The Law of Unintended Consequences: The Effects of the Sarbanes-Oxley ...
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The Law of Unintended Consequences: *The Effects of the Sarbanes-Oxley Act on Venture Funding of Smaller Enterprises*

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Small businesses are a driving force in the U.S. economic growth and the major source of new job creation.

—Jacobe [2003]

NVCA [the National Venture Capital Association] believes that under the typical structure of a venture capital fund, a representative of that fund on the audit committee presents no material risk of abuse of control and, indeed, brings significant benefit to the company and its shareholders.

—NVCA [2004]

In a post-Enron fit of buyer's remorse, congress passed corporate-reform legislation in July 2002. But small companies are finding themselves disproportionately affected by another, more pernicious law: the one that guarantees unintended consequences.

—Murphy [2003, p. 18]

The Sarbanes-Oxley Act of 2002 (SOX) was designed to rejuvenate investor confidence in corporations traded on U.S. public equity markets following a wave of corporate and accounting scandals such as Enron, Tyco, and WorldCom. SOX was intended by federal policy makers to "promote corporate responsibility, enhance public disclosure, improve the quality and transparency of financial reporting, create a Public Company Accounting Oversight Board (PCAOB) to oversee the accounting profession, protect the objectivity of research analysts, and strengthen penalties for volitions of securities law" (Deloitte & Touche [2003, p. 1]). A major focus of SOX is to enhance the transparency of publicly held corporations, which should result in superior economic benefits for investors.

However, these benefits to investors do not come without costs that the small and medium-sized public corporations (SMEs) and private equity investors must also incur: the unintended negative consequences of SOX for informal equity investors, the venture capital industry, corporate venture investors, and the smaller growth-oriented firms that they fund. Consequences of SOX regulatory mandates do not rest exclusively on publicly traded firms. Even privately held SMEs, specifically those that may at some point be acquired by a publicly held firm, should develop financial systems to comply with SOX to avoid tremendous due diligence issues and costs in the future (Hill and Gambaccini [2004]; Mills [2004]). In addition, any SME that hopes to obtain corporate venture capital funding should comply with the provisions of SOX to be considered an attractive candidate for corporate venture capital investing, and even in some cases traditional bank financing (Hill and Gambaccini [2004]).

PURPOSE

The primary purpose of this article is to examine how SOX may impact high-growth

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SMEs and their primary sources of equity funding including informal venture investors (business angels), venture capital funds, and corporate venture capital funds. In addition, this article suggests that future regulatory policy more explicitly and carefully consider the impact of mandated regulations on SMEs and the private equity industry.

THE IMPACT OF SOX ON SMEs AND NEW BUSINESS FORMATION

One of the major motivations for entrepreneurs to establish a new venture is typically financial. Entrepreneurs, like venture capitalists, want to exploit opportunities that have favorable financial returns, typically through some type of harvest strategy. In the recent past many of the dot.com/dot.bomb entrepreneurs focused more on generating immediate wealth at the initial public offering (IPO) than the establishment of a sustainable, profitable business model. It may, therefore, be good public policy to design disincentives for this type of "non-sustainable" business activity. However, it is certainly not effective public policy to discourage economic incentives for the majority of entrepreneurial business formation. One of the more salient reasons that business formations should be encouraged rather than discouraged by public policy is that evidence strongly suggests that SMEs do stimulate job growth (see for example Birch [1987]; Winders [2000]). Unfortunately, SOX directly and negatively impacts the financial attractiveness of IPOs, which have often been the preferred value realization strategy for high-tech businesses.

The major impact of SOX on SMEs is that it will tend to greatly increase administrative costs, without a commensurate increase in revenues, thus driving down financial returns. Granted, many of the provisions of SOX conceptually enhance the governance processes and corporate social responsibility performance of SMEs, yet the associated administrative and regulatory burden will do nothing but increase administrative complexity and costs.

GrayCary [2002] suggests 10 critical provisions of SOX that will have significant effects on SMEs. The remainder of this section describes and discusses each of these provisions.

1. *Ban on loans to officers and directors.* Title IV—Enhanced Financial Disclosures, Section 402—Enhanced conflict of interest provisions amends the Securities Exchange Act of 1934 by adding the following language:

> In General—It shall be unlawful for any issuer (as defined in section 2 of the Sarbanes-Oxley Act of 2002), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. (Sec. 402 (a))

Home improvement loans, consumer credit loans, and similar loans that are available to the public are not precluded under this section. This provision greatly restricts the temptation for corporate directors or officers of closely held companies to "raid the corporate piggy-bank" with the impunity that they formally enjoyed and was crafted to mandate more financial integrity in corporate directors and executives.

2. *Disclosure of insider stock trading.* Title IV, Section 403—Disclosures of transactions involving management and principal stockholders amends the Securities Exchange Act of 1934 and makes more stringent the filing requirements of directors, officers, and principal stockholders (direct or indirect owners of more than 10% of any class of non-exempted equity security). The disclosures must be submitted to the Securities and Exchange Commission (the Commission) if there is a change in ownership within two days. The disclosures will be made available to the public by the Commission on a publicly accessible Internet site and by the issuer on its corporate website (if available). While not directly applicable to SMEs, voluntary compliance with this provision will provide investors more future-focused earning information and honest executive expectations of SME performance. (Sec. 403)

3. *CEO & CFO certification of financial statements.* Title III—Corporate Responsibility, Section 302—Corporate responsibility for financial reports mandates that the Commission require all principal executive officers and principal financial officers to certify in each annual or quarterly report filed with the Commission that:

(1) the signing officer reviewed the report;
(2) the report contains no untrue statements of material fact;
(3) the financial statements and information included in the report fairly present in all material respects the financial condition and results of operations of the issuer;
(4) the signing officers:
  (A) are responsible for establishing and maintaining internal controls;
  (B) designed such internal controls so that material information would be made known to the officers;

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(C) evaluated the effectiveness of internal controls within 90 days of the report;

(D) presented their conclusions concerning the effectiveness of internal controls in their report;

(5) the signing officers disclosed to the independent auditors and the audit committee of the board of directors:

(A) all material weaknesses in the design or operation of internal controls;

(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers indicated in the report if there were significant changes in internal controls whether before or after their evaluation. (Sec. 302 (a))

This requirement may not have a material impact on SMEs because, in many instances, the executives and directors of SMEs are required to sign off on corporate statements. However, their direct involvement in the design, establishment, maintenance, and evaluation of internal controls may impose an additional burden. It remains to be seen if these requirements will result in a reduction in corporate financial frauds in these SMEs. If so, potential investors and venture capitalists will reap the financial benefits.

4. *Disclosure controls.* Title III, Section 302 directs the Commission to issue a certification rule. The Commission, in *Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports,* coined a new term—"disclosure controls and procedures." These are defined as:

> Controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports filed or submitted under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the Commission's rules and forms. 'Disclosure controls and procedures' include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in its Exchange Act reports is accumulated and communicated to the issuer's management . . . as appropriate to allow timely decisions regarding required disclosure. (SEC *Final Rule* . . .)

These controls are intended to be broader in scope than internal controls related to financial reporting. In fact, internal controls for financial reporting may be viewed as a subset of these newly defined disclosure controls. The development and implementation of these control systems may greatly increase the administrative cost structure for SMEs that typically have much less sophisticated accounting information systems in place.

5. *Rotate lead audit and review parties every five years.* Title II—Auditor Independence, Section 203—Audit partner rotation amends the Securities Exchange Act of 1934 by adding the following language:

> It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, had performed audit services for that issuer in each of the 5 previous fiscal years of the issuer. (Sec. 203)

SMEs that choose to comply with this provision should not experience significant costs if they retain the current public accounting firm but with a different audit partner. If, instead, they elect to change audit firms, the cost of the initial audit with the new firm will typically increase. Many publicly traded firms that fall under the requirements of SOX are electing this second option to enhance the independence—in appearance and fact—of the external auditor and the independent audit report.

6. *Independent audit committee.* Title III, Section 301—Public company audit committees amends the Securities Exchange Act of 1934 by directing the establishment and functions of each issuer's audit committee. The audit committee, as a committee of the board of directors, is responsible for the appointment, compensation, and oversight of any registered public accounting firm employed by the issuer. Each member of the audit committee should be independent. To be independent, the member may not "accept any consulting, advisory, or other compensatory fee from the issuer; or be an affiliated person of the issuer or any subsidiary thereof." (Sec. 301 (3) (B) (i) and (ii)) The audit committee may hire advisors (Sec. 301 (5)); the issuer is responsible for funding both the audit committee and its advisors. (Sec. 301 (6) (B))

Most privately held corporations lack both an independent board of directors and an independent audit committee. SMEs that establish an independent audit committee signal to venture capitalists and potential investors the

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enterprise's commitment to transparent corporate governance and financial reporting. This benefit should greatly exceed the increase in administrative costs that will occur.

7. *Establish whistle blower procedures.* Title III, Section 301 (4) mandates that audit committees establish procedures for

(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and

(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters. (Sec. 301 (4) (A) and (B))

The latter provision (B) is better known as the whistle blower procedures. The requirement to protect the anonymity of corporate whistle blowers (the Association of Certified Fraud Examiners prefers the less pejorative term of corporate sentinels) may be much more difficult to effectively implement in SMEs than in a larger corporation where there often are a limited number of employees with access to information. However, this function may be readily outsourced to a number of different companies that will design and implement specific procedures for the client enterprise.

8. *Separation of audit and accounting services.* Title II, Section 201—Services outside the scope of practice of auditors identifies nine non-audit services that auditors may not provide to issuers contemporaneously with the audit:

(1) bookkeeping or other services related to the financial records or reports;
(2) financial information system design and implementation;
(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
(4) actuarial services;
(5) internal audit outsourcing services;
(6) management functions or human resources;
(7) broker or dealer, investment advisor, or investment banking services;
(8) legal services and expert services unrelated to the audit; and
(9) any other service that the Board (Public Company Accounting Oversight Board or PCAOB) determines, by regulation, is impermissible. (Sec. 201 (g) (1)–(9))

It is not difficult for SMEs to review the relationships with their external auditor so that incompatible services may be identified and eliminated. It is far easier to realign these services in advance of an IPO rather than once the decision to go public has been made. Furthermore, complying with this section of SOX provides another strong signal to venture capitalists and potential investors of the importance placed on the independence of the external auditors by the enterprise.

9. *Establish code of ethics.* Title IV—Enhanced Financial Disclosures, Section 406—Code of ethics for senior financial officers mandates that the Commission issues rules concerning 1) the adoption by issuers of codes of ethics for senior financial officers (including the comptroller or other chief financial officer) and 2) the immediate disclosure of waivers or changes to such code. Code of ethics is defined as those standards as are reasonably necessary to promote—

(1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
(2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and
(3) compliance with applicable governmental rules an regulations. (Sec. 406 (C) (1)–(3))

Robideaux, Miles, and White [1993] found that SMEs (as represented by *INC* 500 corporations) and larger publicly traded corporation (as represented by *Fortune* 500 firms) tended not to exhibit any significant differences in their adoption of formal codes of ethics. This suggests that SMEs tend to implement corporate social responsibility systems at a similar rate as larger firms. Both larger corporations and SMEs would be better served by adopting formal codes of ethical conduct.

10. *Real-time disclosure.* Title IV, Section 409—Real time issuer disclosures requires that each issuer:

> Shall disclose to the public on a rapid and current basis such additional Information concerning material changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations . . . as is necessary or useful for the protection of investors and in the public interest. (Sec. 409 (1))

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This criterion suggests that the regulators crafted SOX to be used to enhance transparency and good governance. Requiring that the information is presented and communicated in a manner that will maximize its readability and usefulness to stakeholders is a very positive step in the direction of legislating good corporate governance.

These new requirements will greatly increase the administrative cost of public firm security compliance efforts, and most significantly for small businesses that elect to adopt them (Hoffman [2002]). For example, Murphy [2003, p. 18]) reports that for even small corporations "setting up compliance will cost several hundred thousand dollars and that maintaining it will require at least an extra $50,000 a year each in accounting and legal fees." While larger publicly traded corporations will be able to absorb and pass on compliance costs of SOX, SMEs will face significant cost increases that may negatively impact profitability and returns to investors (Herrera [2002]).

SARBANES-OXLEY AND VENTURE FUNDING

The impact of SOX on SMEs may be even more pronounced than simply increasing the administrative burden and costs for SMEs. SOX may, in fact, greatly reduce the availability of venture funding in the U.S. by making venture investing much less financially attractive to investors. The three major forms of venture, or risk, capital in the U.S. are: 1) business angels' investments and informal private equity, 2) formal venture capital firms, and 3) corporate venture capital. Each form of venture capital, discussed below, has different motives and different exit strategies.

1. *Business angels.* Business angels often invest in the hope of earning a superior rate of return, while concurrently providing the investor opportunities for employment, consulting, or board of director positions. Business angels realize returns directly from their investments 1) when the firm is sold either through a trade sale or IPO, 2) when profits are distributed by the SME as an ongoing business, and 3) indirectly through employment, consulting, or board of director opportunities. As previously discussed, SOX may limit the ability of SMEs to realize maximum profitability of their investment through an IPO or trade sale.

2. *Formal venture capital firms.* Formal venture capital firms tend to have specific financial objectives that they hope to realize at some predetermined time when they sell their equity either in a management buyout (MBO), trade sale, or IPO. Formal venture capital funds typically realize value only at the sale of equity in the SME.

3. *Corporate venture capital.* Corporations typically invest in SMEs as a form of corporate venturing for some combination of strategic benefits, organizational development, or financial returns (Miles and Covin [2002]). Corporations can realize financial returns to corporate venture capital investments in SMEs through 1) the return from the sale of the venture at a trade sale, MBO, or IPO, 2) ongoing operating profits of the business, and/or 3) the additional revenue derived from the sale of the investing corporation's products due to growth in the industrial "ecosystem" (Covin and Miles [2004]). For example, Intel realizes gains from its investments in SMEs that produce more efficient batteries through the incremental sales of their chips that are part of and complements of smaller and more powerful laptops. For an SME to be an attractive candidate for corporate venture investing, it would be forced to comply with the SOX guidelines.

SMEs are largely dependent on these three sources of equity for the risk capital required to successfully exploit innovative entrepreneurial opportunities. SOX over time may have a chilling effect on venture financing of all types in the U.S. This is because venture capital funds typically use initial public offerings as the preferred mechanism to realize the financial value in their investments in small, entrepreneurial firms. With the additional costs incurred by SMEs to comply with SOX, the return on formal venture capital investing may drop below the already low average rate of returns during the early part of this century on private venture investing (Primack [2002]). The costs associated with SOX compliance have made taking an SME public through an IPO a much less financially attractive proposition, both for the founders and the venture capitalists. In fact, there is some evidence that the administrative costs are so burdensome for some publicly traded SMEs that they are going private again (Cecil [2003]).

CONCLUSIONS

The authors hope that this article stimulates further research and discussion on the important topic of the consequences of Sarbanes-Oxley on SMEs and the venture capital sector. SOX is a positive step towards better corporate governance, but may be most beneficial for larger corporations. We simply hope that it does not create too many economic and regulatory disincentives for SMEs and private equity investors. Additional research may fruitfully consider the administrative and regulatory burden that SOX

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places on the three forms of venture capital funding and how these increased costs will impact the supply of venture capital. Subsequent studies may contribute to this dialog by considering the impact on job creation, income, and social welfare of publicly traded firms going "private" to avoid the SOX mandates and regulations.

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Strategies and Techniques for Venture Investing

STRATEGIC RESPONSES TO AN ENVIRONMENTAL JOLT: EXECUTIVE TURNOVER IN INTERNET IPOs 63

DANIEL P. FORBES, SHALINI MANRAKHAN, AND SANJAY BANERJEE

We develop a model that predicts the likelihood that publicly-traded start-up firms will respond to a sudden drop in environmental munificence by replacing their CEO. The model proposes that CEOs who were founders, those who had prior experience as CEOs, and those who also held the position of board chair will be less likely to be replaced. We base these predictions on a set of knowledge-based and political considerations. We test the model on a sample of 127 Internet IPOs during the period following the dramatic devaluation of Internet stocks that occurred in Spring/Summer 2000. Results support all three hypotheses.

THE LAW OF UNINTENDED CONSEQUENCES: THE EFFECTS OF THE SARBANES-OXLEY ACT ON VENTURE FUNDING OF SMALLER ENTERPRISES 70

LESLIE B. FLETCHER AND MORGAN P. MILES

This article describes how the Sarbanes-Oxley Act of 2002 may adversely impact venture funding of smaller enterprises (SMEs). We suggest that the Sarbanes-Oxley Act of 2002 may in fact result in a less attractive economic environment for SMEs and their private equity investors.

U.S. TAX PLANNING CONSIDERATIONS FOR INVESTMENTS IN FOREIGN PORTFOLIO COMPANIES 76

DAVID M. NEUENHAUS AND FRANCIS J. HELVERSON

Foreign investment by U.S. funds is increasingly common. Foreign investment involves complex U.S. tax issues that differ from those encountered in the purely domestic context. This article provides a road map to help advisors and fund professionals better understand a number of the important considerations. The article is not written in technical "tax speak," and is intended to be accessible to readers with a non-tax background. It provides an overview of the tax considerations involved in making and holding foreign portfolio investments, a description of the tax treatment of the various participants, and then applies the concepts to three simplified common investment structures.

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