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Sarbanes-Oxley: Its Impact on the Venture Capital Community

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In the aftermath of The Perfect Storm that blew across the public markets, the venture capital industry was ready to get back to business as usual. A concession that most of the 1990s were the best decade the venture industry will ever see has moved most venture capitalists to wish they could go back to the way venture capital worked in the 80s. But alas, and to layer a metaphor, we're not in Kansas anymore.

The Sarbanes-Oxley Act of 2002¹ is not just changing the landscape for corporations. It has created a new continental divide.

When signing the Act in July of 2002, President Bush said, "The Act adopts tough new provisions to deter and punish corporate and accounting fraud and corruption, ensure justice for wrongdoers, and protect the interests of workers and shareholders."² Organized into eleven sections, the Act deals with such issues as auditor independence, director independence, corporate responsibility, financial disclosure, conflicts of interest for directors and attorneys, insider trading, corporate accountability, and internal control and reporting. It establishes a public company accounting oversight board.

Experts characterize Sarbanes-Oxley as creating the most sweeping changes since the Securities Acts of 1933 and 1934. It is too easy to look at these actions as reactionary, enacted just because of a few large corporate bad apples.

The consulting firm of McKinsey and Company notes that the investment community is on the bandwagon for reform: "Governance has

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¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204.

² <http://www.whitehouse.gov/news/releases/2002/07/20020730-10.html>

moved to the heart of the investment decision with more than 60% of institutional investors. More than 60% stated that poor governance might lead them to avoid the stock of a company.”³ Red Herring magazine, a bastion of venture capital support, took the position in its October 2002 issue that “the Act needs to be recalled to avert a clash between sound corporate governance and innovation.”⁴ While the rules may change in some regards and grandfathering of implementation on some items may take place, a major recall or modification appears unlikely.

Unfortunately, the Red Herring editorial also defends practices in the venture capital community not aligned with proper corporate governance. These quips characterize the rhetoric of much of the venture capital community and its management teams:

“The pendulum will swing back as the economy improves and politicians move on to their next battle.”

“It doesn’t really affect small public companies very much as the focus is on large firms.”

“We can wait on a lot of items to see how things evolve in DC and NY.”

“It certainly doesn’t affect our private deals.”

Each of these statements is false. More than just saber rattling from Washington, Sarbanes-Oxley has broad, derivative implications that few attorneys, accountants, or boards have fully appreciated or begun to address.

Real-time disclosure of material product and customer events and faster quarter close requirements will put time and cost pressure on financial staffs, senior management, and boards.

Option accounting changes and shareholder activism will create discontinuities for some individual firms and the fund industry. Compensation experts and large institutional shareholder groups are advocating eliminating fixed price option programs in favor of indexed options and restricted stock, with long holding periods. Proxy voting over the next several years will reject many compensation and option plans. Speculation is that sector funds, a staple of small cap investing, could dwindle because of the increased overhead for funds needing to certify their results.

³ Quoted at <http://www.auditsupervision.com/>

⁴ <http://www.redherring.com/Article.aspx?f=articles%2farchive%2fmag%2fissue118%2f4525.xml>

Mutual Funds will have to disclose proxy voting results and reasons or risk having assets withdrawn or threatened to be withdrawn by large fiduciary players like CALPERS, AFL-CIO, and TIAA-CREF.

The investment banking business will change dramatically. Initial public offering (IPO) allocations will continue under scrutiny and research conflict and compliance will be much tighter. The ultimate resolution of the IPO Securities Litigation Case⁵ against underwriters and corporations is likely to change the IPO process, legal terms, and liability and indemnification procedures substantially. The investment banking leadership community is taking actions to be consistent with a resized IPO market that focuses on larger and fewer IPOs.

The costs of being a public firm are going up dramatically. Scale not only matters, it is required. Unless exemptions are instituted in new rules, small public firms and new IPOs will be ill positioned in this environment. Although this is not what venture capitalists and entrepreneurs want to consider, the true small cap market may not bounce back as in past cycles. And most venture capitalists aren't prepared to deal with the derivative implications that will affect them and the management of their own businesses.

The ideal of information transparency in the public market is flowing into the hedge fund market with expected regulation and disclosure. It is also beginning in the venture capital fund industry via the Freedom of Information Act, actions at Public funds, and the tension between management and venture capitalists during a downturn. This will continue as a direct result of several Sarbanes-Oxley disclosure requirements.

Add to this mix limited partners accusing general partners of bad investment decisions, mismanagement, fraud, and breaches of fiduciary duty. Even more -- portfolio companies are accusing general partners of failing to live up to their duties of loyalty and care as board members.

Greater Cost and Reduced Flexibility for Public Companies

Answers to questions asked privately and at panels on Sarbanes-Oxley suggest that for comparative work, audit fees will increase 15-30% per year, legal service fees 10-20% per year, and costs related to directors and officers (D&O) issues will vault 50-100% each year for the next several years.

While accountants may seem embattled, their survival and effective oligopoly will allow steady increases in audit fees in coming years.

⁵ 21 MC 92 (SAS).

Insurance carriers can look to the next several years for makeup time for recent disasters. They've hit the jackpot on D&O coverage.

Companies can expect to add new expenses required by Sarbanes-Oxley to support specific internal control and audit committee activities. For a typical \$50-100 million revenue technology firm, which may now pay \$2-3 million for these services, with D&O insurance as the biggest piece, the result will be at least a doubling of those expenses in two to three years. That's 5-10% of revenue and likely 50% of targeted pretax income! These factors point toward two actions.

The obvious one is to manage the cost increases with a particular focus on D&O. Easier said than done, this argues for monitoring and compliance with evolving "Best Practices" of the governance, audit and compensation guidelines D&O carriers will be monitoring. NACD, ISS, AICPA, IIA, IRRC, AFL-CIO Paywatch, and the Council of Institutional Investors all have large and active roles in driving Best Practice guidelines that affect auditing, compensation, options, board governance and proxy voting that influence large mutual fund and ERISA investors as well as directors and officers. Ignoring these will cost more money, risk losing large portions of the investor base, and impact proxy votes. Not a wise choice to make knowingly.

The second action is to get scale rapidly and absorb the growth or acquisitions overhead with growth or acquisitions or be acquired and exit the public market. Obviously, these are major strategic and governance considerations. Acquiring to get scale is a viable and necessary path for many venture capital-originated companies operating in lower baseline growth environments or crowded competitive spaces where consolidation economies can be realized.

Yet the Sarbanes-Oxley environment makes these moves more risky and difficult since (1) the company now must certify the financial results of the company being acquired if it is material; and (2) the internal controls of the acquired company need to be certifiable as well. The result is that acquisitions will be more carefully pursued, with deeper due diligence and a SWAT team approach to integration, both operationally and in financial controls.

The Impact on Venture Capital Liquidity

Most venture capitalists say they will need the next few years to go back to basics and build sizable companies in the private market, sell them without large-scale opportunities, and take public those that reach scale. Great, but beware that Sarbanes-Oxley may apply sooner than you think to the private firms and actions they might take. Remember the 8,000 - 10,000 firms venture capitalists backed since the mid 90s?

To the buyer, selling a portfolio company for a material amount means you need to comply with Sarbanes-Oxley. This includes a 5-year look-back to determine fraud, manipulation, or a lack of internal controls. It will result in lower prices and larger and longer escrows. A buyers' market will cut returns and options for exits over the next few years.

Venture Capital Practices Must Change

Feeding the winners to get to scale has planning implications that will create issues in conflict with legal requirements and "Best Practices." In any event, a company must be in full compliance when it files the initial S-1 with the SEC.

This means the company needs to staff its board committees with independent persons and establish its internal controls at least a year before filing. One National Association of Corporate Directors Best Practice is that no outside director with a full-time job should serve on more than 4 boards. Also, a full-time professional director should serve on no more than 6 boards and 3 audit committees. While one may argue the applicability of this guideline to both public and private boards, the firm's director and officer liability carrier is likely to monitor this and apply exclusions from coverage if the guideline is not met. There is a need to disclose exactly how many boards one serves on to provide the necessary transparency.

American venture capitalists have long practiced the Japanese concept of *keiretsu*, where groups of companies gain competitive advantage by creating long-term full-group strategies. The companies often own equity in each other. The Sarbanes-Oxley requirements for independence are likely to cause more scrutiny of potential conflicts in this historic venture capital practice.

Once disclosed, information previously undisclosed may raise uncomfortable issues. Directors from two different venture capital firms previously seen as independent may no longer be considered independent. Once disclosed, common investments, the identity of common limited partnership investors, and board actions could be interpreted as actions in concert. Aggregate ownership could eliminate some venture capitalists as candidates for board and committee work. If the venture capital community extends *keiretsu* to directors, lawyers, and investment bankers to invest in their funds and deals, there will be substantial interlocks among venture capitalists across companies. Any company doing business with another venture capital firm's board member's portfolio company will undergo a greater level of scrutiny and disclosure than ever before. The result will be significant changes in practices. Since many major venture capital limited partners are among the main drivers and watchdogs of the changing environment, their attention to these details of transparency will increase as it influences their own results and public initiatives.

The “NEW” Audit Committee

Audit committees are drawing particular focus. As explained by the New York Stock Exchange’s Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees:

In its oversight capacity, the audit committee is neither intended nor equipped to guarantee with certainty to the full Board and shareholders the accuracy and quality of a company's financial statements and accounting practices. Proper financial reporting, accounting, and audit functions are collaborative efforts conducted by full-time professionals dedicated to these purposes. The audit committee, as the first among equals, oversees the work of the other actors in the financial reporting process - management, including the internal auditor, and the outside auditors - to endorse the processes and safeguards employed by each. In particular, the audit committee should encourage procedures that promote accountability among these players, ensuring that management properly develops and adheres to a sound system of internal control, that the internal auditor objectively assesses management's accounting practices and internal controls, and that the outside auditors, through their own review, assess management and the internal auditor's practices.⁶

Time commitments will undoubtedly increase. Estimates in numerous industry forums and polls of existing members of audit committees of public firms suggest the time required increases by 3-5 times over two years ago. “Independence” and “financial expertise” are merely the beginning of the list of the items required of audit committee members under Sarbanes-Oxley in Sections 301, 406, 204, 906, and 302. They must:

- Select, retain, and evaluate independent auditors
- Engage outside advisors
- Establish a process for confidentially receiving and independently reviewing financial whistleblower complaints from employees and other sources. These sources include the firm’s lawyers, who lose the attorney client privilege under Sarbanes-Oxley.
- Implement a code of ethics
- Prohibit directors who are not considered independent from serving on the audit committee
- Determine that no member of the audit committee has any business or family relationship with the company or its management team.
- Review the performance of audit committees

⁶ <http://www.nyse.com/pdfs/blueribb.pdf>

- Evaluate appropriate compensation levels, indemnification, and director and officer insurance to attract and retain qualified members
- Review all alternate accounting treatments
- Review and all financial statements and financial disclosures at least once in each quarter
- Review and accounting policy issues at least once in each quarter
- Review internal controls to identify key risks and monitor corrective actions
- Monitor the company's internal audit function
- Prohibit all officer loans
- Prepare full review of financials for the SEC at least every 3 years
- Implement training and education programs to ensure that audit committee members remain current on recent accounting and finance developments

Sarbanes-Oxley and the associated NYSE and NASDAQ requirements are at relatively early stages of implementation and the essential elements of compliance and new practices are clear. They constitute major changes for boards and senior management over the next several years and the greatest change in corporate finance and governance in over 50 years. While Congress targeted Sarbanes-Oxley at the largest firms in the US, an entire new body of law and practices will evolve over the coming years that will trickle down to the smaller public sector, including aggressive private firms, many backed by venture capital, that have relied on the public markets for growth.

Actions to Take

Get going on implementation

This marked transformation will affect everyone. There is a need for new processes among boards, committees, and management. Substantial set-up times and costs will require new internal resources and costly outsourced resources. The good news? Setting benchmarks and measuring a company against prevailing and forthcoming best practices will gain respect in the investor community, make dealing with the SEC more manageable, and set a framework for minimizing risk and long-term cost.

Reset expectations

Costs will increase for all companies. Small cap firms, particularly those under \$300 million in revenue, could see decreases in baseline earnings. Coupled with the flow of capital expectations, profit-earnings ratios may not return to the peaks of the late 90s.

Require scale. It is likely that the minimum level of revenue for a firm with a quality IPO will be \$50 million. Acquisitions will help smaller firms get the scale and breadth of customers to enable lower disclosure financial risk, a critical concept in the new regulations. A S.W.A.T team approach involving management and outside assistance will provide proper execution and compliance with audit committee guidelines.

Success for venture capitalists in the next decade will not be predicated simply on a return to past practices. It will incorporate new realities of the public market. Good venture capitalists and good investments are market driven and customer focused. Large investors, including parent entities of leading limited partners of venture capital funds, with the help of SEC oversight, have changed quickly. They have become a more informed, active and demanding group. According to L. Modigliani of Morgan Stanley, "In today's post-Enron environment, we believe that investors will pay a premium for companies with high governance standards".⁷

Discontinuities require massive change and the venture capital community needs to change their practices and to lead themselves and their portfolio firms in new directions. The opportunities to retain investor assets and build value will be recognized by the players that address these market and risk dilemmas.

⁷ http://www.jmdutton.com/PDF_Files/2002_ISS_CGQ.pdf

