The Silicon Flatirons Roundtable on Entrepreneurship, Innovation and Public Policy
Report No. 1
Topic: *The Unintended Consequences of Sarbanes-Oxley*
Discussion held on February 26, 2007

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On Monday, February 26, 2007, the Silicon Flatirons Program sponsored a roundtable discussion on the Unintended Consequences of the Sarbanes-Oxley Act of 2002. Brad Feld, Managing Director of *Foundry Group*, co-sponsored the event and provided generous financial support. Attendees included some of the leading figures in the Front Range entrepreneurial community: over 20 discussants participated, including venture capitalists, businesspersons, lawyers, professors, and entrepreneurs. (A list of attendees is included here as Attachment A.) University of Colorado Associate Professor Victor Fleischer moderated roundtable discussion. The purpose of the roundtable was to examine the Sarbanes-Oxley Act of 2002 ("SOX") and its relationship to public policy, entrepreneurship, and the day-to-day practice of business and law.

The roundtable focused on measures relating to corporate governance and auditing controls. Specifically, the roundtable identified SOX-related measures which discussants deemed most important and, moreover, identified measures which discussants deemed onerous— especially for emerging growth companies. More generally, the participants considered more cost effective strategies for securities regulation and, in particular, considered why institutions that should have detected recent high-profile instances of corporate fraud (such as Enron) failed to do so until very late in the process. Finally, discussants examined recent concerns about corporate wrongdoing, such as options backdating and the HP wiretapping scandal. In particular, they explored how legal, accounting, and business professionals could be encouraged to take risks while working to promote legal and ethical behavior.

Overall, the roundtable highlighted several notable and emerging trends and provided a forum to consider discussants' contentions surrounding Sarbanes-Oxley and its impact on emerging companies. Notably, in addition to well-documented SOX-related costs for companies, several discussants characterized SOX as the catalyst for—or at least emblematic of—a fundamentally changed regulatory environment. Particularly when considered against the wider backdrop of expanding corporate governance and reporting requirements over the past decade or so, SOX and other developments have emphasized compliance and accounting-related activities. While to a certain degree this shift was part of SOX's intent, the regulatory shift has engendered other unintentional effects, too. For example, amid the changed regulatory environment, there is empirical evidence indicating that smaller companies are "going private" at higher rates. Additionally, while too early to definitively tell, some worry that the current environment may push some companies to capital markets outside of the United States. Also, especially as initial public offerings become a more difficult exit for emerging companies, there is concern that the venture capital industry—which has helped fund much innovation in the United States—could be dramatically altered. Finally, some discussants expressed the more general concern that today's compliance and accounting emphases are increasingly displacing attention once provided to issues of strategy, innovation and competitive advantage.

Each of these developments and trends bear careful monitoring going forward. These perspectives, as well as additional viewpoints articulated during the discussion, are more fully explored in the sections below.

SOX's Unintended Consequences

The roundtable began with a humorous video clip created by Sam Zell that shines light on SOX's negative aspects.[1] Professor Eric Talley[2] then initiated roundtable conversation with a summary of his working paper "Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis."[3] As denoted by its title, Talley's study focused on whether SOX has motivated firms to go private. Professor Talley's research found that from 2000 through 2004 the majority of the firms going private were smaller issuers—generally, firms with a market cap of $20 million or less.

There are two clear implications from Talley's research. First, large firms are willing to absorb the costs of additional compliance associated with being a public company. This should not be too surprising, particularly because there are few other viable options for the larger firms traded on America's public markets.[4] Second, in the wake of SOX, small firms have been more likely to go private rather than absorb the additional costs of compliance. As one CEO has noted, "the problem is that the lack of adequate staff and infrastructure forces the hand of the smaller public company to seek outside consultative support to carry out the necessary testing."[5] For smaller firms, outside consultation can be prohibitively expensive and can limit their budget to such an extent that the public markets are no longer profitable.

In reference to the study on SOX's effects, Foundry's Feld asked Talley what lurking variables and peripheral factors skewed or, conversely, may not have been accounted for in the study's results. For example, the "Internet Bubble" at the turn of the 20th century gave rise to a unique situation within the capital markets. Specifically, an inordinate number of companies entered the public markets based on business models that were far too optimistic and wholly unrealistic. Once the "bubble burst" and the market crashed, the majority of small firms that did not dissolve were left with no choice but to go private. Thus, while SOX certainly drove some smaller public firms into the private arena or precluded other firms from going public altogether, Feld noted that the exodus from the public markets that followed the burst may be too greatly and incorrectly attributed to the burdens imposed by SOX.

The impact of the bubble, however, should not be overstated. As Hogan & Hartson LLP Partner Dan Shea noted, the capital markets were inundated with firms that had no business being public even before the bubble, and the fact remains that there have always been companies

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[1] The Zell clip is available at the URL: < http://www.yegsz.com >.
[2] Professor of Law, University of California at Berkeley Boalt Hall School of Law; Senior Economist, RAND Corporation.
[3] SSRN.com USC CLEO Research Paper No. C06-5; USC Law Legal Studies Paper No. 06-10
[4] Firms like General Electric, which spent about $33 million on SOX compliance in 2004, are not likely buy-out targets for hedge funds or private equity funds. *See* Ann Bednarz, *Execs Tell Regulators that Sarbanes Oxley's Costs Exceed Benefits* (Network World, May 11, 2006) (available at http://www.networkworld.com/news/2006/051106-sox-costs.html?page=1).
[5] *Id.* (citing Steve Sherwin, CEO of Cell Genesys).

within the public markets that should not be publicly traded. Nonetheless, discussants generally appreciated concerns that SOX was a significant factor in the empirical data collected by Talley. The important concern, demonstrated by Talley's study and echoed frequently during the roundtable, is that SOX—and, more generally, the push for further reaching and more extensive corporate governance and oversight—are driving smaller firms from the U.S. public markets.

SOX and Corporate Governance

The accounting scandals of Arthur Andersen, Enron, and WorldCom brought corporate greed and unethical (as well as illegal) business practices to the forefront of American politics. As sometimes happens in moments of political crisis, Congress reacted with broad-sweeping regulation.[6] Recently, former Congressman Michael Oxley (and principal co-sponsor of SOX) acknowledged as much, explaining that the political pressure to do something was extraordinary and that, if he knew then what he knows now, he "would have written [SOX] differently."[7] Given the significant demands of the law that was enacted, a side effect is the privatization of small-cap companies. Highlighting this fact, both the Securities and Exchange Commission's Advisory Committee on Smaller Public Companies and the Committee on Capital Markets Regulation have emphasized the unintended consequences of the law and called for reform. With the average cost of compliance generally above $4 million per year, SOX is a significant deterrent for emerging growth companies considering an IPO.

The attendees agreed that, for purposes of the roundtable, SOX-mandated requirements should be understood to emphasize two related areas of regulation: (1) Section 404's internal accounting mandates and general corporate governance requirements; and (2) attention to details of corporate governance to such an extent that strategy and innovation may suffer.

The roundtable initially discussed §404's mandates and the requirements for accounting oversight in the more general context of SOX's interaction with and relationship to Delaware corporate law. Though the roundtable accepted that §404's requirements were quite onerous, Hogan Partner Shea expressed concern that too often too much blame is placed on SOX for the board control mechanisms that actually come from Delaware law; Shea noted that the majority of boards' actions are driven by Delaware law. At the time SOX was implemented, Delaware law already mandated the Board ensure proper procedures for corporate governance. SOX, on his view, simply mandated audits. Others, such as Jason Mendelson, a Managing Director of Foundry Group, challenged the importance of this distinction from a company's perspective. On balance, however, discussants generally agreed that SOX has come to represent a more rigid system of corporate governance requirements.

Looking at the larger issue of corporate governance, the discussants worried that the demands for compliance had gone too far and the benefits of the added controls were outweighed by the costs. In particular, some discussants were concerned that the majority of public boards'

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[6] Ironically, as many commentators have noted, Enron's practices as to corporate governance complied with many of the requirements later imposed by SOX. In fairness, however, other company's practices—such as Worldcom's—would not be SOX-compliant.
[7] Liz Alderman, *Spotlight: Michael Oxley, 'It Was Not Normal Times'*, INT'L HERALD TRIBUNE, Mar. 2, 2007, *available at* http://www.iht.com/articles/2007/03/02/business/wbspot03.php?page=1.

time is now spent focused on issues related to regulatory compliance. This focus, some discussants suggested, comes at the expense of corporate oversight of strategy and innovation, which, particularly for entrepreneurial companies, are necessary ingredients to achieve and sustain a competitive advantage.

The concern of VCs, articulated by Foundry's Feld, is that the board time spent on regulatory compliance must come from company and/or board time that would otherwise be allocated differently. Moreover, while a company's focus on strategy and innovation might suffer, Brad Feld also expressed concern about those directors who sit on multiple boards. In particular, it is these directors who will not be able to spend their time on longer board meetings, but, instead, will have to decline board seats on nascent companies that would greatly benefit from these directors' experiences and insights. Accordingly, the concerns of corporate governance and regulatory oversight *versus* strategy and innovation not only affect time spent on boards, but also the board composition. For example, earlier this year, Jim Clark, one of the founders of Netscape and a director of Shutterfly, resigned his board seat. Citing SOX as the reason for his resignation, Clark noted, "[SOX] dictates that I not Chair any committee due to the size of my holdings, not be on the compensation committee because of the loan I once made to the company, [and] not be on the governance committee."[8] Additionally, it was noted at the roundtable that the effects of rules like these do not stop with the board. Stephen Meer, CTO of Intrado, Inc., commented that the concern for regulatory compliance flows down to the supervisor: such concerns become viral, and, soon, technology takes a back seat to auditing certificates.

One of the more notable examples of technology taking a back seat to auditing concerns and the struggle between innovation and oversight is the situation of "pretexting" at Hewlett-Packard. Although many of the facts are disputed, it is apparent there was a divide between what Tom Perkins, a board member of HP and a partner of the VC firm, Kleiner Perkins Caufield & Byers, called the "Guidance board" and the "Compliance board."[9] The basics of the HP story are relatively clear. Concerned about leaks to press, Patricia Dunn, Chairman of the HP Board, initiated an investigation to discover who was leaking information. With the approval of counsel, the leak investigation started to focus on various board members. During this process, investigators—impersonating board members—would trick operators into releasing phone records, or the investigators would set up fake email accounts and send emails to reporters who had published the leaked information. Irrespective of how the disputed facts and questions unfold, what is clear is that the rift between the guidance board and the compliance board in one the nation's largest companies monopolized time that could have been spent focusing not only on strategy and innovation but also corporate governance and oversight.

With these problems and the examples of these problems demonstrating the difficulties of SOX, the attendees offered some insightful suggestions for alleviating these constrictions. In response to the comments from Feld, Meer, Mendelson, Josh Pace (Chief Financial Officer of Webroot), and Tom McGimpsey (former General Counsel of McData Corporation) regarding time allocation, some discussants suggested abolishing the requirement for quarterly reports.

[8] *See* Caroline McCarthy, *Is Silicon Valley strangled by SOX?* (CNET, January 18, 2007) (available at http://news.com.com/Is+Silicon+Valley+strangled+by+SOX/2100-1014_3-6151059.html?tag=st.num).
[9] Tom Perkins, Op-Ed, *The 'Compliance' Board*, WALL ST. J., Mar. 26, 2007, at A11.

Many agreed that the quarterly reports—known as 10-Qs—not only require a large amount of time, but also help to proliferate what is sometimes an irrational obsession with quarterly earnings. The roundtable acknowledged, however, that abolishing quarterly reporting does have its own problems. In response to this point, the roundtable discussed a range of ideas to help break the current over-reporting cycle, such as revising the Generally Accepted Accounting Principles (GAAP) and the Public Company Accounting Oversight Board (PCAOB).

In response to concerns about auditing controls and §404, there was consensus among roundtable discussants that the SEC should continue to offer exemptions for small-cap companies. Additionally, some discussants noted the irony that SOX—which in some respects represented a reaction to poor accounting practices— effectively deputized private auditors and transformed them into *de facto* agents for the government.[10] As a result of this agency relationship between outside auditors and the government, the consequence has been a boon to the audit industry. Notably, the number of internal auditors has tripled—mainly because companies are more apt to trust their own employees. This results in greater costs for companies. On a generous view to auditors, the extent of §404 requirements provides a safeguard from litigation; many believe, however, that such requirements are a boon—rather than a penalty—to the profession, highlighting that the auditing profession has fought attempts to cut back on the applicable requirements.[11] Discussion highlighted that these costs and problems could be alleviated if the depth of §404 were restricted to only the most critical auditing controls.[12]

Finally, in response to the issue of the struggle between guidance boards and compliance boards, it was discussed that compliance boards will most likely be a reality for many years to come. In order to survive and compete, companies and their boards will have to reach an equilibrium, in which guidance and compliance are no longer binary opposites. The company with a board comprised of guidance-minded directors that also understand compliance requirements will likely prosper, as opposed to the board that focuses on compliance or guidance at the expense of the other, as this company will necessarily fail.

Private Equity and Foreign Markets

In light of the controversy around SOX's impact and its unintended consequences, the participants discussed whether they believed capital is moving from domestic public markets into both foreign markets and private equity. The roundtable's general consensus was that enough time has not elapsed to determine whether capital is moving away from the American markets and into foreign markets. As for private equity, there was less of a consensus within the roundtable; though the attendees did agree the private equity market's sustainability is questionable.

Although it was agreed that the question of whether capital moving to foreign markets cannot be fully answered because not enough time has lapsed, the roundtable also acknowledged

[10] A somewhat ironic twist, considering SOX is a result of auditors' infractions.
[11] Kara Scannel, *Softening A Sarbanes-Oxley Thorn*, WALL ST. J., Apr. 5, 2007, at C2.
[12] For an in-depth analysis of SOX reforms, *see* Comm'n on the Regulation of U.S. Capital Mkts. in the 21st Century, Report and Recommendations, Mar. 2007 (available at http://www.uschamber.com/publications/reports/0703capmarketscomm).

that the VC industry will not exist as it does today if the American markets continue with their current trajectory. Mendelson pointed out the high-returns that attract VC funding are not as established with foreign companies or within the current foreign markets. Thus, because foreign markets do not affect or attract the extremely valuable companies (*e.g.*, Google), the companies likely to be most affected are companies expected to produce mid-level returns. Feld underscored this point, noting this is an issue that can only be viewed in terms of macroeconomics. Specifically, he pointed out that if this trend continues and mid-level companies either seek financing abroad or simply stay home, the leakage of profit will eventually produce a reduced VC industry within the U.S. and, as a result, accelerate the industry's move abroad. On the same point, Hogan & Hartson LLP Partner Paul Hilton added that some banks are already taking companies to the Shanghai Exchange. The real question, he suggested, is whether over the next five years the foreign markets will actually be able to take a substantial portion of the U.S.'s market share.

The roundtable's discussion on private equity focused on private equity's ever-increasing growth and whether such growth is, in fact, sustainable. Feld noted the similarity between this increase in growth and that of the VC industry before the bubble burst.[13] Webroot's Pace also addressed this point and noted that private equity deals are continuing to grow in both number and value. On this point, Feld noted there is a certain irony in these deals because the companies are traded from one firm to another, but the limited partners often remain the same. The discussion of private equity concluded with the point that, to some extent, the private equity market's success is contingent on the credit markets. Thus, the concern, as Feld explained, is that if the credit markets tighten, private equity firms' returns will decrease while cost of capital to these companies will increase, and overleveraged firms may see a sharp reduction in their equity value.

Conclusion

Consensus from roundtable discussants is that SOX's cumbersome and costly requirements may frustrate the ability of innovative emerging companies to avail themselves of public capital markets in the United States and, additionally, may affect the venture capital landscape. Indeed, SOX does have useful aspects, and the purpose of the roundtable was not to present a forum for people to gripe and use SOX as the regulatory punching bag *de jour*. Nonetheless, the discussants identified that there is considerable room for improvement within SOX. Such improvements may be needed going forward in order to promote the continued prosperity and success of the U.S. capital markets.

[13] Brad Feld noted that during the bubble there was about $200 billion in VC money and now there is about $70 billion. For a more in depth discussion of the comparison between the VC bubble and the current PE growth, *see* Feld Thoughts, *Looking Inside People's Big Brains* (posted March 2, 2007) (available at http://www.feld.com/blog/archives/002211.html).

ATTACHMENT A
LIST OF PARTICIPANTS AT FEBRUARY 26, 2007 ROUNDTABLE
(participants listed alphabetically by last name)

(1) Brad Bernthal, *University of Colorado Law School*— Lead Instructor for Colorado Entrepreneurial Law Clinic; Research Associate
(2) Scott Berdan, *Kamlet Shepherd & Reichert, LLP*-- Partner
(3) James M. Crowe, *University of Colorado, Class of 2007*
(4) Brad Feld, *Foundry Group & Mobius Venture Capital*—Managing Director
(5) Victor Fleischer, *University of Colorado Law School*—Associate Professor
(6) Paul Hilton, *Hogan & Hartson LLP*—Partner
(7) Heidi Horton, *University of Colorado*—Program Coordinator of the Silicon Flatirons Program
(8) Paul Jerde, *Deming Center for Entrepreneurship, University of Colorado Leeds School of Business*— Executive Director,
(9) Laura Kornish, *University of Colorado, Leeds School of Business*—Assistant Professor
(10) Dominic Lloyd, *Baker Hostetler LLP*—Partner
(11) Tom McGimpsy, *McData Corporation*-- Former General Counsel,
(12) Jason Mendelson, *Foundry Group*—Managing Director
(13) Stephen Meer, *Intrado, Inc.*—Chief Technology Officer & Co-Founder
(14) Josh Pace, *Webroot*— Chief Financial Officer
(15) Scott Peppet, *University of Colorado Law School*—Associate Professor
(16) John Ploetz, *Patton Boggs LLP*— Associate
(17) Jim Pollock—*CTEK Boulder--* Director
(18) Dan Shea, *Hogan & Hartson LLP*—Partner
(19) Eric Talley, *University of California, Berkeley School of Law*—Professor & Co-Director of the Berkeley Center for Law, Business, and the Economy
(20) Jill Van Matre, *University of Colorado*—Silicon Flatirons Research Fellow
(21) Mark Walker, *University of Colorado, Class of 2007*—Finance and Programs Director of the Silicon Flatirons Program
(22) Phil Weiser, *University of Colorado Law School*—Professor & Executive Director of the Silicon Flatirons Program