

April 26, 2007

COMMENTARY

The Sarbox Monster

 By **ROBERT E. GRADY**

April 26, 2007; Page A19

The debate over whether the United States is losing its competitiveness in global capital markets, and thus might consider reforms of the Sarbanes-Oxley statute and other laws and regulations, has settled into a handful of arguments.

One camp, led with great skill by NYSE Group CEO John Thain, points out that 23 of the 25 largest global IPOs in 2006 were not listed on U.S. exchanges. A second group advocating doing nothing in response, led not surprisingly by academics, points out that the U.S. started losing its IPO share in the late 1990s, well before Sarbanes-Oxley, and that in any event we should welcome the growth, increased transparency and deeper liquidity emerging around the world.

Allies in this "stay the course" camp include Sarbanes-Oxley defenders like former SEC Chairman Arthur Levitt, who point out that with the Dow at an all time high, reverse LBO IPOs reaching a top last year, and the U.S. economy humming along with a 4.4% unemployment rate, the regulators in their genius must actually have *increased* the competitiveness of U.S. markets by "increasing investor confidence."




Corbis

Both sides are missing a key point: It is not only the *share* of U.S. IPOs that has been dropping precipitously, but, particularly in the small cap, emerging growth sector, it is also the *absolute number* that has fallen off the cliff. Consider the following: Throughout the 1990s (not just during the bubble at the end of the decade), there were an average of 157 technology IPOs per year in the U. S. For the last six years, the average has been 27 per year. In total, across all industry sectors, venture-backed IPOs have dropped from an average of 178 per year during the 1990s to 50 per year in the last six years. This has serious long-term implications.

For three decades, venture capital-backed startup companies have been the job-creating engine of the U.S. economy. According to a study by the consulting firm Global Insight released by the National Venture Capital Association (NVCA) last month, firms backed by venture capital since 1970 today employ 10 million Americans, and in 2005 generated sales of \$2.1 trillion.

That's right, these companies employ over 9% of the U.S. private-sector work force and account for an astounding 16.6% of GDP. This is astounding when you consider that the \$23 billion invested by venture capitalists in 2005 represented only 0.2% of GDP. Talk about bang for your

DOW JONES REPRINTS

 This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit:
www.djreprints.com.

- [See a sample reprint in PDF format.](#)
- [Order a reprint of this article now.](#)

buck!

These companies -- from Apple, Intel, Cisco, Amgen, FedEx, Home Depot and Google to the up-and-coming mobile technology and lifesaving drug and device companies of today -- have generated far higher than average wage growth, have accounted for a significant and growing proportion of U.S. civilian R&D, and have spawned some of the most innovative products, services and business models of our era.

Today, however, we are killing that job-creating engine with a combination of high transaction costs and tremendous friction that is hampering our capital markets, particularly the Nasdaq. These problems are the unintended consequences of a bevy of regulations, each of which seemed like a good idea at the time but in total have turned out to be a disaster.

The first was the decimalization of the Nasdaq, which ironically was promulgated by the NASD itself, convinced as it was that its broker-dealers were making too much on commissions. Next came the SEC's Regulation Full Disclosure, or "FD" for those in the trade, followed closely by then New York Attorney General Eliot Spitzer's "global settlement," which separated investment banking from equity research and made certain that a research analyst's pay could not be a function of his involvement in winning investment banking business for his Wall Street firm.

In combination, these three steps wrung all the economics out of Nasdaq market-making and small cap sell-side equity research. And the result was predictable. The top 20 firms on Wall Street dropped more than 30% of the companies for which they previously provided market-making and wrote equity research. Today, 60% of the stocks trading on the Nasdaq have one equity research analyst or fewer covering them, and 40% have none. That giant sucking sound is the exodus of sell-side research analysts leaving to provide proprietary research for hedge funds.

The granddaddy of them all has of course been Sarbanes-Oxley. At the time of passage, the official estimate of the cost of compliance with its now infamous Section 404 was \$93,000 per company. In reality, even tiny companies with \$50 or \$100 million or less in revenues are incurring up to \$2 and \$3 million in *incremental* expense, just to comply with the blizzard of paperwork and documentation required by 404. Even the accounting industry, ironically the prime beneficiary of Sarbanes-Oxley's high cost, has estimated average compliance cost at just under \$1 million per company -- but in my experience, this estimate is low.

Not surprisingly, the combination of the absolute abandonment of small cap research and market-making by underwriting firms, and radically higher costs for small cap issuing companies, has substantially raised the bar for the size of company that can go public on today's Nasdaq. As recently as 1996, the average deal size of a Nasdaq IPO was \$34 million, and the average market capitalization was \$133 million. Ten years later, the average IPO deal size was \$113 million, and the average market cap was over \$330 million -- a size that only a much bigger company can sustain.

Some of this is the inevitable byproduct of the spectacular crash of the late 1990s technology bubble, during which it was clear that some companies went public too early. But consider this: when Intel went public in 1970, it offered \$8 million of stock and sported a market value of \$53 million. Cisco's IPO in 1990 raised only \$50 million, at a price which yielded a post-deal market cap at IPO of \$226 million. E*Trade's initial offering raised \$59 million in 1996 at a market value of just \$165 million.

The point is that these companies created the majority of their value and the jobs that came with that value *after* they were public. Today, they sport market caps of \$126 billion, \$160 billion and \$9 billion, respectively, and employ among them hundreds of thousands of people.

Today, none of these deals would be doable. The offering and overall market value of the firms would be too small for most underwriters. The more likely outcome is that they would be sold. In fact, again for the last six years running, 90% of all the exits from venture-backed companies have been through M&A transactions instead of through the IPO market, which accounted for well over half of the exits in the 1990s.

This is the real competitiveness issue. The evidence suggests that we are now killing our most promising companies, our future "national champions," before their time. Studies performed by the venture capital faculty at the Harvard Business School, Professors Josh Lerner, Bill Sahlman and Felda Hardyman, suggest several things about the U.S. venture capital model. Their work shows that the majority of the big investment returns generated by the VC industry in the past three decades was contributed by a relatively small number of the best firms, and that the substantial majority of the gains came from a relatively small number of big winners.

Importantly, the vast majority of the gains generated by those big winners came *after* they were public. This will not happen in the future if our most promising companies are sold to larger entities just as they are showing revenue and customer traction and reaching maturity. Does anyone seriously believe Cisco would have grown more if it had been acquired by Digital Equipment, or that Microsoft would have thrived inside IBM?

Yet that is the bet we are implicitly making today. No one will shed any tears over the fact that the death of the small cap IPO will mean lower returns for venture capitalists. But here is how the food chain works: By definition, it will also mean less company creation, less job growth, and less innovation in the United States.

To be sure, it is not only the condition of the capital markets that will determine the future competitiveness of the United States. Not to worry. The startup economy is increasingly being affected by equally idiotic regulatory and legislative decisions on other fronts. At a time of increased global competition for talented scientists and engineers, our government has slapped a disastrously low limit on the number of H1-B visas it grants to talented people from other countries who want to study and stay here. As this newspaper reported, the 65,000 visa cap for fiscal year 2008 was exhausted in a matter of hours on April 2 when these slots were made available.

That's right, high tech, high growth employers have access to no more visas for their best foreign workers through Sept. 30, 2008. The government's investment in basic R&D, which has spawned innovation in areas from biomedical science to high performance computing to materials science, is under relentless budgetary pressure, mainly due to the unrestrained growth of entitlement spending. And our K-12 educational system remains on a path that will not produce enough math and science teachers, math and science students or knowledge-economy workers.

But the crisis in our small cap capital markets is the problem most addressable today. Fortunately, SEC Chairman Chris Cox, a venture capital lawyer before he became a Congressman and now regulator, seems attuned to the problem and is advocating some initial cost-saving reforms. Specifically, he has been championing the process whereby the SEC and the Public Company Accounting Oversight Board will issue guidance regarding the implementation of Sarbanes-Oxley

Section 404.

The point is to clarify what is and is not material and what will bring some sanity to the process of outside auditors attesting to the adequacy of a company's financial controls. As things stand today, no one is objecting to the Sarbox requirement that CEOs and CFOs sign statements verifying the truthfulness of the company's reported statements. What is causing the outcry is a requirement that tiny companies provide shelf after shelf of process-oriented paperwork, at the cost of millions of dollars, that no investor is even likely to read.

Nasdaq has a role to play here, too, and surprisingly has been asleep at the switch. "The stock market for the next 100 years" is watching its main business of listing innovative companies evaporate. The exchange should step forward in a much more forceful way than it has to date to offer a solution to the research and market-making problem.

One simple idea: Why not make it a benefit of a Nasdaq listing that an issuing company is guaranteed at least one piece of research. Nasdaq could contract with an independent party to write the research (Moody's, Morningstar or some such). I don't think young companies would mind the modest increase in listing fees. Such a plan would ensure that any Nasdaq company had at least one estimate of its future revenue and earnings published for the investing public.

For 30 years, venture capital and startups have been the goose that laid the golden egg for the U.S. economy. The availability of risk capital has been one of the most important factors contributing to the strong U.S. economic performance in this period. Today, we are unwittingly killing that goose. This is the real competitiveness issue.

Mr. Grady, who runs the venture capital arm of the Carlyle Group, has just completed his term as the chairman of the National Venture Capital Association.

URL for this article:

<http://online.wsj.com/article/SB11775557121683041.html>

Copyright 2007 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our **Subscriber Agreement** and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com.