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Smaller Issuers Unfairly Overburdened In Complying With Sarbanes-Oxley

ABSTRACTED FROM: *The Impact Of Sarbanes-Oxley On Mid-Cap Issuers*
BY: Marc Morgenstern and Peter Nealis, Kahn Kleinman, Cleveland, OH
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Overview: *Urges Congress to rethink Sarbanes-Oxley, with greater sensitivity to its impact on small and mid-cap issuers. Argues that the smaller issuers face disproportionate compliance costs and that the costs significantly outweigh any benefits provided by the Act.*

Sky-high compliance costs. The Sarbanes-Oxley Act of 2002 has significantly increased the costs of regulatory compliance for public companies. In fact, the compliance costs have proven to be significantly higher than originally estimated. According to one study cited by attorneys Marc Morgenstern and Peter Nealis, the cost of being a public company increased 130% from 2001 to 2002. Companies also face costs that are not easily quantified, such as expanding personal liability for executives and directors, increased D&O insurance premiums, a rise in the compensation demanded by directors, greater audit and legal fees, more and more purchases of financial-control software, and a loss of productivity because executives are spending time on Sarbanes-Oxley compliance. These costs are only likely to grow as Section 404—which requires stringent internal controls—phases in. Issuers commonly react by trying to minimize compliance costs through improved information technology, even as the board analyzes whether the benefits of being public continue to justify the costs. Many are considering a withdrawal from the public marketplace.

Small companies bear the brunt of the burden. Small and mid-cap companies have been impacted the most from this burden, the authors assert, and enjoy little of the clear benefits. Large-cap companies, for instance, benefit greatly from the public's confidence in the stock market that Sarbanes-Oxley seeks to foster, while the smaller issuers face disproportionate costs in complying. They generally have smaller financial staffs, so management will spend a significant amount of time on SEC compliance rather than on running the business. Smaller issuers face a natural disadvantage in accomplishing some of the actions necessary for compliance. For example, Sarbanes-Oxley requires companies to have a certain number of independent directors. Not being as attractive to candidates who have no prior relationship with the company, the smaller issuer has trouble fulfilling the requirement. The problem is only exacerbated by the need to have a financial expert on the audit committee. With very limited exceptions, Sarbanes-Oxley draws no distinction between large and small issuers. The small issuer's only relief from a substantive requirement is being exempt from making a tabular disclosure of contractual obligations in the MD&A. The SEC's only other accommodation for small issuers has been phasing in the compliance deadlines based on market capitalization. Unfortunately, it set the bar fairly low: most mid-cap and many small-cap issuers (and even some micro-caps) are considered accelerated filers.

A break with prior philosophy. Sarbanes-Oxley breaks with the US's disclosure-based philosophy of securities regulation. It requires greater financial transparency, increases personal liability for the chief executive and financial officers, and mandates the composition, role, and expertise of the board of directors. In enacting the law, Congress has reached into the substantive operational activities and corporate governance of public companies. The authors point, for example, to Section 402, which prohibits loans to directors and senior officers. Previously, a loan either occurred in the ordinary course of business (e.g., advances on expense accounts) or was approved by the board. Instead of simply requiring more detailed disclosure on the existence of loans, Sarbanes-Oxley flatly prohibits the directors from approving any loan. Not only is this substantive prohibition unprecedented, but also it has unintended consequences (such as preventing the company from advancing defense costs to officers personally named in a business-related lawsuit).

Ripple effect creating standard practices. In addition to its impact on the public companies to which it actually applies, Sarbanes-Oxley has had ripple effects on private companies and non-profits, remind the authors. The financial community has adopted the new requirements as best practices that all companies should adopt. Venture investors want their portfolio companies to adopt Sarbanes-compliant practices with the view to someday going public. Lenders are requiring borrowers to make Sarbanes-style financial-statement presentations and officers' certifications. Even insurers have begun requiring Sarbanes compliance as a prerequisite to writing D&O insurance. Courts could reasonably conclude that Sarbanes-compliant practices represent the industry standards all companies and boards should adopt. They might then hold liable those that do not conform.

Abstracted from ***Review of Securities & Commodities Regulation***, published by Standard & Poor's, 55 Water Street, New York, NY 10041. To subscribe, call (800) 852-1641 (and press 5). **Editor's Note:** Prof. Curtis Verschoor of DePaul University discusses Sarbanes-Oxley burdens in the March 2005 issue of *Strategic Finance*. Read "Sarbanes-Oxley Section 404 Implementation Needs Modification" at Pgs. 17-18.