroll, *supra* note 1, at 451.

³⁷ *Id.*

³⁸ *Id.*

³⁹ Release No. 33-809, *supra* note 17.

⁴⁰ *Id.*

which reduces investors' risks of fraud without imposing such huge direct regulatory costs that earnings are reduced, so corporate values decline."⁴¹ Critics of Sarbanes-Oxley contend that as a result of the excessive costs it imposes, the United States is no longer an optimal regulatory regime for public companies.⁴² Therefore, public companies have engaged in regulatory arbitrage by: (1) going private; or (2) choosing to list their securities on exchanges outside the United States.

A. *Public Companies Are Increasingly Deciding to Go Private*

Although the reasons behind public companies decisions to go private are somewhat disputable, the issue of whether more companies have opted to go private since the passage of Sarbanes-Oxley is beyond debate. In 2001, prior to the passage of Sarbanes-Oxley, there were 115 disclosed buyout transactions,⁴³ with a total value of \$23.1 billion.⁴⁴ By 2003, the number of disclosed buyout transactions had risen to 507, with a total value of \$94.6 billion.⁴⁵ These numbers increased even more dramatically from 2003 to 2004, which saw 752 disclosed buyout transactions, with a value of \$136.5 billion.⁴⁶

Although the data presented paint a bleak figure, in order to intelligibly assess whether Sarbanes-Oxley has contributed to the decision of public companies to go private, a few preliminary matters need to be addressed. First, it is helpful to distinguish between the various types of "going private" transactions. Next, it is necessary to examine an array of explanations for the decision of public companies to go private. Finally, we will focus on Sarbanes-Oxley, and the extensive data that tend to support the theory that it is largely responsible for the decision of public companies to go private.

1. Types of "Going Private" Transactions

In general, the SEC website defines "going private" as a transaction that results in a company reducing its shareholders below 300, such that it is no longer required to file reports with the SEC. However, despite this simple definition, companies that want to go private can achieve this objective in a number of different ways, including a private equity buyout

⁴¹ Carney, *supra* note 5, at 152.

⁴² *Id.*

⁴³ Private Equity buyouts are just one form of "going private transactions." See *infra*, Section IVA1.

⁴⁴ Carney, *supra* note 5, at 155.

⁴⁵ *Id.*

⁴⁶ *Id.*

and a Rule 13e-3 transaction.⁴⁷

a. Private Equity Buyout

Perhaps the best-known type of “going private” transaction is a buyout by a private equity fund. Private equity funds raise substantial funds from pension funds and other large investors.⁴⁸ The funds then buy public companies, and attempt to make improvements through better management, streamlined operations, and strategic investments.⁴⁹ The private equity fund then turns around and sells the company either to another company, or to shareholders through an initial public offering.⁵⁰ In 2006, private equity firms bought 654 U.S. companies for \$375 billion, setting a new record.⁵¹

b. Rule 13e-3 Transaction

A second type of “going private” transaction falls under the Securities Exchange Act of 1934, Rule 13e-3.⁵² Rule 13e-3 refers to any transaction:

In which certain of the existing stockholders or affiliates of a public target become stockholders of the entity surviving the acquisition of the target and the target is no longer subject to Section 12(g) or Section 15(d) of the Exchange Act.⁵³

Two types of transactions are included within the ambit of Rule 13e-3. First, “true” going private transactions, which is one “by which an individual or group of individuals controlling a public corporation by virtue of an impregnable stock position... undertakes a corporate transaction in order to acquire... the entire equity interest in the corporation.”⁵⁴ This type of transaction is distinguishable from a “technical” going private transaction, in which “the acquirer does not hold a controlling stock position, but is an ‘affiliate’ within Rule 13e-3.”⁵⁵ An example of a “technical” going private transaction is a management buyout (MBO). Another example is a

⁴⁷ SEC Fast Answers, “Going Private”, available at <http://www.sec.gov/answers/gopriv.htm> (last modified Aug. 9, 2004).

⁴⁸ Jaclyne Badal, *Private-Equity Spree Hits Home*, WALL ST. J., Nov. 28, 2006, at D3.

⁴⁹ Diya Gullapalli, *Fund Track: Buyout Boom Helps Some Investors*, WALL ST. J., Feb. 23, 2007, at C1.

⁵⁰ *Id.*

⁵¹ Robert Samuelson, *The Private Equity Boom*, WASHINGTON POST, March 15, 2007, at A19.

⁵² Joshua M. Koenig, *Survey: A Brief Roadmap to Going Private*, 2004 COLUM. BUS. L. REV. 505, 507–08 (2004).

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.*

leveraged buyout (LBO). An LBO is a transaction in which the acquirer purchases the target company with a substantial amount of borrowed money. In some situations, a LBO is identical to a buyout by a private equity fund, as described above. However, an LBO in the context of a “technical” going private transaction is meant to refer solely to a transaction in which a substantial number of stockholders or members of management are aligned with the acquirer. Conversely, a buyout by a private equity fund can refer to a situation in which prior to the buyout itself, the private equity fund does not own an interest in the company.

2. Explanations for the Increase in Going Private Transactions

Although Sarbanes-Oxley has received the vast majority of the blame for the recent increase in going private transactions, there are undeniably other factors that contribute to a public company’s decision to go private. In order to understand one such factor, it is first necessary to understand why companies choose to become public to begin with. In general, one of the chief advantages of being a public company is the easy access to funds through the securities markets. However, some small companies, despite having high profitability and superior business strategies, do not receive the necessary analyst coverage to cause investors to sit up and take notice. As a result, such companies may find that the costs of being public outweigh the benefits, and choose to exit the public market.⁵⁶

Another reason that companies may choose to go private is to avoid the costs of complying with public companies regulation. Obviously, complying with Sarbanes-Oxley is very costly. However, those that are quick to blame Sarbanes-Oxley for the increase in going private transactions seem to forget that it is by no means the only regulatory expense associated with being a public company. Even before the passage of Sarbanes-Oxley, companies had to pay fees in connection with SEC filings, D&O insurance premiums, audit fees, and shareholder derivative suits.⁵⁷ Such costs were in existence long before the passage of Sarbanes-Oxley, and will continue to exist, though possibly at decreased levels, even if Sarbanes-Oxley is substantially revised, or even repealed.

Companies may also prefer to be private in order to focus on long-term growth prospects without worrying about the consequences of sacrificing immediate shareholder returns.⁵⁸ The structure of public companies provides

⁵⁶ Koenig, *supra* note 51, at 508.

⁵⁷ *Id.* at 509–510.

⁵⁸ *Id.*

incentives for management to focus on short-term earnings at the expense of value maximizing long-term decisions. However, private companies are not beholden to the whim of the common shareholder, and therefore, they are better able to balance long-term growth opportunities with short-term earning prospects.

The attractiveness of private company status is also increased by the reduction in agency costs.⁵⁹ Essentially, managers and shareholders of public companies have divergent interests.⁶⁰ Management wants to maximize their compensation, reputation, and job security.⁶¹ Sometimes, these incentives may cause the management to engage in empire building, regardless of whether it is in the best interests of shareholders.⁶² Although shareholders can theoretically control management through the board of directors, the costs of doing so can be high, thus increasing the expense of being a public company. Companies may choose to go private in order to reduce these agency costs.

3. Sarbanes-Oxley is Currently Considered to Be One of the Most Significant Factors Influencing the Decision of Public Companies to Go Private

As the previous section demonstrates, Sarbanes-Oxley is not the only reason that public companies are increasingly deciding to go private. However, it is undoubtedly a contributing factor, and many of its critics believe that it is by far the most significant one. According to a study conducted by Foley & Lardner, a Milwaukee-based law firm, a staggering 20% of public company, is considering going private in order to avoid the costs associated with Sarbanes-Oxley compliance.⁶³ Furthermore, the number of going-private filings in 2004 was nearly double the number of filings in 2002, a fact which even supporters of Sarbanes-Oxley can hardly deem coincidental.⁶⁴ In fact, this figure is even more significant in light of the fact that 2002 came right on the heels of a precipitous market collapse, while 2004 marked a modest recovery from this collapse.⁶⁵

Although supporters of Sarbanes-Oxley may point to the substantial benefits that it offers by way of increased transparency and accountability,

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ Factor, *supra* note 31.

⁶⁴ Carney, *supra* note 5, at 157–58.

⁶⁵ *Id.*

the fact remains that those benefits will not be realized if companies continue to elect to go private instead of incurring the hefty costs of compliance. Sarbanes-Oxley is by no means the sole driving force behind public companies' decision to go private, but it is definitely a contributing factor. The question that must be answered is whether the benefits are truly worth the cost.

4. The Private Equity Boom Bubble and Its Potential Burst

There are other slightly less theoretical justifications that explain the abundance of willing purchasers of public companies wishing to go private. First, lenders have been freely offering private equity firms loans with lower interest rates and fewer restrictions.⁶⁶ This has allowed the private equity firms to have a seemingly endless supply of credit and funds to purchase their targets. As a result, there is a plethora of investors willing to invest in these firms hoping for high returns in a short amount of time. "Over the past 20 years, buyout firms have averaged annual returns of 13.2%" compared with the "stocks in the Standard & Poor's 500 index [which] have averaged only 9.7%."⁶⁷

In addition, institutional investors such as pension funds are investing more money in private equity firms than ever before.⁶⁸ "U.S. private equity firms raised \$199.4 billion in 295 funds during the first three quarters" of 2007.⁶⁹ This is a 29% increase over the same period in 2006, which had 63 fewer funds.⁷⁰ The fund-raising is on pace to break the record of \$254.3 billion from 2006.⁷¹ As a result, private equity funds have been flush with money, and are aggressively going after investment opportunities.

However, in the wake of the subprime crisis, lenders have become apprehensive and have begun to fear that the low rates and favorable restrictions have "caused some risky investments to be funded too easily, as in the subprime mortgage market. Lenders are pulling back from those deals now but also demanding higher interest rates and stricter repayment clauses for fundamentally sound transactions, such as the proposed purchase of U.S. Foodservice."⁷² Private equity firms are finding it increasingly difficult to

⁶⁶ Nicholas Varchaver, *Private-Equity Forecast*, FORTUNE, Jan. 22, 2007, V. 155 at 21.

⁶⁷ Samuelson, *supra* at note 51.

⁶⁸ Varchaver, *supra* note 66.

⁶⁹ 2007 *Private Equity Fund-Raising Up 29 Percent*, SACRAMENTO BUSINESS JOURNAL (Oct. 11, 2007).

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² Thomas E. Heath, *Private Equity Deals Slow Down*, WASHINGTON POST, June 29, 2007 at D01.

find investors to fund deals, and to persuade banks to underwrite these transactions. Recently, “there have also been a number of reports that major investment and retail banks have approached private equity firms about calling deals off. The banks have offered to pay the breakup fee to keep the large loans off their books.”⁷³

The eager investors may also begin to diminish because of fears that the rates of return will decrease due to the credit crunch and overpriced purchases. In 2006, private equity firms had a tremendous amount of cash and the prices of targets began to soar.⁷⁴ The private equity firms began to bid against each other and drive the prices above their fair market value. Many target firm shareholders were receiving, and in some cases rejecting, offers with premiums at or above 33%.⁷⁵ As a result, the private equity firms were forced to borrow more money. As a result, private equity firms have substantial interest payments, which are increasingly absorbing a greater portion of the firms’ cash flow.⁷⁶ This in turn has decreased the returns to investors.

The combination of stricter credit and more cautious investors has slowed private equity deals. Many forecast this to continue, and expect more funds to collapse.⁷⁷ While the signs are present, the extent of the damage remains unclear. This begs the question whether this correction in the market will be detrimental to, or but a speed bump for, private equity firms and targets wishing to go private.

B. Sarbanes-Oxley Has Made United States Capital Markets Less Attractive to Both Foreign and Domestic Companies, Causing Them to List Overseas

As globalization continues to take root, cross-border initial public offerings (IPOs) are at an all-time high. In 2000, over 90% of the capital raised by foreign companies as a result of new stock offerings was raised in New York.⁷⁸ However, since the passage of Sarbanes-Oxley, the preeminence of New York, and therefore the United States, as the financial capital of the world have come into question. By 2005, 90% of the capital

⁷³ Update: Harman Intl Says KKR, Goldman Sachs Pullout of Buyout, DOW JONES NEWS SERVICE, September 21, 2007.

⁷⁴ Shawn Tully, *Why the Private Equity Bubble is Bursting*, CNNMoney.com, available at <http://money.cnn.tv/2007/08/06/markets/privateequitybubble.fortune/index.htm?postversion=2007080709>.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ DeMint, *supra* note 14.

raised by foreign companies as a result of new stock offerings was raised abroad.⁷⁹

At the onset, it should be noted that the problem of companies choosing not to list in the United States can be broken down into two separate trends. First, companies that are already listed in the United States are choosing to delist, instead choosing to list overseas where the regulatory burdens are less onerous. Second, companies engaging in IPOs, rather they be foreign or domestic, are choosing not to list in the United States to begin with. For purposes of simplicity, these two issues will be treated together.

Critics are quick to blame Sarbanes-Oxley for the decreased attractiveness of United States capital markets, citing costly compliance as the primary reason that companies are choosing to list overseas. This begs two very important questions: First, are there other reasons, unrelated to Sarbanes-Oxley, for the decision of companies to list overseas? second, is this “race to the bottom”⁸⁰ a recipe for disaster?

Although Sarbanes-Oxley is undoubtedly a contributing factor with respect to companies’ decisions to list overseas, it is by no means deserving of all of the blame. First, globalization, a phenomenon that has been widely touted by academics and the businesses world for decades, has firmly taken hold, and with globalization has come truly competitive capital markets.⁸¹ Ten years ago, foreign companies may have been forced to travel to the United States in order to raise funds. Today, the same companies have a myriad of choices. Second, listing and underwriting fees are substantially less in many countries.⁸² For example, it has been estimated that the transaction fees in London are half of those that would be incurred in conjunction with a comparable sale in the United States.⁸³ Additional factors have been cited that are completely beyond the control of U.S. regulators, such as the fact that London is in a better time zone.⁸⁴ Finally, it is important to note that some experts claim that the United States started to lose its predominance in the IPO market in the late 1990s, well before the passage of Sarbanes-Oxley.⁸⁵

Although Sarbanes-Oxley is not the only reason that companies are choosing to list overseas, it is incontrovertible that it is a contributing factor. However, the question is whether this fact should lead to a revision or repeal

⁷⁹ *Id.*

⁸⁰ Harshbarger, *supra* note 2, at 24.

⁸¹ Jenny Anderson, *About Those Fears of Wall Street’s Decline*, N.Y. TIMES, Jan. 26, 2007, at C6.

⁸² Stephen Labaton, *A Push to Fix the Fix on Wall Street*, N.Y. TIMES, Dec. 17, 2006, §4 at 4.

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ Robert E. Grady, *The Sarbox Monster*, WALL ST. J., Apr. 26, 2007, at A19.

of Sarbanes-Oxley, or whether U.S. regulators should refuse to engage in a “race to the bottom.”⁸⁶ For example, it is widely-accepted that small public companies are choosing to list in London, which boasts of having “virtually no regulation.”⁸⁷ However, it is a slippery slope for the United States to attempt to compete on those grounds.

In support of the proposition that the United States should refuse to lower its standards in the name of competition, Nasdaq president Bob Grierfield reminds Sarbanes-Oxley critics of the 1980s, when “ADRs fled the American market in droves”... after the SEC “tightened up the 12(g)3-2b exemption.”⁸⁸ He says that “[t]he real lesson of the ‘80s is not how many companies fled from regulation, but how many came back.’ He predicts a similar about-face following the latest furor over 404 requirements.”⁸⁹

Despite Mr. Grierfield’s optimistic predictions, the fact that New York is no longer the center of the financial world is cause for alarm. As the concentration of IPOs shifted away from the United States, so will trading.⁹⁰

[W]here the company lists will dictate where there will be more liquidity, more hedging and more over-the-counter derivatives in the market where the underlying stock exists. This is a boon for banks like Goldman Sachs and UBS, who will profit on underwriting companies from China to Mars. But the banker doing that deal will hail from China and his bonus will help inflate Chinese real estate, art, and restaurant prices, not New York’s. And as more companies list there, more institutions will seek to do business there—hedge funds, for example—generating more business for the Shanghai office and fewer taxes for New York.⁹¹

Ultimately, we are again left with the question of whether the proven benefits of Sarbanes-Oxley justify the associated costs. Although there is some evidence tending to show that Sarbanes-Oxley has achieved increased transparency and greater accountability by companies to investors, the fact remains that the United States is becoming a less attractive market for both foreign and domestic companies. As the popular phrase goes, sometimes it’s lonely at the top. At some point, the United States must decide whether having the most heavily regulated capital markets is worth giving up its position as the leader among global capital markets.

⁸⁶ Harshbarger, *supra* note 2, at 24.

⁸⁷ Anderson, *supra* note 84.

⁸⁸ Harshbarger, *supra* note 2, at 24.

⁸⁹ *Id.* at 24–25.

⁹⁰ Anderson, *supra* note 84.

⁹¹ *Id.*

IV. POSSIBLE SOLUTIONS TO THE PROBLEMS POSED BY SARBANES-OXLEY

The passage of Sarbanes-Oxley came at a time when accounting frauds such as Enron and WorldCom had negatively impacted the public perception of the accounting industry, and investor confidence was at an all-time low. However, five years later critics of Sarbanes-Oxley contend that it went too far, and are calling for either substantial revisions, or its outright repeal.

Sarbanes-Oxley is undoubtedly flawed. However, what its critics fail to realize is that as time passes, and additional guidance is provided by the SEC, the costs of compliance will continue to decrease. In 2006, the cost of complying with Sarbanes-Oxley fell 23%, to an average of \$2.92 million per company.⁹² This represents a decrease of 25% from the first year of compliance. The reason for this decrease in costs is that once companies have adequate internal control systems in place, the cost of complying with Section 404 decreases dramatically. However, because outside auditors must annually attest to these internal controls, the costs of compliance will never decrease below a certain fixed level. Although this is not necessarily a problem for large public companies which generate sufficient revenue to absorb a relatively small annual fixed cost, it could substantially impede small public companies from effectively competing in U.S. public markets. Therefore, the requirements of Sarbanes-Oxley should be relaxed for small public companies.

As previously stated, small public companies do not have to include a management report on ICFR until they file their returns for the fiscal year ending on or after December 15, 2007, and do not have to include an auditors report attesting to ICFR until they file for the fiscal year ending on or before December 15, 2008.⁹³ Many critics of Sarbanes-Oxley support extending this exemption indefinitely.⁹⁴ In support of a permanent exemption, proponents contend that for small public companies, the benefits of compliance are vastly outweighed by the costs.⁹⁵ Furthermore, these proponents contend that this exemption would not negatively impact investors because, “due to the small size of the companies, other means of ensuring proper behavior by the companies, such as auditing, would ensure accountability of management and the finances.”⁹⁶ Also, because they

⁹² Kara Scannell, *Moving the Market: Costs Fall Again for Firms to Comply with Sarbanes*, WALL ST. J., May 16, 2007, at C3.

⁹³ Release No. 33-809, *supra* note 17.

⁹⁴ Carroll, *supra* note 1, at 465.

⁹⁵ *Id.*

⁹⁶ *Id.* at 466.

would still be subject to the antifraud provisions of the SEC, managers of small public companies would still be motivated to implement effective internal controls and engage in scrupulous business practices.⁹⁷ Even Representative Oxley has admitted that if he had to do it over again, he would be in favor of implementing slightly less burdensome rules for small-to mid-sized companies.⁹⁸

Although the argument for exempting small public companies from compliance with Section 404 of Sarbanes-Oxley undoubtedly has its supporters, so does the argument that small public companies should be subject to the same regulatory structure as larger companies. Opponents to exempting small public companies from Section 404 argue that such an exemption would negatively impact investor confidence, as well as the U.S. economy as a whole.⁹⁹ According to these opponents, the exemption would remove approximately 80% of public companies from the reach of Section 404.¹⁰⁰ Therefore, with respect to a substantial segment of the U.S. public market, companies would be free to operate without effective internal controls, essentially leading us back to the same culture and system of incentives that bred the accounting scandals of 2001.

The answer is not to exempt small public companies from compliance with Section 404 in its entirety, but it is also not to refuse to acknowledge the disadvantages they face relative to large public companies. Rather, the answer lies somewhere between the two extremes. The SEC should promulgate regulations that require small public companies to implement effective internal controls, while still acknowledging the difficulties they face in terms of independence as well as segregation of duties. To some extent, the SEC has already done so through AS-5, as well as its Interpretive Guidance for Managers of Public Companies. However, this enhanced flexibility does not go far enough. The SEC should promulgate audit standards and interpretive guidance that solely address the unique circumstances and concerns of small public companies.

CONCLUSION

In conclusion, Sarbanes-Oxley, like most major pieces of legislation, is by no means perfect. Critics contend that the high costs imposed by Section 404 have caused companies to engage in regulatory arbitrage, therefore

⁹⁷ *Id.*

⁹⁸ *Id.* at 468.

⁹⁹ *Id.* at 466.

¹⁰⁰ *Id.*

deciding to either go private or list overseas.

However, Sarbanes-Oxley and most notably Section 404 bring numerous benefits to the table, and as the associated costs decline, it will become an entrenched and accepted part U.S. regulatory law.