Reform Sarbox To Galvanize High-Tech IPOs

By JACQUELINE OTTO AND RYAN RADIA
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Silicon Valley is teeming with budding startups whose user bases and valuations are skyrocketing. As these companies seek breathing room to grow, they will face a tough decision: stay private, seek out a buyer or go public.

Making this complex choice all the more challenging is government uncertainty. Filing for an initial public offering is harder than ever due to the onerous regulations and burdensome laws Washington has handed down over the past decade.

Microsoft's $8.5 billion purchase of Skype surprised analysts, many of whom had predicted Skype would seek an IPO or a deal with Facebook or Google.

Meanwhile, Facebook has kept quiet in face of speculation over whether it might file for an IPO. So far, the social networking giant has focused on raising capital privately. Given the risks of going public in this environment, Facebook's decision is understandable.

While some tech firms — including LinkedIn, Kayak and Demand Media — have gone public or filed for IPOs in the past year, many others — including Hulu, Zynga, and Twitter — are reportedly leaning against going public this year. Some of these may be acquired, as happened with AdMob, a mobile advertising startup rumored to be pondering an IPO until Google bought it for $750 million in 2009.

Why do tech companies appear more reluctant to go public today than they were during the tech sector's heyday of the early 2000s?

While many factors are at play, new regulations on the finance sector and heavy-handed legislation enacted since the dot-com boom deserve much of the blame.

Raising capital through an IPO is especially tough, discouraging startups from seeking to go public. This increases the attractiveness of raising capital through private sources or by being acquired by a bigger firm.

The Sarbanes-Oxley Act, enacted in 2002 after the Enron scandal, has been devastating for investors and promising startups. The law's onerous mandates on public companies have forced many nascent companies to forget about or delay going public.

According to a 2005 report by the American Electronics Association (now TechAmerica), U.S. public companies spend over $35 billion each year to comply with Sarbanes-Oxley.

William Niskanen, a Cato Institute scholar and former economic adviser to President Reagan, argues that the section of Sarbanes-Oxley "requiring companies to perform internal audits has turned out to be far (costlier) than proponents projected, especially for smaller firms."

These costs, Niskanen laments, have caused many small companies to remain private and even led some foreign firms to list outside America or exit U.S. stock exchanges.

We might forgive Sarbanes-Oxley's destructive consequences if the law achieved its noble intentions of calming nervous investors and combating corporate fraud. But investors do not appear to have been comforted.

The average price-earnings ratio of the S&P 500 index, regarded by economists as an indicator of investor confidence, has trended downward since 2002. It finally took a positive turn in 2010, but remains far below its pre-2002 level. For the tech sector to boom again, Washington needs to get out of the way.

Companies like Microsoft, Apple and Google created immense wealth and opportunity in an era of less heavy-handed regulation. Firms such as Facebook and Skype may well represent tomorrow's giants, but mandates such as Sarbanes-Oxley make these innovative firms much less likely to launch independent public companies.

Seeking an acquirer is often a sensible move for startups, but whether and when to go public should be based on market opportunities, not the costs of short-sighted legislation.

For the sake of today's entrepreneurs and investors, Congress needs to take a close look at burdens that discourage companies from seeking public offerings. Revisiting the Sarbanes-Oxley Act would be an excellent first step. Section 404, which purports to prevent conflicts of interest, should be scrapped. The section establishes duplicative layers of oversight that are exorbitant to maintain. For instance, companies must assess for fraud, assess the measures to assess for fraud, then assess the assessors!

The murky waters on the tech IPO front should serve as a wake-up call to legislators. If America's entrepreneurial spirit is to realize its full potential, many more capable high-tech firms may need to go public to raise the capital they'll need to grow. The next generation of innovation depends on it.

• Otto is a research associate at the Competitive Enterprise Institute , where Radia is associate director of technology studies.