Remarks of Professor William J. Carney to

SEC Advisory Committee on Smaller Public Companies

June 17, 2005

Mr. Chairman, thank you for inviting me to participate in these hearings. As I understand your committee's charge, you are to examine the impact of the Sarbanes-Oxley Act ("SOX") on smaller public companies. I've recently done a study on the costs of securities regulation, including the increased costs imposed by SOX, for these companies from their filings on Schedule 13E-3 for calendar year 2004. My study will be published later this year in the EMORY LAW JOURNAL. In order to be consistent with the methodology of earlier studies, I used only companies that filed their first Schedule 13E-3 in that year, rather than include those that were filing amendments to an initial filing in a previous year.

Let me begin by noting that not all cost increases have been related to SOX. The SEC has continued to add to regulatory burdens by accelerating timetables for traditional filings, including 10-Ks, 10-Qs and 8-Ks, and by expanding the required disclosures in 8-Ks. At the same time, auditing costs are rising. But this is only part of the increase in costs. More executive time is required to be devoted to compliance activities rather than growing the business, which is a hidden cost of regulation. Premiums are increasing for D&O insurance policies. My paper includes a survey of others' estimates of the rising costs of compliance with the securities laws. Generally these cost estimates are for larger companies, but they are indicative of the trend.

My study, as I indicated, focuses on all companies that filed a Schedule 13E-3 in 2004. The numbers of filings have been steadily rising since 1998, from a low of 25 to a high of 114 in 2004. This has been accompanied by a steady increase in leveraged buyouts, where I have less data. LBOs have been driven by the growth of private equity firms, which provide an alternative means for exiting public markets. The number of LBOs has nearly quintupled between 2002 and 2004. I have better data on the dollar volume of LBOs, which shows a much steadier rise. Here the numbers show roughly a rise of 400% from 2002 to projected 2005 numbers, if the first quarter is a reliable indicator. I have no way to separate those LBOs that may be partly explained by avoidance of regulatory costs from those driven by other motivations, but given the evidence I provide below, it seems likely that avoiding these costs explains at least part of the trend.

The striking feature my study sample is the small size of the 13E-3 filers, with median gross revenues of only $25 million. Of the 114 firms filing in 2004, 44 of them, or 39%, not only listed high compliance costs as a reason for terminating registration, but also provided cost estimates. One has to assume that in nearly all of these cases these firms were facing further increases in costs as Section 404 requirements kicked in. Some of the other firms also mentioned increased regulatory costs, but they didn't detail them.

I should caution that I think the numbers in these filings understate the costs of compliance. They include only out-of-pocket costs, such as increases in auditing and legal fees, as well as the costs of hiring additional employees in a few cases. But they do not include the increase in executive and other employee time devoted to these tasks. In some cases it appears that firms seriously underestimated the anticipated costs of compliance. One firm estimated the cost of compliance with SOX at $25,000, while two others put the cost at $34,000 and $36,000.

I've excluded one very large 13E-3 filer from my statistics, because it seriously distorted the results, leaving 43 companies. Here are the numbers for these companies:

Average cost of compliance with securities laws	$291,000
Average cost added by SOX	174,000
Average net profit	545,000
Compliance costs as a percentage of profits	53%
SOX costs as a percentage of other compliance costs	148%

One really useful feature of this data is that these companies estimate that compliance with SOX increased their compliance costs by 148%. I have to caution that these filings didn't specify which of these costs were one-time start-up costs for SOX and which would be ongoing increases.

Next, I'd like to address the identity of these companies. It's obvious they are relatively small, and that their profits are modest. In the list I provide I've highlighted those companies that appear to be community financial institutions. Fifteen, or over onethird, appear to fit in that category. This means that community banks and thrifts will no longer be owned by the community in many instances.

In some cases, companies whose stock prices declined after the NASDAQ bubble burst in 2000 may have found that being a public company was no longer attractive, regardless of the increases in compliance costs imposed by SOX. I have a chart that attempts to compare the rising number of going private filings, shown in the bar graph in yellow with the NASDAQ composite index, shown on an annual basis with a blue line. Note that the number of filings began to rise before the market collapsed, and then increased rather dramatically in 2003, even as the index rose. This suggests that compliance costs rather than stock prices were the stronger driver in the recent trend.

This isn't the first time that companies have gone private in significant numbers, and some of it has been related to overall stock market price levels. We've seen similar phenomena in the early 1970s, and then again in the 1980s. This suggests caution in interpreting these numbers. But when companies filing to do something as dramatic as terminate registration identify and specify regulatory costs as a reason, it suggests that there is something different about this movement.

I should point out that terminating registration under the securities laws has an odd set of consequences. In some cases a small group of shareholders will remain in what has become a closely held company. In others, the number of shareholders will be reduced below 300. In these cases investors may find exiting their investments very difficult.

They may get less information than the securities laws required, and it may be delivered on a less current basis. In some cases local brokers may make a market if the companies are willing to provide sufficient information to enable a broker to comply with Rule 15c2-11, but the quality and currency of that information may be inferior to that previously provided by these companies. While many of these companies probably had little access to public markets for further financings, there was at least the possibility of PIPES financing based on the market price of their securities, which has now dried up. Are investors and would-be investors in these companies better off as a result of SOX? I find it impossible to conclude that they are.

Keep in mind that the 148% increase in compliance costs didn't dramatically improve the information flow these investors would have received had their companies remained public. Financial institutions were already audited and regulated by outsiders. The others had audited financials, which they produced at the peril of fraud liabilities before SOX. From my perspective, section 404 is less an anti-fraud provision than an anti-negligence provision for most companies. When the financial stakes are large enough, it may be possible to justify an increase in costs to prevent negligent audits, but it's pretty clear that isn't true in smaller companies. They will choose to exit public markets rather than incur these increased costs.