SOX: Culprit Behind Increased Delisting?

In-House News:

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"[The Sarbanes-Oxley Act] was good medicine for corporate ills, but even good medicine prescribed without due care for side effects can be toxic." This was an apt comment by Neal Wolkoff, chairman and chief executive officer of the American Stock Exchange.

Since its implementation in 2002, the Sarbanes-Oxley Act's (SOX) internal controls requirement has proven too costly for smaller public companies. In particular, the steep costs of designing, documenting, and auditing financial controls, as necessitated in Section 404 of SOX, have caused many corporations to "go dark" or voluntarily deregister themselves from major exchanges.

William Despo, former enforcement counsel for the American Stock Exchange, said in the New Jersey Law Journal, "Record-keeping and other costs are serious issues for smaller companies."

According to a study conducted by Christian Leuz, an accounting professor at the University of Chicago's Graduate School of Business, 484 companies delisted from a major exchange and went to pink sheets between 1998 and 2004.

Within the first two years that SOX was implemented, 370 publicly traded companies delisted from a major exchange and went to pink sheets. This figure comprises 76 percent of the total number of companies that delisted between 1998 and 2004.

Pink sheets, an electronic quotation service, do not require companies to register with the Securities and Exchange Commission (SEC), thereby exempting smaller companies from maintaining and disclosing their financial filings. As a result, they can save between $500,000 and millions of dollars in accounting and legal bills, depending on size of their company--a practical and desirable option for smaller companies.

However, in exchange for expendable cash, going dark has many ramifications. The most important one, perhaps, is losing the trust of American investors.

Being listed on a major stock exchange is very prestigious accomplishment. To get and remain listed, companies must qualify, abide by federal regulations, and maintain certain standards. If they fall below standards or violate regulations, they will be delisted.

The tough requirements are supposed to ensure the quality of the listed companies and bolster the reputation of the stock exchange. It's an elite club that vouches for the company's superior standards, quality management, and proven success. Remaining listed proves to investors that the company is a stable, desirable, and trustworthy investment.

Unfortunately, if smaller companies choose to delist in order save time and money, they degrade their public respectability and reputation. In the eyes of

investors, delisting is delisting. Investors cannot differentiate between smaller companies that chose to delist because they couldn't afford SOX compliance and larger companies that were forced to delist because they refused to comply with SOX.

Usually, delisting from a major stock exchange is a red flag indicative of accounting manipulations and flagging financial vigor. As a result, many investors may liquidate their stocks, further decreasing the company's share price by increasing the selling supply. In fact, Leuz's research shows that the share price generally drops 10 percent after the company delists itself from major exchanges.

Although businesses complain about it, SOX requirements bolster consumer confidence. Kenneth Thompson, chair of the Corporate Securities and Financial Institutions Group at McCarter & English, told the New Jersey Law Journal, "Institutional investors seem to support the transparency and management focus that have also come with it."

Nonetheless, evidence suggests that SOX is detrimental to America's economy in today's global market. A recent survey conducted by Russell Reynolds Associates, a global executive search and assessment firm, shows that 58 percent of companies listed in the U.S. would consider delisting because of SOX's steep costs and troublesome bureaucracy. Concurrently, of the 145 leading European companies interviewed for the survey, 70 percent did not want to obtain a U.S. listing because of heightened regulation.

The chairman of a leading Dutch company noted in Russell Reynolds Associates' survey, "Global markets are now very efficient; as a result, the

necessity for a U.S. listing is diminished. European companies are not investing in American's capital market, and American companies are choosing to list in countries with lower regulations.

Studies by PricewaterhouseCoopers, an international accounting and consulting firm, show that the number of U.S. listings has dropped from 260 initial public offerings (IPOs) in 2004 to 221 IPOs in 2005. Meanwhile, the number of IPO listings in the European exchange has increased from 433 IPOs in 2004 to 603 IPOs in 2005, a staggering 40-percent hike.

Excessive regulations are crippling American stock exchanges, forcing smaller companies to make the switch from U.S. listings to foreign and/or unregulated listings. In April, the SEC recommended that smaller businesses be excused from certain SOX provisions in order to mitigate SOX's harmful and unintended effects.

Wolkoff detailed three insightful steps that might ameliorate the current system in his Financial Times article: "First, clearly define through a public company accounting oversight board interpretation of specific standards for compliance with Section 404. These standards could differ based on criteria such as revenues or market capitalization. Second, relieve companies that receive clean Section 404 certifications from the cost of annual certification in favor of bi- or tri-annual certification. Third, allow the smallest public companies to choose an exemption from Section 404 compliance and allow for disclosure to investors of such choice."