

Wall Street Journal

August 15, 2005

RULE OF LAW

Sarbanes-Oxley Is a Curse For Small-Cap Companies

By Neal L. Wolkoff

Sarbanes-Oxley (SOX) was established in 2002 to improve corporate governance and internal controls after a wave of accounting scandals. While the intent was laudable, the new regulations made no distinction between a billion-dollar large-cap company and a \$75-million small-cap one. This has made it extremely difficult for smaller companies to compete and grow in this regulatory environment.

As chairman and CEO of the American Stock Exchange, I feel qualified to voice concerns on the effects of SOX on this particular community. The Amex is the only public exchange that caters to small and mid-sized companies. While some of our 600 companies are large-caps, the majority has small- and mid-capitalization between \$50 million and \$500 million. A regulatory system that discourages such companies from participating in the public markets is of vital concern for our Exchange and our listed companies.

Three years since their institution, the debate on the impact of the internal-control audits required by SOX has intensified. Smaller companies argue that the costs of compliance outweigh the intended benefits. The SEC has begun to listen, which is heartening.

But while we bolster investor confidence by strengthening regulations, the current system now threatens to stifle entrepreneurship and deter companies, domestically and overseas, from accessing the U.S. capital markets. Investors need to be protected from the corporate scandals that inspired SOX, but context is crucial. Bear in mind that the large scandals involved large companies or, like Enron, those pretending to be so. These had thousands of unsuspecting shareholders, and their securities were the bulk of many retirement/pension accounts. The investor interests that were abused in the Enron scandal typically are not present with small-cap and micro-cap stocks. A random sample of Amex-listed companies will show that these smaller companies are frequently owned by the entrepreneurs who founded the companies, their families, and public shareholders. These people are not out to cheat themselves.

The key problem that confronts the smaller company is Section 404, which requires the designing, documentation and auditing of financial controls. The SEC has taken steps to address these issues by creating an advisory committee to examine the impact of SOX and other laws on smaller companies.

As I prepared to testify before this committee, I approached the heads of many Amex-listed companies to discuss their thoughts on the one-size-fits-all approach of SOX and Sec. 404. I received passionate feedback — and thoughtful insights on how to implement securities regulations to accommodate smaller companies. The CEOs of our listed companies want the SEC to understand that when it comes to regulating corporate governance, different standards need to apply to companies with small market cap or minimal revenues.

The concerns that our CEOs voiced on Sec. 404 related to duplicative or prohibitive costs, the adverse impact on a company's relationship with its auditors, and the requirement of segregation of duties within a small company. The compliance costs of Sec. 404 are severe. Some of our companies told us that their auditing fees have trebled or quadrupled. A \$500,000 auditing bill may be a drop in the bucket for a company with a \$10 billion market-cap; for a \$100-million company, it's significant.

Several suggested that the regulations threaten the very survival of their companies as independent, publicly traded entities. And many questioned how spending such large amounts of shareholder money would benefit the shareholders enough to justify the cost. Since companies receive neither compensating income nor any noticeable improvement in company valuation to mitigate the costs, the sharp rise in auditing fees is a financial strain. As one

CEO told us: “It is next to impossible for us to meet 404 requirements and still remain profitable to our stockholders. Without adequate relief for small companies, we cannot survive or remain profitable.”

The Amex has seen the impact first-hand as more than a dozen small companies delisted from the Exchange and deregistered their securities because of the high costs of trying to comply with Sec. 404. This serves no public interest, as many of these securities are still available for purchase on the unregulated “Pink Sheets.”

Sec. 404 is also making it more difficult for them to find a “Big Four” accounting firm to audit their financials. Another CEO told us that, after 35 years with the same “Big Four” firm, the auditor informed the company that it could no longer perform audits for him because they were concentrating on larger companies.

Sec. 404 has also led to demands on companies to erect firewalls between certain types of internal duties, which have forced companies to increase their headcount by preventing individuals from acting in multiple capacities.

Large companies are different from smaller ones in more than just size: Large organizations often have complex business models that make for complex accounting practices. Smaller companies generally have less complicated financial statements requiring less rigid internal controls. So small and large companies should not be forced into the same regulatory mold when it comes to internal controls and external auditing. Governance measures should be tailored to a company’s size, and should require as little additional cost as possible. And regulators must avoid imposing a uniform doctrine on small and midsized companies in the formative stages of growth. Development-stage companies with little or no revenue cannot afford burdensome compliance costs.

SOX costs about \$824,000 for companies with annual revenues under \$100 million, compared with about \$1.5 million for companies with sales of \$100 million to \$500 million, according to a study by Financial Executives International. At the Amex, the median revenues for our companies are \$57 million, which means that compliance costs would consume nearly 1.5% of revenues, severely squeezing operating margins — in many cases to near zero — and depleting funds available for a reinvestment. Small companies create jobs and drive the growth of our economy. We need to implement regulations that allow them to compete, not kill them off with red tape.

Mr. Wolkoff is Chairman & CEO of the American Stock Exchange.