



Does Sarbanes-Oxley Hurt Shareholders and Hide Poor Management?

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In April 2004, minutes after posting healthy increases in sales and earnings, the publicly traded Niagara Corp. announced it was "going dark," delisting its common stock. The company, a steel manufacturer with sales last year of nearly \$300 million, was hardly alone: During 2003 for example, 198 firms went dark, up from only 67 in the previous year. While most companies say they are deregistering from major exchanges to escape the steep costs associated with regulatory filings, some investors and others see darker reasons, rooted in serving insiders' self interest. A new study co-authored by Wharton accounting professor [Christian Leuz](#) entitled, *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, analyzes this recent trend.



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In 2002, responding to a spate of accounting scandals that threatened to undermine confidence in the American securities market, Congress enacted the Sarbanes-Oxley Act of 2002 (SOX). Designed to promote transparency, the Act mandated increased disclosure, required new board oversight and internal controls, and promised to give investors better information. But in the year following its passage, the number of firms that went dark and ceased to issue detailed financial reports tripled, meaning more investors were receiving no information at all.

When a company goes dark it can no longer be listed on a big exchange like the NYSE but can continue to trade on the Pink Sheets, an electronic quotation medium for over-the-counter stocks. Stocks that list here do not have to meet minimum requirements or file with the Securities and Exchange Commission (SEC).

Why did they go dark? Cost was certainly a factor in some of the decisions, says Leuz. "Some smaller companies estimated that the cost of complying with SOX was as high as \$500,000 per firm, while the cost for bigger companies could be in the millions," notes Leuz, who co-authored the study with Alexander Triantis and Tracy Wang from the University of Maryland's Robert H. Smith School of Business. Among the estimated increased costs are those related to "higher audit and legal fees, new internal control systems that need to be implemented, higher director and officer insurance premiums, and a host of other expenses associated with compliance."

Adding to increased corporate effort and expense is Regulation FD, which was introduced in 2000 and focuses on expanding the sphere of disclosure. Thus, deregistration has the potential to directly increase profitability by cutting out these added costs as well.

Plummeting Stock Prices

Under SEC rules, a company with a class of securities registered under the Securities Exchange Act of 1934 may choose to terminate its registration if certain conditions are met - if the securities have fewer than 300 record holders, for example, or if there are fewer than 500 record holders and the company's total assets have not exceeded \$10 million at the end of the company's three most recent fiscal years.

As noted in Leuz's paper, the number of companies deregistering after the enactment of SOX jumped from 67 in 2002 (and 43 in 2001) to 198 in 2003. That increase, along with surveys indicating that nearly 40% of CFOs surveyed saw SOX having very little or no effect on efficiency, suggests that the added costs of compliance were just too much for many businesses.

This was the reason given by SmartDisk Corp. for its decision to go dark in May 2003. But soon after the company - which produces consumer electronic and computer products - made the announcement, its stock price was pummeled, dropping from 35 cents a share to about five cents a share (it has since climbed back to about 26 cents a share on the Pink Sheets).

If SmartDisk's move to go dark was a cost-cutting strategy in response to Sarbanes-Oxley, why did the market punish the stock?

Leuz's paper documents that on average, firms experience a large negative market reaction to the initial announcement and the subsequent filing of deregistration, with their share prices declining about 10%. This reaction is more pronounced for smaller firms that would be expected to benefit the most, on a proportional basis, by going dark. According to Leuz, this evidence runs counter to the cost savings argument. "We can't say for certain whether or not Sarbanes-Oxley is good or bad for investors. But the data show that the consequences of SOX go beyond added cost, since the outcomes do not support a simple cost savings story."

Leuz sees two potential explanations for the spike in deregistrations and the subsequent negative market reaction. "The first theory is that companies that exhibited weak performance and were sitting on the fence may have been convinced, after Sarbanes-Oxley, that it would be better to go dark," he suggests. "The second explanation is that the controlling insiders would like to evade the outside monitoring and additional scrutiny [required by] SOX, maybe because they are not managing the firm in the most efficient way or because their compensation is excessive."

The study looked at the issues and asked if there were indications that favored one theory over the other, he adds. "In fact, we found that there is evidence for both," says Leuz.

The second theory - the avoidance of outside monitoring - is what some observers think happened in April 2004, when Niagara Corp. went dark minutes after it posted a 24% rise in first-quarter sales and a 100% increase in earnings.

According to an article in *BusinessWeek*, the company, which produces cold drawn and hot rolled steel bars for the automobile industry and other businesses, saw its stock plunge by about 30% to \$3.64 a share soon after announcing it was going dark. True, Niagara's stock climbed back to \$6.25 a share by October 29, but Leuz says that share price generally continues to go down.

Meanwhile, Niagara CEO Michael Scharf said the "rising costs of staying public" under SOX and other new rules drove the firm to delist. But according to *BusinessWeek*, "some speculate that Scharf aims to depress its value, buy a majority, and perhaps take over the company for a song."

Niagara was not part of Leuz's study, which ended in 2003 due to data availability, but he notes that "a careful analysis of trading after the deregistration" shows that there are only a few cases where firms first go dark and then subsequently go private. Most are still trading in the Pink Sheets.

A 'Lights-out' Environment

One of the significant issues considered by the co-authors was whether or not the companies that went dark had previously experienced a sudden increase in the short-term, or current, component of long-term debt. When this occurs, it indicates that lenders are requiring an early payment of outstanding debt - which can mean that they are not comfortable with the long-term prospects of the debtor company. "We saw that an increase in short-term debt significantly predicts the companies that subsequently went dark, which supports the first theory - that they deregistered in an effort to conserve cash," explains Leuz. "Since their debt is coming due sooner than anticipated, they need more cash in order to survive."

But that wasn't the whole story, he adds. "We also found that firms with higher 'free cash flow' (generally defined as the amount of cash a company has after paying its bills for ongoing activities and capital projects) and firms with lower-quality accounting are more likely to go dark. This evidence suggests that, at least for some firms, less benign forces are at work, which would provide some support for the second explanation. For them, SOX may simply serve as an excuse."

Looking at the trend, Leuz notes that firms deregistering after the passage of SOX suffered a larger

negative price drop when compared with companies that deregistered before SOX was enacted. "This evidence suggests that shareholders believe managers may be seeking refuge in a 'lights-out' environment that permits increased control benefits and decreased exposure to legal liability," he explains. "Investors are typically very upset when firms go dark."

Recently a number of institutional investors petitioned the SEC to amend one regulation - Rule 12g5-1 of the Securities and Exchange Act of 1934, which was added in 1964 in response to legislation enacted by Congress - that they believe has led to a loophole in the deregistration process. Essentially, they say, the rule allows companies to circumvent the requirement to have "less than 300 shareholders" of record.

According to one such petition noted in Leuz's paper - known as the "Nelson petition" and filed in July 2003 on behalf of nine institutional investors - when Rule 12g5-1 was initially proposed, it would have required each account held in "street name," or under the name of a financial institution, to be counted as "held of record." An issuer would have been entitled to rely in good faith on the representations made by the broker-dealer or bank concerning the number of accounts holding securities in street name.

But the petition notes that "in response to numerous comments from brokerage industry participants who complained that Rule 12g5-1 as proposed would be too burdensome," the Commission dropped the requirement to count each account held in street name as held of record. Instead, the Commission required issuers to count as held of record only those shareholders listed on the corporate records who had been issued a stock certificate.

As a result of the "transformation of clearing and settlement procedures," many firms that meet these criteria have thousands of beneficial shareholders, most of whom have their shares held in street name by financial institutions, each of which represents only one holder of record, say the Nelson petitioners.

"In its first annual report for the year ended December 31, 1999, SmartDisk disclosed that over 16 million shares of its common stock were outstanding with over 1,000 beneficial owners," the petitioners argue. "The vast majority of these shares were held in street name. Accordingly, the corporate books showed only 76 holders of record."

The petitioners add that in the period beginning January 2003, they identified 24 issuers that have "deregistered their securities under circumstances suggesting manipulation of the capital markets and circumvention of the Exchange Act."

As of late October 2004, the SEC was still gathering comments regarding changes in Rule 12g5-1.

Should SOX Be Changed?

Leuz argues that it might be worthwhile to consider modifying some requirements of Sarbanes-Oxley, and SEC disclosure requirements in general, for smaller firms, since the cost of compliance can represent such a heavy burden to them. He suggests, however, that under such a multi-tiered format, smaller firms would have to disclose that they are playing by different rules.

"The point is that if you do not want firms to deregister, you need to reduce the costs of being a public firm," he notes. "And given that the costs are likely to be particularly high for small firms, relative to larger ones, it might make sense to consider 'breaks' for the smaller firms. If you make it harder for firms to reconsider their decision to go public when business conditions change, then firms will be more reluctant to go public in the first place."

In the meantime, Leuz says that some investors may be caught in a difficult position. "If a firm in your portfolio goes dark, it's usually bad news for the stock price - but of course by then it's too late for you to do anything about it. However, if the first theory holds true - that the company is trying to slash costs to conserve cash - and the market price has adjusted appropriately, then you will get a fair return going forward."

Of course, investors are now dealing with a company that is no longer required to issue reports, which is a risk that not everyone might be prepared to bear. And, warns Leuz, "empirically many dark companies continue to post low returns over the long term." On the other hand, he says, if investors suspect that a company may go dark - for example, if it's getting close to the lower limit of 300 shareholders, and is in

financial distress - they may want to get out before the company delists.

"We basically find that going dark can serve as a way to conserve cash but it may also be exploited by insiders trying to avoid the scrutiny of the market," says Leuz. "Whether insiders succeed, and whether the decision to go dark is a good or bad one, therefore depends on the governance in place."

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