

# More Pain Than Bane

## Start-ups survive Sarbanes-Oxley strictures

Is the entrepreneurial spirit gasping for breath under the Sarbanes-Oxley Act (SOX)? The concerns some people have expressed along those lines appear to be greatly exaggerated. Venture capitalists who keep a finger on the pulse say the spirit is alive and well. "If SOX has had any effect on the level of innovation, it is only marginal," says Brooke Seawell, venture partner at Technology Crossover Ventures. Nor, according to Seawell, is the law choking the flow of capital, the lifeblood of start-ups. "I don't see VCs pulling back on investments because of SOX."

The pain, however, is real. SOX saddles all public companies with some heavy burdens: an expensive and time-consuming new layer of accounting and auditing procedures and scary criminal liabilities for CEOs and CFOs. These also have serious implications for any start-up with IPO aspirations.

"The accounting firm of one of the companies I work with said it would cost \$800,000 just to get SOX compliant," says Deric Emry, partner with ABS Capital Partners, a venture firm. "I hear estimates that ongoing costs to stay compliant can be as much as \$1.5 million per year." These are heady numbers for most pre-IPO firms, and it is here that SOX does change the start-up game. "It is not a sea change," says Seawell, "but it does raise the bar on taking a company public."

It also means, according to Paul Albright, former VC with Greylock Venture Partners in San Mateo, Calif., and now CMO of Informatica, that more start-ups will consider different [non-IPO] exit strategies. "The burden SOX places on small, public companies makes the acquisition alternative more attractive than ever before," says Albright. "This isn't always the best way to nurture innovation."

John W. Stodder, retired investment banker, points out that this law could also discourage early-stage investors. "The critical mass required to go public rises under SOX," says Stodder. "So private investors have to wait longer for profitable liquidity. I think this could put a chill on the private investment phase."

Anita Rao, vice president at Garage Technology Ventures, hasn't seen the chill. "Angel investors who are passionate about technology and have money are still investing," she says. Rao does agree that the "time to liquidity" is now longer, but blames natural market forces rather than SOX.

The tough new criminal penalties are most clearly defined for CEOs and CFOs who must personally certify financial statements filed with the SEC. Fines as high as \$5 million and prison terms of up to 20 years are designed to discourage the kinds of abuses that came under the spotlight a few years ago in spectacular revelations of corporate mischief at firms such as Enron and WorldCom. But Albright isn't worried about the effect on start-ups. "Entrepreneurs are risk takers by nature, so these criminal penalties aren't going to stand in their way."

## Board Recruitment Might Suffer

It is the gray area of whether board members may be penalized that might have a more immediate effect. A firm's board has new responsibilities under the law to certify to the SEC that accounting and audit procedures are SOX compliant. Some questions of board member liability, according to Jim Armstrong with Clearstone Venture Partners, are unresolved. "One of my main concerns is that it will be harder to recruit board members," says Armstrong."

Stodder agrees. "If liability spreads to the board, it will be much harder for a small company to get experienced directors."

Increased liability also sends the cost of directors' and officers' (D&O) insurance through the roof. "I have seen D&O insurance premiums go from \$7million to \$15million for some large public companies," says Emry. While this is not an immediate issue for most start-ups, it is one more thing to think about.

The general consensus is that SOX, while not the harbinger of the death of innovation that some predicted, does need some modification. "SOX, like most legislation," says Carter Dunlap, president of Dunlap Equity Management LLC in San Francisco, was well intentioned but ill crafted. There are some absurd provisions, such as the requirement that audit firms must rotate the senior partner in charge of a client's audit every three years. How does this give you a clearer window into financial data?"

Stodder thinks the law should be more precise in its definition of criminal activity. Emry agrees, "There need to be safe harbor provisions that say, 'If you are doing x you are covered.'"

And, more important for start-ups, Emry says the law should have some scale factors built in. "Right now, SOX holds a \$50 million company to the same standard as Microsoft. I don't think this was given appropriate consideration in the drafting of the legislation." Stodder says, "They used a Howitzer here where small arms would have been more appropriate."

Defects and all, Armstrong says SOX is far better than what might have happened. "The excesses and abuses we saw a few years ago really shook things up. People don't know how close we came to having the government just step in and say, 'we'll take over all the oversight functions. It was scary."

In other words, Sarbanes-Oxley is just another chapter, or paragraph, in the story of the debate over what should be the proper role of government in regulating business, a story that goes back at least to the gilded age of the 1890s and will likely continue well into the 21st century. — *Mark Leon*