Sarbanes-Oxley and US Firms' Exits from the Public Capital Market

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Holmstrom and Kaplan (2003):

“. . . the Act’s expected overall effect is as yet unclear. Our guess is that the effect will be positive for companies with poor governance practices and negative for companies with good governance practices. . . . At the margin, ths may lead some public companies to go private and deter some private companies from going public.”

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- Do public firms go private?
- Do private firms stay private? Or list elsewhere?
- Do firms remain publicly traded but do so in ways that evade SOX?
  - Moving to (or staying on) Pink Sheets
  - Canceling (or never beginning) cross-listings in US
  - Staying small in order to delay compliance?

Difficulties with SOX research

- Control groups
- Many ways to avoid SOX compliance

Three recent papers on the incidence of US public firms taking actions that evade SOX:

1. Engel, Hayes and Wang [EHW] *Journal of Accounting and Economics*, 2007

2. Leuz, Triantis and Wang [LTW] *Journal of Accounting and Economics*, forthcoming 2008

3. Kamar, Karaca-Mandic and Talley [KKT] (unpublished manuscript, 2007)

EHW (2007): Sample selection and research design

- 470 going-private transactions between 1998 and May 2005 (Schedule 13E-3)
  - Drop bankruptcies, foreign firms, and liquidations
- Compare pre-/post-SOX rate of transactions
- What firm-level characteristics predict the market response to the going-private announcement?

EHW (2007): Main results

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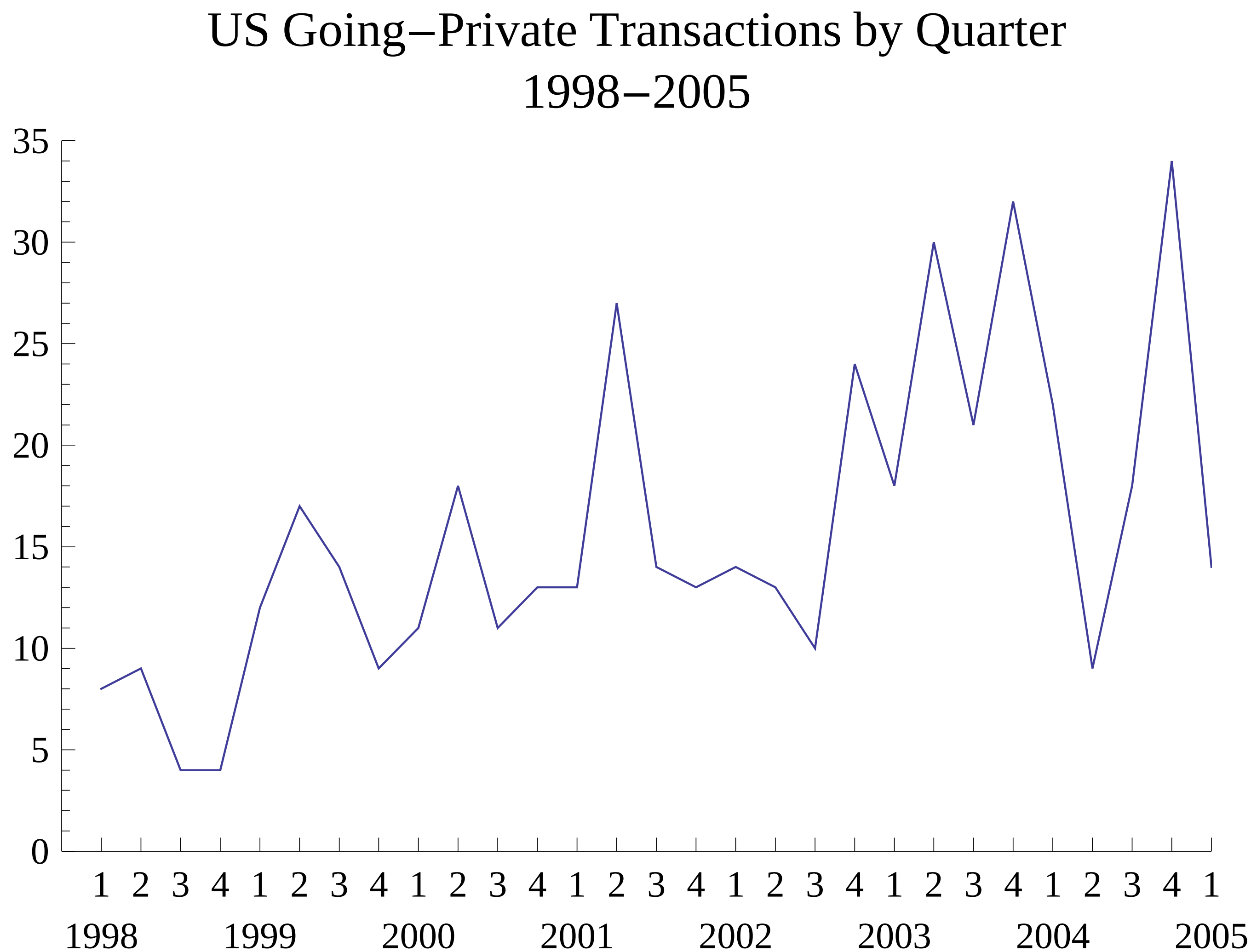

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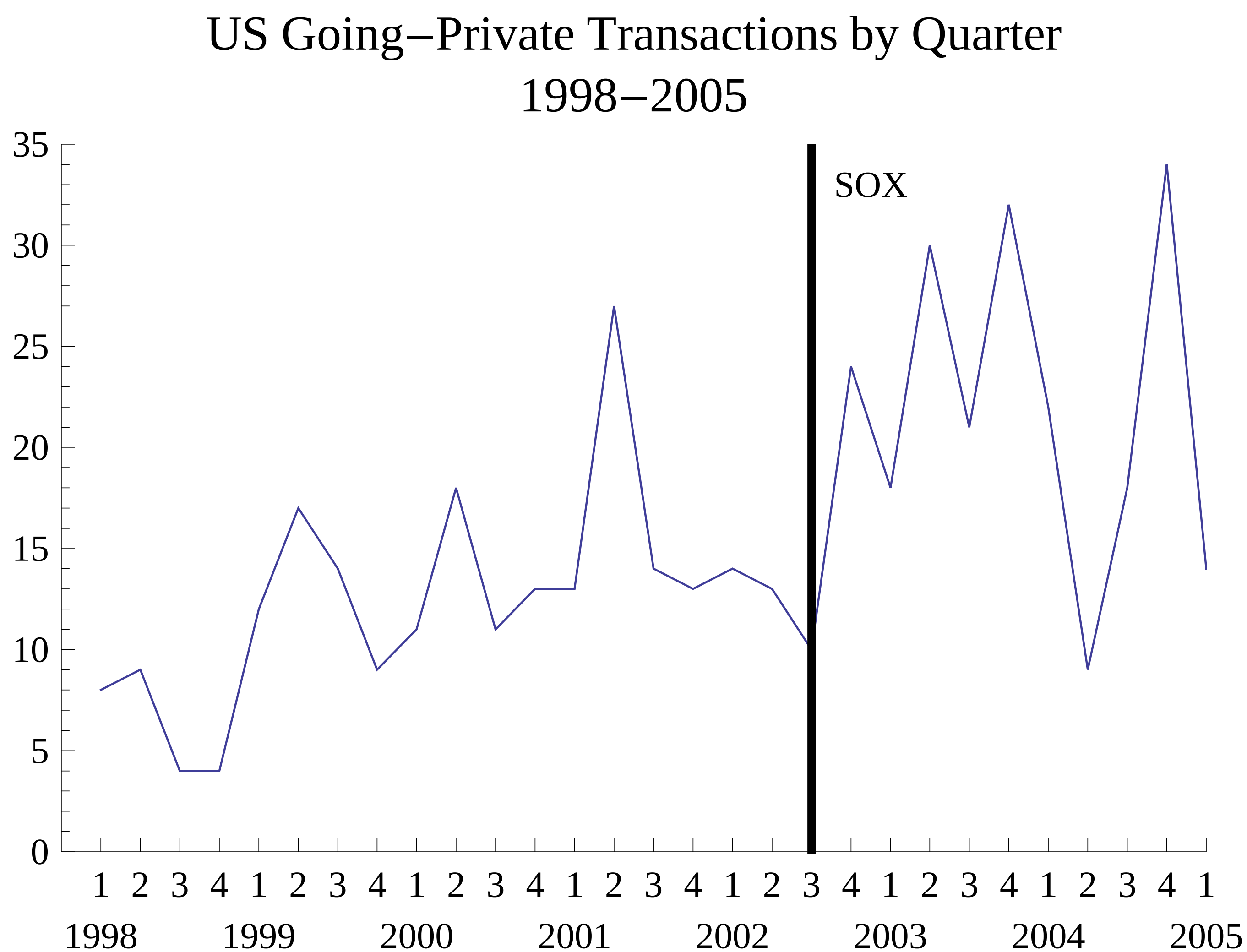

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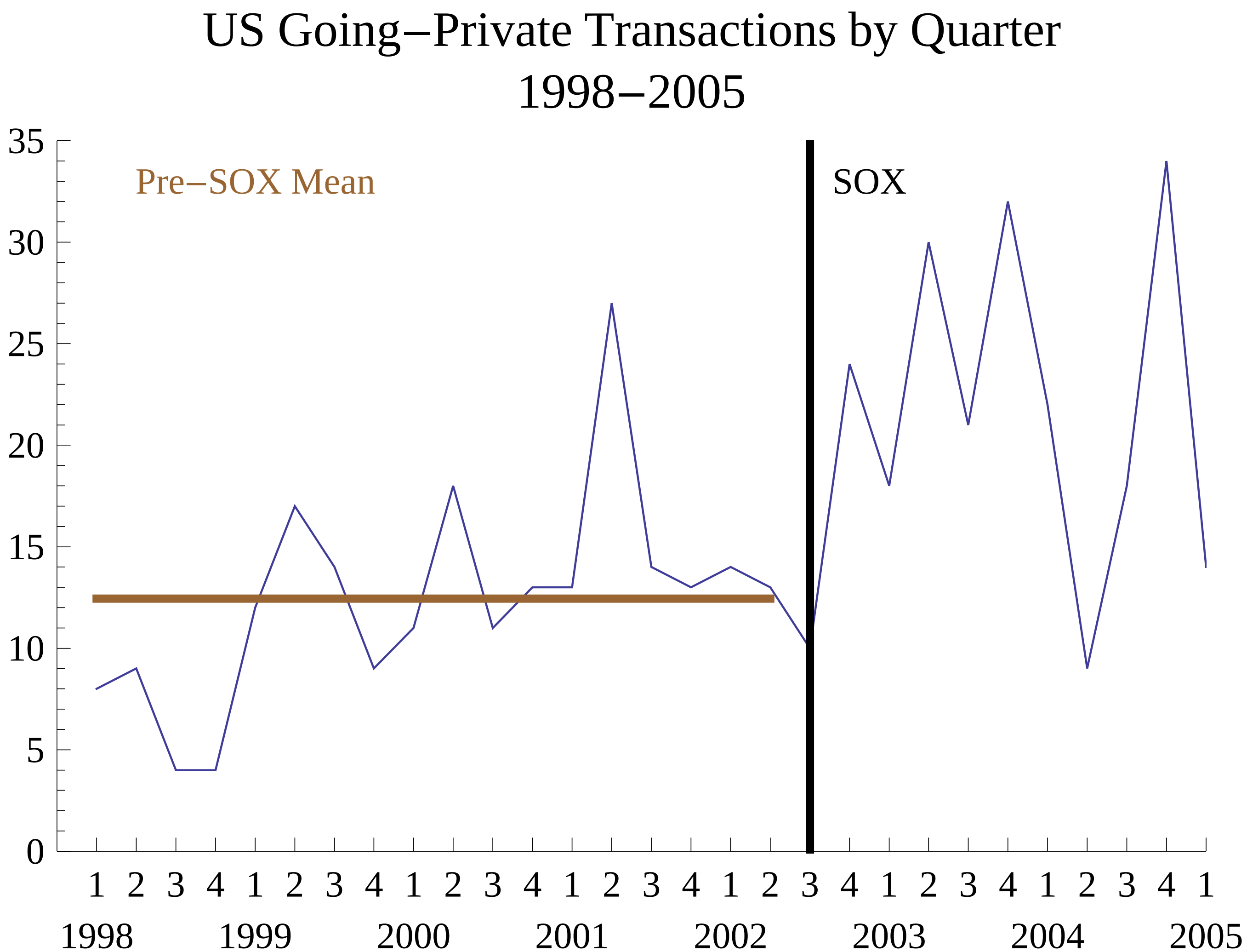

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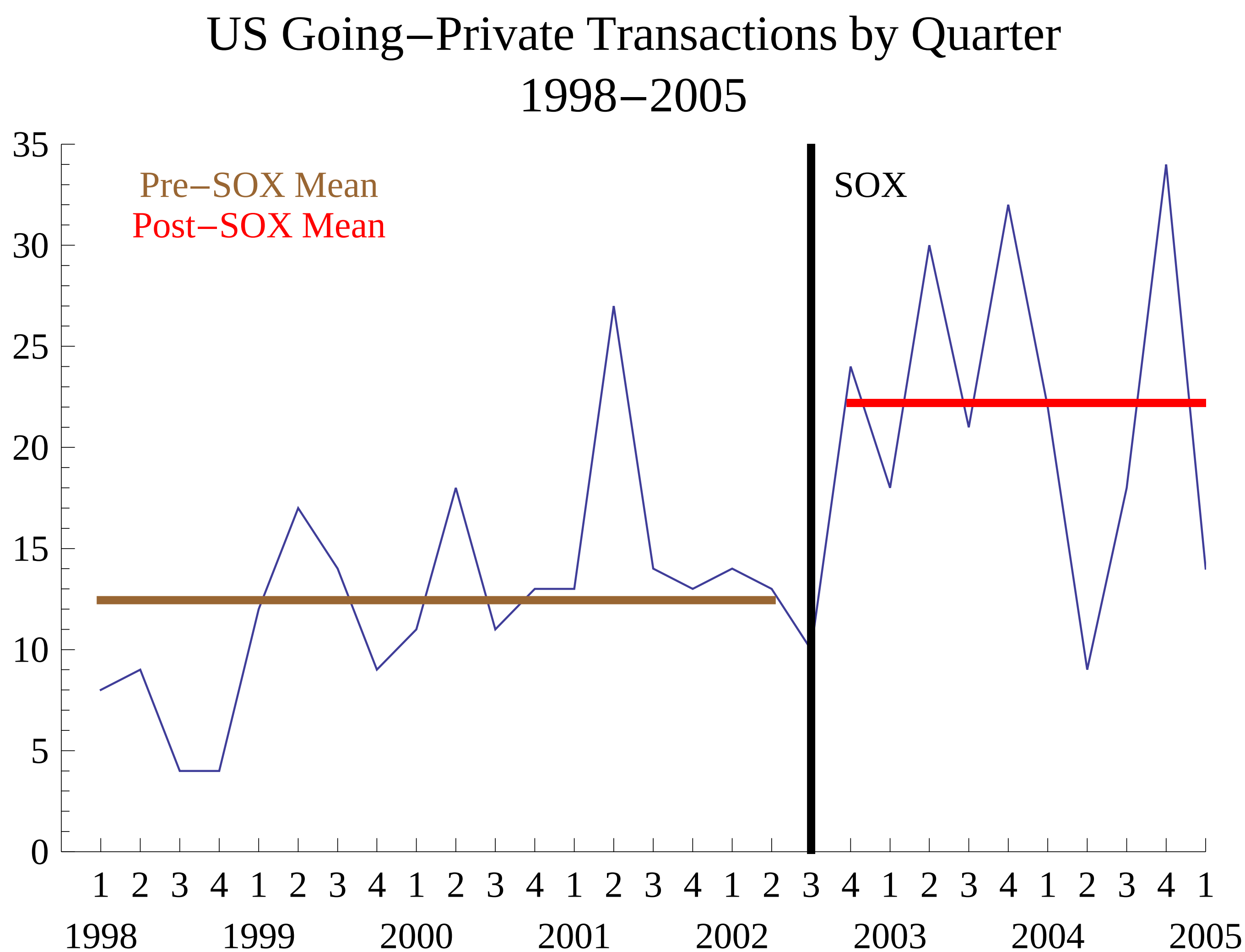

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- Increase in Schedule 13E-3 going-private transactions post-SOX
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- Changes in how firm characteristics predict market response
  - Smaller firms with greater inside ownership see higher going-private announcement returns in the post-SOX period compared to the pre-SOX period

EHW (2007): Going-private announcement returns

Percentage point effect on abnormal returns from a 10 percentage point increase in manager and director ownership:

	Pre-SOX	Post-SOX
Large firms		
Small firms		

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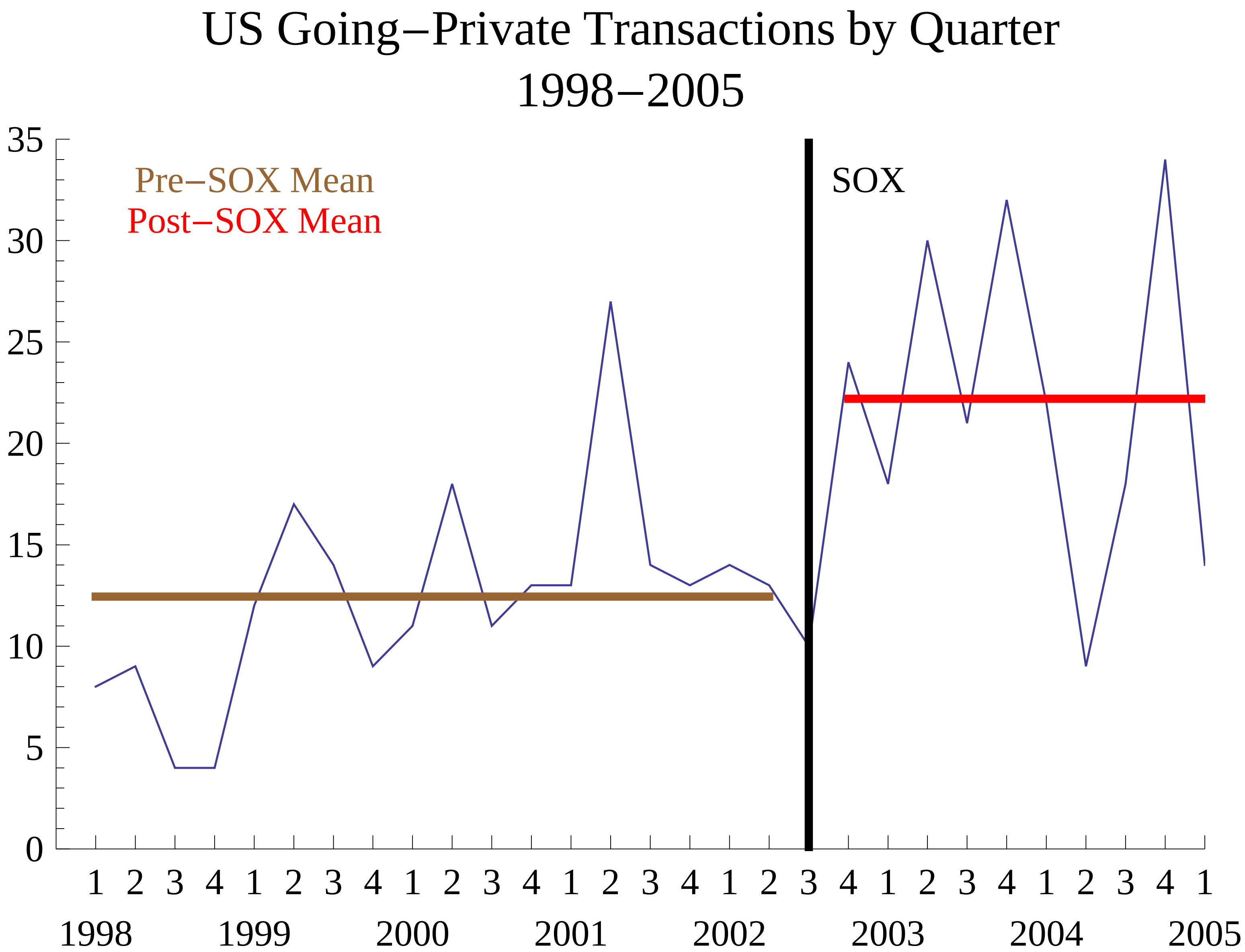
Small firms	−1.8	1.2

EHW (2007): Some strengths and weaknesses

- Sample selection similar to earlier literature on going private
- Hard to identify a control group of firms that was unaffected by SOX
- Most sample firms cease trading; but can evade SOX simply by deregistering


US Going−Private Transactions by Quarter
1998−2005
Pre−SOX Mean
Post−SOX Mean
SOX
0
5
10
15
20
25
30
35
1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1
1998
1999
2000
2001
2002
2003
2004
2005

LTW (2008): Sample selection and research design

- 484 going-dark firms between 1998 and 2004 (Form 15)
- Compare pre-/post-SOX rate of going dark
- What firm-level characteristics predict the going-dark decision and the market response to the going-dark decision?
  - Have those characteristics changed since SOX?

LTW (2008): Main results

- Increase in monthly frequency of deregistrations after SOX

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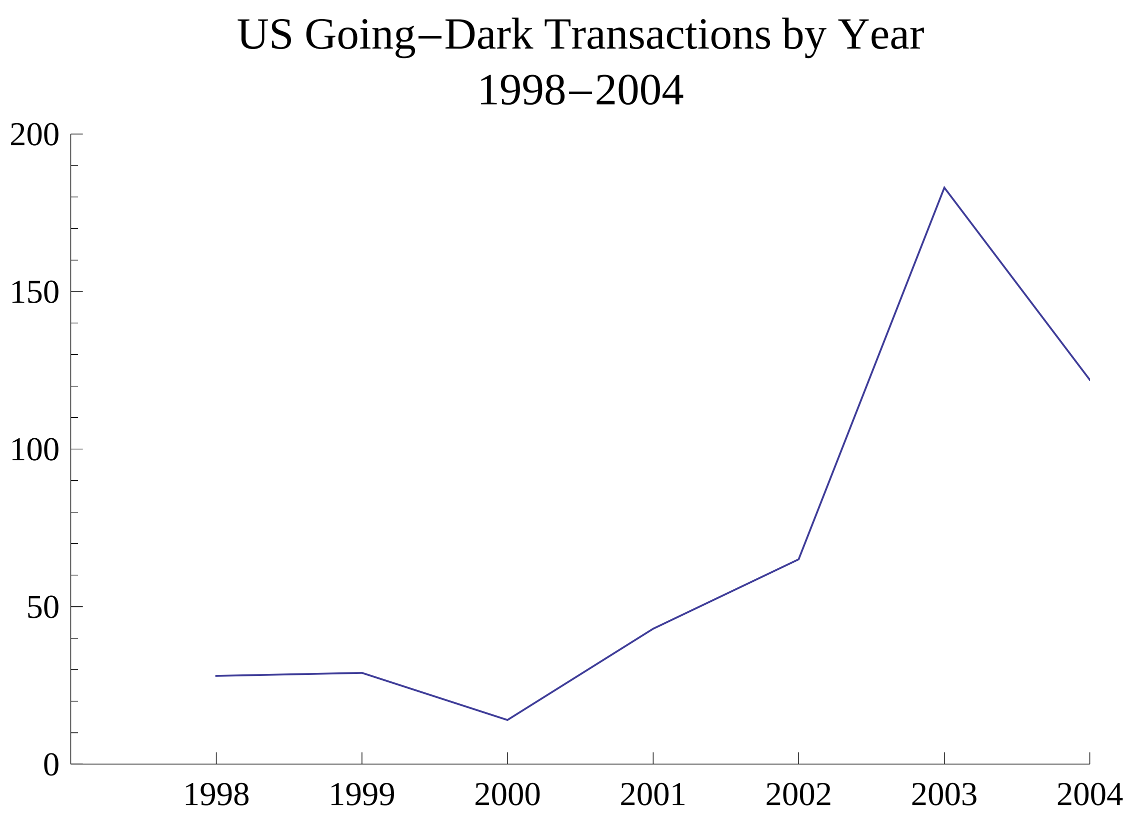

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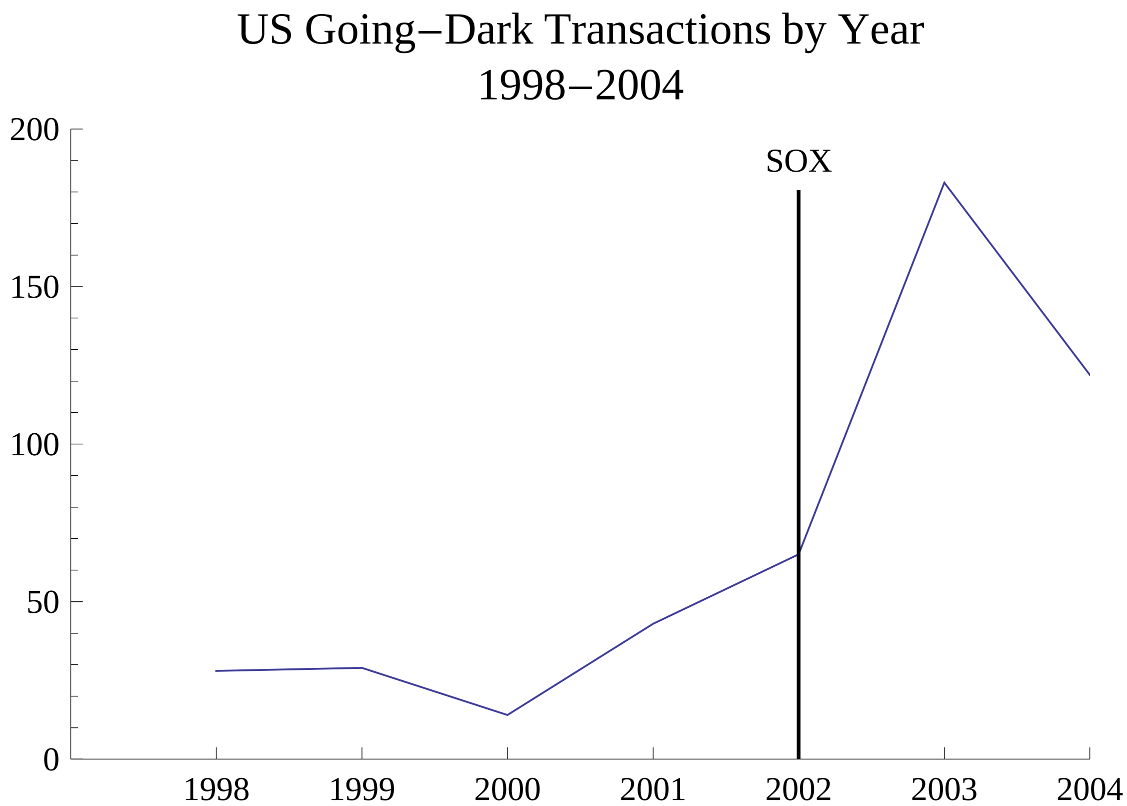

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- Increase in monthly frequency of deregistrations after SOX
- Negative market reaction to going dark
  - Attributable to poor prospects, agency costs, increased SOX costs

KKT (2007): Sample selection and research design

- All acquisitions between 2000 and 2004 involving targets traded on public exchanges
  - American and foreign targets
- Difference-in-difference design

  Compare:
    - Post-SOX change in probability of American public firms undergoing acquisitions being acquired by a private firm

  to
    - Corresponding change in probability for foreign firms
  - Control for level of stock prices in listing country

KKT (2007): Advantages and disadvantages of research design

- Compares US to other countries
- Contrasts going-private transactions with acquisitions by public acquirers
- Does not include going-dark firms
- Does not investigate other firm-specific factors

KKT (2007): Main results

- No relative increase in post-SOX rate of acquisition by private acquirers (going private) by American firms *overall*
- Increase in post-SOX rate of going private by *small* American firms
- Increase in rate of going private by small American firms is concentrated in the first year after SOX

KKT (2007): Table 1

Pre-SOX

	US	W. Europe & Canada	All Foreign
% small targets	22	25	24
% private acquirers	23	45	37
% private acquirers among small targets	40	53	45

Post-SOX

	US	W. Europe & Canada	All Foreign
% small targets	30	27	27
% private acquirers	32	42	42
% private acquirers among small targets	54	60	46

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Some conclusions

- Broadly speaking, evidence supports Holmstrom and Kaplan's conjectures
- Methodological problems remain
- Can we say whether SOX is good or bad from this evidence?