How Does Sarbanes-Oxley Affect Firms' Decisions to Go Private?

When Congress passed the Sarbanes-Oxley Act of 2002 (or SOX) in the wake of the accounting scandals that plagued companies like Enron, Tyco International, and World Com, it sought to bring about significant changes in the governance, accounting, auditing, and reporting environment of firms traded in American securities markets. While a number of questions have surfaced in the aftermath of the Act, a central flashpoint concerns whether the compliance costs associated with SOX have driven firms in general—and small firms in particular—out of the public capital markets.

The argument for why small business might leave the capital markets because of SOX is simple enough in theory. Small firms, the theory goes, are likely to face more significant average costs and less significant average benefits of the regulation than are their larger counterparts. On the cost side, smaller firms must spread the costs of complying with SOX over a more modest operational size; in many cases, they lack the accounting staff to monitor the effectiveness of their internal controls. On the benefits side, small firms benefit relatively less than large ones from being public because they neither command the market attention of larger firms nor have their liquidity. Citing this line of reasoning, the SEC's Advisory Committee on Small Issuers recently released a recommendation that micro-cap and some small-cap firms be subjected to reduced internal controls requirements—and in some cases, exempted entirely.

Plausible as this story may sound, assessing the empirical effect of SOX on whether firms go private has proven more difficult because of the many factors that influence the decisions of firms to exit capital markets. For example, one such factor is the liquidity of the financial market, which can affect the willingness of public and private investors to pursue acquisitions. Another factor is the weakness of the public capital market around the enactment of SOX.

A new RAND Corporation study helps to disentangle the effects of SOX from the effect of other contemporaneous market causes by making use of a natural comparison group. Specifically, the study examines whether, after the enactment of SOX, American public firms undergoing acquisitions were more likely to be acquired by private acquirers than by other public firms, all compared to foreign public firms. As long as other distinctions between American public firms and their foreign counterparts did not change when SOX was enacted, this approach significantly helps to screen out changes not related to the legislation.

Using foreign public firms as a comparison group, the study finds that the propensity of small public American firms to be acquired by private acquirers rather than public ones increased by 53 percent in the first year after SOX was enacted. The study does not find evidence of such an effect among larger firms or among smaller firms in the second year following enactment of SOX. Importantly, these findings apply only to public firms that announced they would be acquired. The potential impact of SOX on the decisions of private firms to enter the public capital market or the decision of public firms that did not make a formal announcement that they would be acquired is not addressed by this study.

The dampening effect beyond the first year is consistent with more than one interpretation. One interpretation is that SOX imposed on firms a large upfront cost but a low recurring cost. But this interpretation is at odds with the fact that the most costly component of SOX—an annual report on the effectiveness of internal controls—has yet to be applied to small firms—the very firms whose propensity to go private increased after SOX was enacted.

Another interpretation is that, over time, other countries also tightened the regulation of public firms, bringing going-private rates closer to the American level. But while such reforms may have partially muted the difference between going-private trends in the United States and abroad, the fact that they are narrower in scope than SOX is unlikely to fully explain the disappearance of the SOX effect over time.

The authors' preferred interpretation is that maladapted firms realized their susceptibility to the new regime and went private immediately, leaving behind public firms that were better suited to the new regulatory environment.

The study's findings bear on the ongoing debate about the desirability of SOX and the regulatory regime it catalyzed. To the extent that SOX induced small firms to exit the public capital market immediately after it was passed, it demonstrates negative consequences for entrepreneurship that transcend measured cost increases for firms that remained in the market. Then again, the size of firm that the RAND study finds to have been affected by SOX appears to be much smaller (around $20 million in market capitalization and less) than the exemptions recommended by the SEC's advisory committee (which kick in at around $100 million). Moreover, to the extent that SOX induced small firms that were prone toward accounting problems to go private, it may have improved the functioning of public capital markets. Finally, it is worth noting that the detected shock in going-private rates among small firms was relatively short-lived, lasting less than five quarters.

This summary is based on: Ehud Kamar, Pinar Karaca-Mandic, and Eric Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, RAND WR-300-1-ICJ, 2006.