

Stalling the Start-Ups

By Clark S. Judge

*The Sarbanes-Oxley Act was bad legislation in even more ways than you might suppose. By **Clark S. Judge.***

Almost unnoticed in the rest of the economy, an anxious question is increasingly being asked in the United States' entrepreneurially intense technology communities: could we be seeing the death—or at least the decline—of exit strategies?

Exit strategies are critical to entrepreneurial finance. When backers of high-risk ventures know that, should those ventures prosper, they have ready routes to realize returns, they invest more. The United States has long enjoyed multiple and largely uncongested exit avenues, a big factor in its entrepreneurial vibrancy. Now some in its technology communities fear those avenues are narrowing, perhaps closing.

There are three traditional ways to take venture money from a successful enterprise: initial public offerings (IPOs), corporate mergers or acquisitions, and private equity buyouts. In Silicon Valley, concern is growing that all these routes to entrepreneurial riches are under regulatory attack.

The decline of IPOs has received the most ink. Thanks to the so-called Paulson report (after Hank Paulson, the Treasury secretary who embraced it), the rise of U.S.-backed IPOs overseas is well documented. But equally important has been the drop in domestic deals and dollars raised. Between 1990 and 1995—that is, before the technology bubble and its bursting—U.S. markets produced an annual average of 170 venture-backed IPOs, raising \$5.56 billion. In 2006, 56 venture-backed IPOs raised \$3.72 billion. Today, according to Institutional Investor magazine, the market's appetite for venture-backed enterprises is so weak that at least one Silicon Valley venture capital firm has canceled plans to invest in new funds.

Attention has focused on audit costs imposed on public companies under Sarbanes-Oxley, the corporate governance legislation passed after the Enron scandal. According to a CRA International study recently cited by TheStreet.com, for a lower-end start-up about to go public, these additional audit costs average \$1.5 million in the first year and an additional \$900,000 in the second.

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But Sarbanes-Oxley is damping IPO fires in other ways. In January the legendary Silicon Valley venture capitalist and entrepreneur Jim Clark resigned as chairman of Shutterfly, the photo-printing web service. As he explained in a resignation letter quoted by CNet News Service, Sarbanes-Oxley “dictates that I not chair any committee due to the size of my holding, not be on the compensation committee because of the loan I once made the company, [and] not be on the governance committee.”

Anyone familiar with high-technology start-ups knows that the key to success is having access not just to capital but to “smart” capital—that is, to the participation of experienced hands who bring both brains and funding to the game. Sarbanes-Oxley has in crucial ways put limits on the brains public companies may

enlist if those brains come with too many dollars. Diminishing access to talent may pose a bigger cost to going public than oversized, largely wasted audit costs.

But going public—or even issuing stock options in privately held corporations—is becoming increasingly tricky. One reason is the new section 409A of the tax code. Enacted with the 2004 tax act, it deals with the valuation of stock options. Options have long been a sensitive issue in the tech community. Cash-poor but opportunity-rich ventures depend on them to reward workers to whom they cannot pay competitive salaries. While regulations implementing 409A remain in flux, the section attached for the first time severe financial penalties for misvaluations, sending a chill through the tech and venture capital communities. The confounding question: what is the correct way to value options in a company that is not publicly traded?

At one time the government deferred to corporate boards. In recent years, however, the staff of the Securities and Exchange Commission has become increasingly aggressive in challenging valuations during the registration period preceding an IPO. Over the years, the result has been expensive re-evaluations, reduced reported earnings, and “sand in the gears” of transactions. Once 409A is fully implemented, there will be the risk of IPOs triggering tax penalties and interest and lawsuits from employees with devalued compensation packages.

If Sarbanes-Oxley and 409A have made IPO exits harder, lawsuits and the Arthur Andersen prosecution following the Enron scandal have complicated all exits. Wall Street analysts studying small companies see more risk and less payoff. With less information available, the market for lowcapitalization stocks becomes thinner. And as taking such companies public at a good price later on becomes harder, corporations and private equity funds think twice about acquiring them.

Sarbanes-Oxley has put limits on the “brains” public companies may enlist. Diminishing access to talent may pose an even bigger cost than audit expenses.

High-impact entrepreneurship—the kind that has driven the growth of technology industries and created virtually all job growth in the United States for more than three decades—is a cycle. The capital that venture capital firms and entrepreneurs will invest in a scheme rises and falls with the ease of getting their dollars out if all goes well. Inadvertently Congress, regulators, and prosecutors have made exiting through that door harder. If the obstacles are not removed, the result will be fewer rapidly expanding companies and fewer new jobs. That would be an exit strategy for the United States’ economic growth.

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