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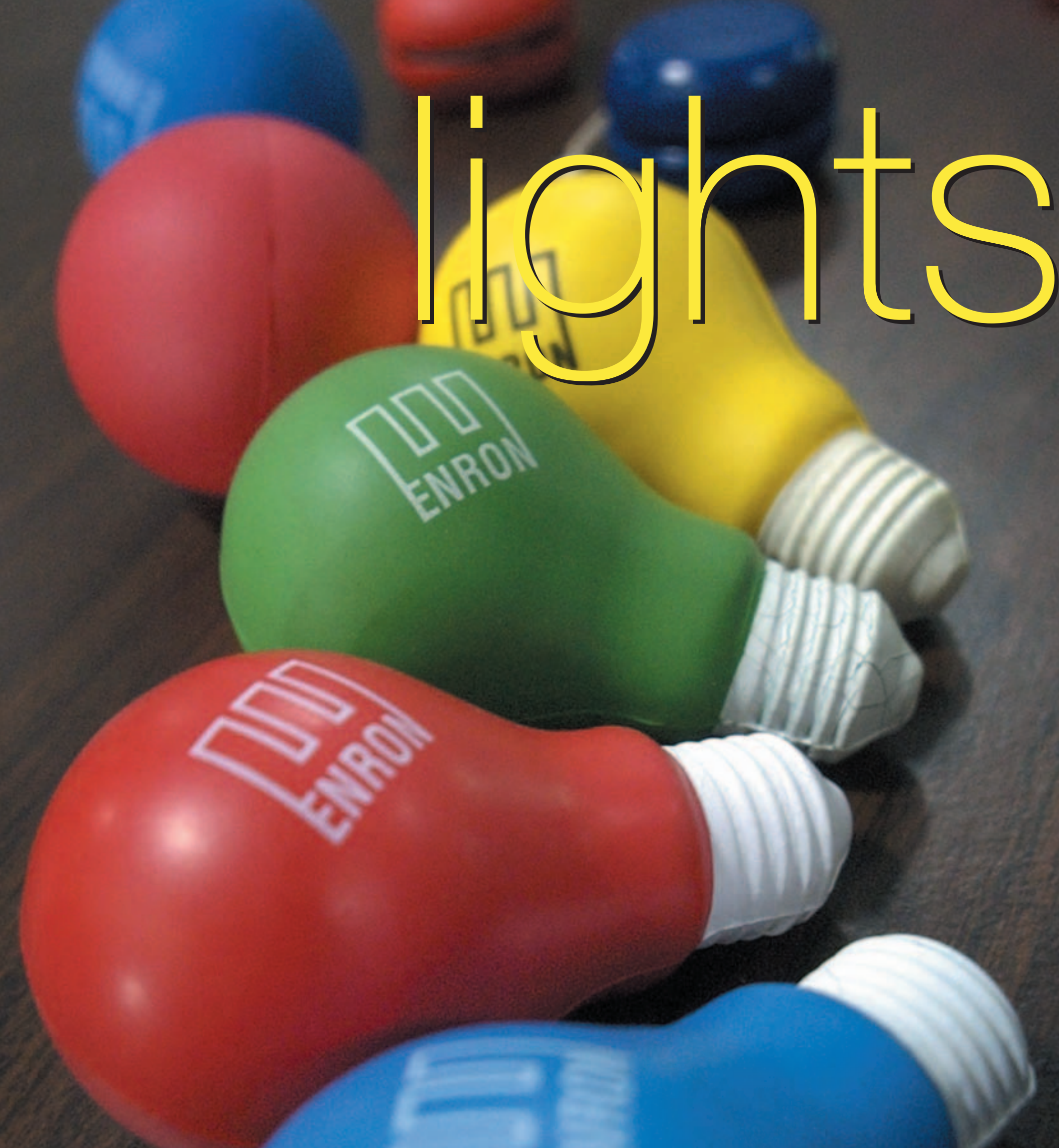


Three years after the enactment of the Sarbanes-Oxley Act, questions are mounting about unintended consequences for hundreds of U.S. firms

BY DOUG CAMPBELL

Squeezable lightbulbs with the Enron logo were just one of a warehouse full of items auctioned off after the company's demise in 2001.

On March 17, shares in discount men's clothier S&K Famous Brands fell 8.6 percent. Executives at the Richmond-based firm were hardly surprised. In fact, Chief Financial Officer Robert Knowles had thought the dive might be steeper.

The day before, S&K had announced that it was terminating its registration under the Securities and Exchange Act of 1934. In market slang, S&K was "going dark." No longer would the company file quarterly and annual reports on its financial condition, and so no longer was the ticker symbol SKFB welcome on the Nasdaq National Market. S&K shares would instead trade on the Pink Sheets, land of the penny stocks, where Securities and Exchange Commission noncompliance is no barrier to membership. S&K officers said they wouldn't have done it if not for the Sarbanes-Oxley Act of 2002. A press release summed it up this way: "The increasing financial cost and commitment of management's time to regulatory compliance have become a burden that will only increase over time."

Knowles estimates his firm can save $300,000 a year by sidestepping just a single component of Sarbanes-Oxley, Section 404, which requires a detailed, independent review of a company's internal financial reporting controls — plus a signed declaration from top executives and auditors that those controls actually work. For S&K, such a review is a budget-buster.

Among other things, compliance would mean documenting how a large sample of S&K's 240 stores in 27 states report each and every transaction — that is, everything from the sale of a $20 necktie to the return of a $500 suit, how they are keyed in, and how they are stored in the warehouse. These are already well-documented procedures at S&K, but reporting under the new rules would bring about, for one thing, the hiring of a second auditor to conduct its own review of S&K's internal operations. Knowles frowns in explaining it all. "It's not a necessary procedure for us," he says. "The shareholder isn't going to get anything more out of Section 404 — other than the fact that we spent $300,000."

S&K's management is far from alone in this sentiment. Corporate America has a new scourge: Sarbanes-Oxley. High-profile critics include the U.S. Chamber of Commerce and the *Wall Street Journal* editorial page.

PHOTOGRAPHY: AP/WIDE WORLD PHOTOS

Citing the new rules, a growing number of firms since 2002 have either stopped making filings with the SEC or gone private. (Unlike "dark" firms, companies that go private stop trading to public investors and usually, but not always, repurchase all of their outstanding stock.) This was not exactly what lawmakers had in mind as a remedy to corporate scandals like Enron and WorldCom.

A new crop of studies lends some support to the claim that Sarbanes-Oxley may be having the unintended effect of driving firms, especially small ones, from the SEC's watch. These findings are in keeping with standard economic theory that excessive regulation is bad for business — and the wider economy as well.

A broad spectrum of analysts and observers agree that portions of Sarbanes-Oxley — chiefly, the notorious Section 404 of the act — provide few direct benefits to investors and even fewer to the companies trying to implement them. Even after Sarbanes-Oxley, internal controls were responsible for detecting fewer financial frauds than those detected by tips, internal audits, and "by accident," according to a 2004 survey by the Association of Certified Fraud Examiners. Meanwhile, critics say Sarbanes-Oxley amounts to a gift to the accounting industry, requiring as it does extra auditors and accountants.

But a closer look at the studies and the firms going private or dark is revealing. First of all, this involves only a tiny fraction of companies that trade in the U.S. public markets. Despite all the chest-pounding over rising compliance costs, a large majority of the approximately 17,000 publicly traded U.S. firms remain under the auspices of the SEC. What's more, for many, getting out of the SEC's view might have been a prudent move even without Sarbanes-Oxley. These are generally small firms that were already on the public-private margin — and that may even go for S&K Famous Brands.

Conflicting evidence like this makes it difficult to assess the effects of Sarbanes-Oxley, especially on small firms. It is entirely plausible that many large corporate frauds have been prevented because of Sarbanes-Oxley. Such deterrence would have a significant and positive impact on the economy. The problem is that it is very hard to measure this possibility. Three years, it seems, has not been enough time to figure out whether Sarbanes-Oxley went too far.

In the Wake of the Crash

Sarbanes-Oxley took effect under the banner "Public Accounting Reform and Investor Protection Act" when President Bush signed it into law on July 30, 2002. It was universally regarded as the most substantial overhaul of U.S. business regulations since the enactment of the Securities Exchange Act of 1934, which created the SEC as the centerpiece of an effort to prevent a repeat of the 1929 market crash.

With the go-go 1990s a fond memory, politicians responded to public clamoring for a corporate crackdown, something to dissuade future Enrons from happening. They produced a set of rules whose main provisions aimed to hold CEOs and CFOs more accountable for their firms' financial disclosures, required more thorough reporting programs, and established stricter standards for membership on board audit committees. There also was the creation of a new oversight board to monitor the accounting industry. Underlining all of it were hefty doses of new criminal penalties — fines of $5 million and 20 years in prison for executives who knowingly certify false financial reports. (Richard Scrushy, the first CEO to be prosecuted under Sarbanes-Oxley, was acquitted June 28 after three weeks of deliberation.)

The reforms came at a time when the country was coming out of recession and less than a year removed from the terrorist attacks of Sept. 11, 2001. At the same time, stock exchanges were toughening their rules for listing, civil lawsuits were mounting, and the criminal justice system was stepping up, as perp walks featuring former Wall Street darlings became commonplace.

To some economists, Sarbanes-Oxley was an unnecessary pile-on. Disclosure is often in the best interests of businesses, since firms that fully disclose their information may command higher share prices for their stock. Disclosure, many academics agree, potentially reduces the age-old agency problem inherent in large organizations whose owners are not necessarily the same as their managers. In this way, shareholders are better equipped to keep an eye on managers, making sure they are doing what they were hired to do: increase the firm's share value.

Disclosure also takes the edge off of adverse selection in capital markets — if all investors are equally and well-

SARBANES-OXLEY ACT OF 2002

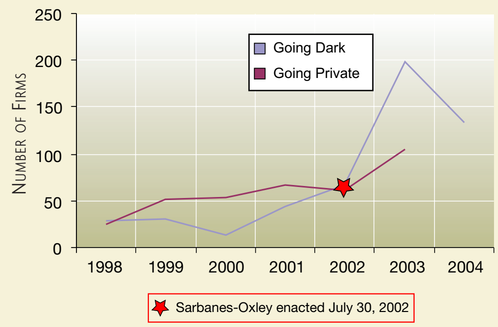
To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

(a) RULES REQUIRED. The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall
(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.

The SOX Spike

Two studies have attributed an increase in the number of firms going dark and going private to the July 2002 enactment of Sarbanes-Oxley.



NOTE: Engel, Hayes, and Wang provide data for going-private firms through 2003 only.
SOURCES: Leuz, Triantis, and Wang (2004) and Engel, Hayes, and Wang (2004)

informed, then fewer will buy shares in firms that ought to be avoided. But in Sarbanes-Oxley, the government was essentially saying that new measures were necessary to reel in agency costs.

Whether Sarbanes-Oxley has actually succeeded in easing the agency problem remains up for grabs. Disclosure does not automatically rid the world of fraud. Companies could meet all of the law's disclosure requirements but still file fraudulent reports. In addition, an economically rational world seeks to "keep on spending on fraud prevention until the returns on a dollar invested in prevention are no more than a dollar," says William Carney, a law professor at Emory University who is studying the costs of being public after Sarbanes-Oxley. In other words, wiping out all fraud would be prohibitively expensive. You don't want it to cost more to prevent fraud than the fraud itself would have cost in the first place. Better, Carney says, is to strive for an "optimal amount of fraud." And he is very skeptical that Sarbanes-Oxley has brought us anywhere closer to achieving optimization. Sarbanes-Oxley, Carney writes, "may have reached the point where the costs of regulation clearly exceed its benefits for many corporations."

Numerous surveys have tried to nail down the new costs of complying with Sarbanes-Oxley. Foley & Lardner, a Chicago law firm, found in 2003 and 2004 that the average cost of being public for firms with annual revenues less than $1 billion grew $1.6 million, or 130 percent, since Sarbanes-Oxley took effect. In a different survey of larger firms, Financial Executives International reported that Section 404 compliance clocked in at an average $4.36 million per firm, which was 39 percent higher than surveyed firms had originally expected to pay.

If rising costs persuade large numbers of firms to exit the public markets to evade SEC regulation, two distinct problems are created. First, the overall economy might suffer insofar as firms may give up investment projects because they may have to rely on higher-cost sources of capital to fund operations. Second, firms that "go dark" may happen to be the very sort of financially stressed organizations which shareholders might want closer tabs on — the very sort of companies Sarbanes-Oxley was designed to police.

(A counter argument is that a "dark" Enron would never have been able to raise as much capital as it did; in this way, the trend of troubled firms going dark may not be such a bad thing because shareholders wouldn't be funding the new capital by buying up stock.)

Going dark is probably the most extreme reaction to climbing compliance costs. Among the main requirements for being able to deregister is having fewer than 300 (sometimes 500) shareholders of record. It can be a quick process. When S&K delisted, for example, it needed only to provide written notice to Nasdaq of its intent to delist and then file a Form 15 with the SEC. With that, all obligations to operate under the auspices of the SEC ceased and S&K — or any other deregistering organization — could join the Pink Sheets, an automated quotation service known informally as an over-the-counter bulletin board. This is the land of no-name stocks, firms which are longest-shot candidates to grace the covers of *Fortune* and *Forbes*. Inevitably, firms that go dark see their stock prices fall, a function of both the Pink Sheets' looser listing requirements and the relative lack of liquidity compared with the Nasdaq or New York Stock Exchange.

People started to notice a spike in "going dark" maneuvers shortly after Sarbanes-Oxley went into effect. In the summer of 2003, some institutional investors filed a petition arguing that many firms going dark were unfairly taking advantage of the 300-shareholder rule. It was alleged that many of these firms actually had thousands of shareholders, but because their stock was held by a relatively small number of brokerages and other institutions, the delisting firms could point to less than 300 holders of record. Three business school researchers took notice of the petition and decided to investigate further. "In the back of our minds was that maybe Sarbanes-Oxley was responsible for this," says Alexander Triantis, a University of Maryland business professor and co-author of the paper "Why Do Firms Go Dark?"

Just as they suspected, the authors found that the number of firms that went dark surged sharply after the enactment of Sarbanes-Oxley: from 43 in 2001, to 67 in 2002, and then way up to 198 in 2003 (see table). Because figuring out who's going dark requires combing through SEC filings, 2004 numbers were still being tallied this spring, but the researchers estimate that 134 companies delisted in 2004, still far above the pre-Sarbanes-Oxley pace.

An examination of going-dark filings among firms with headquarters in the Fifth District is inconclusive, mainly because of the small sample size. In 2001, six Fifth District firms filed to go dark; in 2002 it was down to four but in 2003 the number jumped to 10. The pace slowed to six going-dark filings in 2004. In a fairly typical announcement just before its 2003 deregistration, Maryland-based International Dispensing Corp. said it expected to save up to $190,000 a year: "The company believes that the cost savings of terminating reporting obligations far outweigh the benefits of maintaining the company's status as a Securities and Exchange Commission reporting company."

Triantis describes the national delisting trend as "consistent with a Sarbanes-Oxley effect but not completely conclusive." Firms may be going dark for completely sensible, above-board reasons — that is, the benefits of SEC listing are now swamped by the costs due to Sarbanes-Oxley. Most firms that go dark are described in their paper as distressed and small. By delisting, even factoring in the usual 10 percent stock price dip, firms are making an economically rational choice that may benefit shareholders over the long term.

The more negative interpretation has it that the firms' managers are thinking more about their own interests than that of other shareholders. They want to protect themselves from liability, and to continue using their companies as their own private piggy banks, keeping their jobs and increasing their compensation.

"We think Sarbanes-Oxley definitely has to be driving some of this," Triantis says. "Whether that's simply due to the cost of Section 404 that all these firms are complaining about or whether it's the increased scrutiny and liability that managers want to avoid — that's a little harder to determine."

From High Flyer to Low Profile

S&K is a virtual case study of the going-dark decision. Here is a company with an almost mythical-sounding beginning. As told on the S&K Web site, the company opened in 1967 when founder Hip Siegel loaded up his station wagon with discounted suits from department stores, then resold them at a profit. The operation grew to 10 stores by 1983, the year it first offered shares to the public. With the money raised, S&K immediately doubled in size and kept a consistent growth pattern through the early 21st century, today peaking at 240 stores.

Stuart Siegel, Hip's son, soon took over as chairman. He is a well-known figure in Richmond, a philanthropist whose home was recently featured in the local newspaper. Only four years ago S&K cracked *Forbes*' list of "200 Best Small Companies," landing at exactly No. 200. At the time, despite the business-casual trend of dress, it was coming off five years of strong profit and sales growth. Then in early 2004, it retired almost all of its debt, making for a healthy balance sheet.

But for all the growth, the market was no longer rewarding S&K as before. S&K's book value — essentially, what it would be worth if it sold off all its assets — was $20 a share, higher by several dollars than the typical trading price in 2003 and 2004. Two years ago, the last two analysts covering S&K stock dropped their coverage, leaving investors with fewer options for independent scrutiny of the company's earnings prospects. Trades of S&K stock grew rarer and rarer, making it more difficult for owners to sell at a profit. With a market capitalization of less than $50 million, S&K was known as a small-cap stock, barely a blip on Wall Street's radar screen.

Then came Sarbanes-Oxley. At first, S&K's Knowles was optimistic. He thought firms like S&K, with no history of governance problems and decent growth prospects, would see their stock prices climb along with a boost in investor confidence. His mood turned sour when the implications of Section 404 became clear.

S&K was caught in the unfortunate position of being both small in terms of financial resources but big in terms of the breadth of work needed to comply with Sarbanes-Oxley. Section 404 mandates a thorough, independent review of a firm's internal financial reporting practices. For S&K, the manpower and the costs involved in compliance were overwhelming. "We have cookie-cutter stores, 240 different sites, over 1 million square feet in 27 states," Knowles says. "Yet we would have to document all that from a representative sample of all those stores and have people who don't know menswear from a tree go in there and try to document and then audit it. And what benefit can possibly come from that?"

Knowles adds with exasperation, "It's like putting on three or four extra seatbelts."

S&K opted to remove those perceived extra seatbelts. The choice prompted the aforementioned stock drop, but has had little other negative impact, Knowles says. The Pink Sheets provide an adequate trading ground for S&K stock. And S&K will continue posting its financial results on its Web site, still have everything audited, and look to continue its growth strategy and reward shareholders. The only difference, Knowles insists, is that S&K won't be following Section 404. "The job is basically the same," he says, referring to his post as chief financial officer. Meanwhile, S&K's stock was trading about $17 a share going into the summer, close to its pre-Pink Sheets price. All things considered, not bad for a dark company.

A Little Privacy

Going dark is not to be confused with going private. A "dark" firm still trades among outside investors. A firm that goes private keeps its stock closely held. A public company can become private in several ways, with the most common methods being a merger with a shell company, a tender offer to purchase shares from other stockholders, or a reverse stock split that reduces the number of shareholders of record to less than 300. In general, it's a bit harder to go private than dark, and sometimes requires a lot more money.

A growing literature posits that many small and midsize firms ought to consider abandoning the public markets. Skyrocketing compliance costs are only one part of the puzzle. These days, smaller public firms experience serious liquidity issues anyway, trading with nothing like the regularity and smoothness of S&P 500 firms. This reduces the presumed advantage public companies have in selling stock quickly and easily.

Besides ditching the costly trappings of Sarbanes-Oxley, private companies get to keep more of their financial information out of reach from competitors. Additionally, private sources of capital — though generally more expensive than public sources — are growing, which means that being private is a less significant barrier to expansion than before.

More intangible but with a potentially greater payoff is the effect going private has on agency costs. Suddenly, the interests of managers and owners are aligned more than ever in a private structure. Instead of gunning for short-term gains that might in the long run hurt shareholders (e.g. Enron, WorldCom), managers of private firms are free to pursue whatever is best for the company. (Going private is not necessarily a new trend; the reduction of agency costs was one of the reasons behind the leveraged-buyout craze of the 1980s, a movement led by players like Kohlberg Kravis Roberts.) Joseph Fuller, CEO of consulting firm Monitor Group, wrote in a 2004 article that obituaries for the public company structure may be a bit premature. "Still," he added, "the form is showing its age and vulnerability."

Sarbanes-Oxley has brought that observation into clear focus: Firms are going private at a faster clip in the wake of the new law. In a 2004 paper, three University of Chicago researchers added up 93 firms that filed to go private in the 19 months before Sarbanes-Oxley was enacted and 142 going private in the 19 months after (see table). Rachel Hayes, an accounting professor and co-author of the study, described that as a "modest increase." Hayes says it's possible that the increase is partly cyclical in nature, but that her study mostly seems to point to a combination of market conditions and the effect of Sarbanes-Oxley as making "going private more attractive."

A Fifth District examination of going-private transactions is, as with the going-dark case, inconclusive because of the small sample size. There were seven going-private filings among Fifth District firms in 2001, four in 2002, a small jump to seven in 2003, and then six in 2004. North Carolina's Quintiles Transnational Corp., a drug-

Darlington County Bancshares, one of the smallest banks in South Carolina, saw its stock price struggle for years before directors decided to go private.

testing company, served up one of 2003's biggest going-private transactions when a group led by the firm's chairman bought it out for about $1.7 billion. The complaint voiced in a Wilmington, N.C.-based Reeds Jewelers Inc. announcement in early 2004 was representative of the going-private mood: "Operating as a privately held entity will enable Reeds to reduce certain costs related to being a public company, including, among others, legal compliance costs."

As with going-dark firms, a theme with the recent spate of going-private firms is their size: They're small. After the enactment of Sarbanes-Oxley, the average size (by annual sales) of firms going private was $74 million. And that was less than half the size of the typical firm going private before the new law, when the average was $170 million in annual sales. (For comparison, consider that cracking the Fortune 500 requires at least $3.6 billion in annual sales.)

Although Hayes is comfortable noting the modest increase in going-private transactions since Sarbanes-Oxley, she is not so certain about drawing larger conclusions. "It's so hard for us to look at our data and say these guys would not have gone private otherwise," she says. "It's very possible a lot of these would have gone private anyway."

Never a Darling

Henry Funderburk is candid about the very real possibility that his bank might have gone private anyway. Darlington County Bancshares, one of the smallest banks in South Carolina, executed an odd-lot tender offer that brought its number of shareholders to 278, spending about $175,000 to purchase the stock of people owning less than 100 shares.

Darlington Bank wasn't even listed on a stock exchange to begin with. If a shareholder wanted to sell some stock, bank management would put them in touch with a potential buyer, and vice versa, referring to a list kept at the bank's only office. But since it used to have more than 300 shareholders, Darlington did have to file the usual 10Ks and 10Qs with the SEC. After Sarbanes-Oxley, that meant spending money on a new auditor to review controls that were already reviewed by multiple bank officers and regulators.

Banks are unlikely suspects for stepped-up regulation. "The irony is that these institutions were already highly regulated, with records scrutinized by government officials as well as their own auditors," says law professor Carney in his paper "The Costs of Being Public After Sarbanes-Oxley." All that work reporting to banking regulators is, unfortunately, not entirely transferable to SEC reporting requirements; everything must be documented consistent with Section 404's unique standards. Referring to a finding that 15 percent of all going-private filers in 2004 were banks, Carney says: "Surely investors and depositors in these communities will not feel better off because of these developments ... Say good-bye to the community bank that was owned by the community."

Even though it's now private, Funderburk's organization remains subject to heavy regulatory scrutiny, since it's a bank. "We still have to comply with everything," he says. "We just don't have to do the reporting." And because of that, the bank figures to save $100,000 a year in auditor fees.

That is a lot of money for Darlington Bank, whose 2004 net income was just $343,000. Funderburk says Sarbanes-Oxley "gave us a final push" but admits that going private was something the

PHOTOGRAPHY:DARLINGTON COUNTY BANK

bank's directors had been considering for years, anyway. Not even listed on a stock exchange, what sort of benefits was Darlington reaping from being public?

As it happens, that's the same question directors at S&K Famous Brands had been asking themselves for some time. Karen Newman, an S&K director and former dean of the business school at University of Richmond, says that when she took her seat on the board in the spring of 2004, discussions were already happening about how to deal with S&K's lifeless share price. Sarbanes-Oxley, Newman says, was "the straw that broke the camel's back."

Whether going dark is merely a stepping stone to going private or a way station before returning to SEC supervision depends as much on economic conditions as it does on Sarbanes-Oxley. CFO Knowles says that returning to the Nasdaq might very well be in S&K's future.

For now, low interest rates make bank debt more desirable than raising capital through the equity markets, he says. So long as S&K's operations and strategic growth can be funded through loans, then there's no rush to return to the Nasdaq. That said, Knowles adds that any reforms by the SEC to make Section 404 less burdensome for smaller firms would change that formula. "There's no question we would reconsider listing if the small-firms issue was addressed," Knowles says. "I liked the idea of being on the Nasdaq. It carried a lot of clout."

A SOX for Small Firms?

Overwhelmed with complaints about Section 404, the SEC has taken notice. This spring, the commission for the third time extended the deadline for smaller public firms to comply with Section 404. And there is growing support, even among some lawmakers, for softening Sarbanes-Oxley rules when it comes to small companies.

For the few hundred firms that go dark to evade investor scrutiny, "Sarbanes-Oxley has certainly not served investors," says Triantis, the University of Maryland professor. But he is not rushing to entirely dismiss Sarbanes-Oxley as ineffective. Despite the backlash, most firms are not straying from the public markets or going dark.

Triantis says there are "hundreds of firms that could deregister that don't and many more that have 300 or more shareholders that could get below that, so we're not talking about thousands of companies." Additionally and even more persuasive, is an easily overlooked finding in his study: The negative stock slides of going-dark firms have been worse since the passage of Sarbanes-Oxley than before. To Triantis, that means the market is placing a higher value on disclosure, which by extension ought to lift share prices for firms that remain SEC-compliant.

Robert Litan, senior fellow in economic studies at the Brookings Institution, says that disentangling the impact of Sarbanes-Oxley from other concurrent developments is difficult. Perhaps it did have the effect of restoring investor confidence in the markets, but then again what about the role of the criminal justice system, which responded more aggressively than Litan had expected? Or the clamping down of the New York and Nasdaq stock exchanges, beefing up requirements for membership? Or mounting civil lawsuits against alleged wayward executives? "You could argue that the deterrent effect of [those things] alone could have accomplished all the benefits being claimed to Sarbanes-Oxley," Litan says. "Much of this might have happened without Sarbanes-Oxley."

Sarbanes-Oxley is, of course, named after its sponsors: Sen. Paul Sarbanes, a Maryland Democrat, and Rep. Michael Oxley, an Ohio Republican. Many analysts and observers credit the pair's legislation with a renewed emphasis on good corporate governance that has restored integrity and trust in U.S. firms.

In a 2004 press release on the two-year anniversary of Sarbanes-Oxley, Sen. Sarbanes summed up the case for the legislation that bears his name: "I believe that we have succeeded in raising standards," he said, "with increasing international support, to give investors a new degree of confidence in our capital markets." Still, there are dissenters. Over at S&K headquarters, CFO Knowles notes that Sarbanes is retiring after his current term expires in 2006. It's an open question whether S&K stock can hold up that long in the dark. **RF**

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