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at

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of the

Committee on Financial Services

of the

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Chairman Garrett, Ranking Member Waters, and Fellow Members of the Committee:

I. Introduction

I thank you for inviting me. Since the enactment of Sarbanes-Oxley a decade ago, two theories have been regularly at war in legislative debates over financial regulation. Theory One, which certainly underlies the recently enacted JOBS Act, is that our capital markets are buried under an avalanche of overregulation. Theory Two is that our capital markets are suffering from the loss of investor confidence. It is, of course, possible that both theories could be correct to some degree and to different degrees at different times. Nonetheless, I believe that the contemporary evidence far better supports the following generalization: The greatest obstacle to competitive capital markets and job creation today in the U.S. is not overregulation, but the loss of investor confidence.

This loss of investor confidence dates back to the burst of the Internet Bubble in 2000 to 2001. In its wake, investors learned that securities analysts in the U.S. were deeply conflicted. Over the next two years, Enron, World Com and a record number of accounting restatements furthered their disenchantment, and cast doubt over the integrity of audited financial statements. Since then, the IPO market has never returned to its pre-2000 levels of euphoria and volume.[1] The Enron and World Com scandals led, of course, to the passage of SOX a decade ago. Since SOX, it has been possible (and sometimes fashionable) to argue that the reduced number of IPOs is attributable to the regulatory burdens imposed by SOX, but it is even easier (and intellectually simpler) to see the

[1] The IPO market has always been volatile and changes in its volume may partly reflect new waves in technology (such as the Internet revolution that surged in the late 1990s and produced many successful IPOs). This factor could alone explain the reduced number of IPOs. A variety of factors also explain the decline in smaller IPOs of less than $100 million, including the demands of institutional investors for liquidity (which smaller IPOs inherently lack).

reduced level of IPOs as attributable to investor memories that still have not forgotten Henry Blodget, Jack Grubman and Pets.com.

Past bubbles are only one factor in the low level of investor confidence today. Currently, there are much more compelling reasons for increased investor skepticism. To understand this, one only has to survey the recent headlines:

1. The Futures and Commodities Market. The MF Global and Peregrine Financial scandals effectively told clients of futures and commodities brokers that they cannot be certain where their funds are and whether they have been misappropriated. The Peregrine scandal may have continued for 20 years (and thus rivals Bernard Madoff's Ponzi scheme for the length of time that it went undetected). Internal compliance and audit procedures and the segregation of customer funds to have been either lacking or woefully implemented. Other similar scandals could still be buried.

2. The Libor Scandal. The American public now understands that at least some within the largest banks in the U.S. and abroad were eager to collude to fix a critical benchmark rate. Equally important, there is some evidence that regulators (both in the U.S. and the U.K.) were equivocal about stopping this practice. This suggests underregulation, not overregulation.

3. The London Whale. JPMorgan's problems with its Chief Investment Office strike me as more a blunder than a crime, but there is certainly evidence of weak compliance efforts (and there may also be evidence that some traders successfully hid their losses for a time). Worse, the Federal

Reserve Bank of New York had 40 bank examiners on the ground at JPMorgan, but none at its critical Chief Investment Office in London. Like Inspector Clouseau pursuing the Pink Panther, they could not distinguish JPMorgan's headquarters from its hindquarters.

4. Chinese Reverse Mergers. It is estimated that approximately 80 Chinese issuers bought listings on U.S. exchanges between 2008 and 2011 — without conducting an initial public offering under U.S. law.[2] Many of these companies lacked any significant assets or revenues (Sino-Forest was actually listed in Canada, but it has become the symbol of this dubious class of issuers that have streamed into U.S. markets). Investors bought them on overly optimistic hopes for the Chinese economy. Interestingly, Chinese regulators are derisive about the U.S. acceptance of these companies, pointing out that the same companies could not have listed on the major Chinese exchanges. This year, the "Chinese Bubble" has deflated, and the 82 companies listed on the Bloomberg Chinese Reverse Merger Index have declined by some 52% between January 2011, and July 16, 2012.[3] Investors eventually learn — but the lessons are often bitter.

5. Facebook and the U.S. IPO Market. Although IPO markets are always volatile, American investors have lost considerable confidence this year in the domestic IPO market. This is evidenced not only by the much discussed fiasco surrounding the Facebook offering, but by the fact that

[2] See "Chinese Stocks Fleeing U.S.," Market Montage, July 21, 2012.
[3] *Id.*

the IPO pipeline has dried up over recent months and that the stock prices of the other companies in the "social media" industry that recently went public— i.e., Zynga, Groupon, Ren-Ren, and Zipcar[4] — are now trading well below their initial offering prices. Retail investors are angry that reduced analyst forecasts were selectively disclosed to institutional investors but not to them. Again, a bubble has deflated.

6. The JOBS Act. The perception that overregulation is responsible for the decline in IPO volume has strong adherents and was obviously the motor force for the JOBS Act that passed earlier this year. Although I believe that some provisions of the JOBS Act were reasonable in updating or streamlining existing exemptions, I regard other aspects of the JOBS Act as a major retreat from our longstanding commitment to principles of transparency and full disclosure.

What has been the impact of the JOBS Act? Of course, it is too early for any serious assessment. But already there is anecdotal evidence that it is attracting to the U.S. offerings that other markets would not list. The leading example is the approaching IPO of Manchester United, the British soccer team. Other jurisdictions would not permit Manchester United to list "dual class" shares that effectively disenfranchised public shareholders (the shares held by the public in Manchester United will have only one tenth the voting rights per share of the shares held by the control group). The U.S.'s willingness to list shares that do not carry full voting rights plus the exemptions available

[4] For a recent review of the price discounts on these offerings from the time of their IPOs, see Larry Doyle, "Social Media: You Know You're in a Bubble When . . .," Benzinga.com June 19, 2012.

to "emerging market companies" under the JOBS Act appears to have won the U.S. this offering. Nonetheless, it may have been a Pyrrhic victory, and other nations are mocking the U.S.'s success. A recent story in the New Zealand Herald notes that, under the JOBS Act, Manchester United is classified as an "emerging growth company," even though it is 134 years old and has been steadily operating at a loss.[5] A leading Singapore paper has praised the Singapore Exchange ("SEX") for not lowering its standards to those of the U.S.[6]

Should the U.S. be proud of its achievement? The Manchester United offering will not create jobs in the U.S. (as the issuer is a British sports team), but it does suggest that the U.S. is actively competing in a race for the bottom. Perhaps, in the future, some of the Chinese reverse merger stocks that snuck into the U.S. through the back door will instead enter through the front door, now that the JOBS Act has reduced the level of transparency that an IPO issuer must endure. In my view, the U.S.'s success in winning such listings is a dubious honor that will again bring few, if any, jobs to the U.S., but will probably import more than a few frauds. Over the long run, investor confidence will again suffer.

II. H.R. 6161: "The 'Mature Mediocrities' Act of 2012".

[5] See Brian Gaynor, "Why Man U's rules Are Turning It Into a Loser," New Zealand Herald, July 14, 2012.

[6] See Goh Eng Yeow, "Hold IPO Hopefuls to High Standards; Goal of SEX to Attract Brand Names, But They Should Be Actively Traded," The Strait Times, July 9, 2012.

All this brings me to H.R. 6161 (the "Fostering Innovation Act"). It is another proposed step in the headlong retreat from transparency. Equally important, it would be a step that would be taken in the face of a detailed SEC recommendation to the contrary.[7]

Essentially, H.R. 6161 changes the definition of "accelerated filer" in SEC Rule 12b-2 so that companies that are neither "emerging" nor "growth" companies can also escape Section 404(b) of the Sarbanes-Oxley Act (which requires an annual audit of internal controls). Specifically, I have three basic criticisms of H.R. 6161:

First, it goes further than the "emerging growth company" concept of the JOBS Act, because the JOBS Act confers typically only a five year compliance postponement after the date of an issuer's IPO. The JOBS Act's provision can thus be justified as a transitional provision for young companies. In contrast, H.R. 6161 would extend permanent immunity from SOX's Section 404(b) to firms that stayed below $250 million in their "public float" (i.e., their value of stock held by public investors who are not affiliates). Whatever the case for sheltering "emerging growth companies" for a limited period, it is far stronger than the case for immunizing "Mature Mediocrities" forever, as H.R. 6161 would do.

Second, H.R. 6161 goes well beyond what was contemplated by Section 989G of the Dodd-Frank Act because it redefines the term "accelerated filer" (in SEC Rule 12b-2[8]) to require that an accelerated filer must have revenues in excess of $100,000,000 during its most recent fiscal year. The Dodd-Frank Act's Section 989G had contemplated <u>only</u> the possibility of eliminating companies with a modest public float (in the $75

[7] See Office of the Chief Accountant, U.S. Securities and Exchange Commission, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers With a Public Float Between $75 and $250 Million, (April, 2011).

[8] See 17 C.F.R. 240.12b-2.

million to 250 million range). Under this revised definition in H.R. 6161, a company could have revenues of $90 million and yet have a public float of $600 million (because it had a relatively high price/earnings ratio), and it would not be deemed an "accelerated filer."[9] Such high p/e companies are probably those most needing oversight over the adequacy of their audit controls. In any event, this is a more open-ended exemption than it first appears.

Third, unlike the "emerging growth companies" exemption, H.R. 6161 confers immunity on mature companies that may have a dubious regulatory history. For example, suppose a company with a public float of $200 million had recently experienced a major accounting restatement within the past two years. This sounds like exactly the type of company that needs the oversight of Section 404(b). But it would be exempted because it did not qualify as an "accelerated filer" under H.R. 6161's definition, even if it had experienced multiple restatements and several SEC enforcement actions. My point is that certain "bad boys" should not qualify for this extended exemption.

Finally, there is a likelihood that H.R. 6161's $100 million revenues and $250 million public float tests will be gamed by some issuers. An issuer could defer earnings to the next year to avoid surpassing $100 million in revenues or, even more likely, it (or an affiliate) could buy back stock to stay under the $250 million public float test. The SEC's study reports evidence that issuers do "attempt to avoid Section 404 costs by reducing or managing their public float in order to become or remain a non-accelerated

[9] To illustrate, suppose a company had $90 million in revenues and $20 million in net earnings and the market capitalized its earnings at a 30:1 price to earnings ratio. Its market capitalization would thus be $600 million, but it would still be exempt because it had less than $100 million in revenues.

filer."[10] The possibility of such manipulation is probably greater under H.R. 6161for issuers that are at or near the $250 million float level than for those at or near the $75 million level.[11]

III. The Impact of Section 404(b)

Beyond these narrow drafting comments about H.R. 6161, the broader question of the impact of Section 404(b) deserves a brief comment. Section 404(b) did not on its face require an audit, but it was interpreted to require a full-scale audit before an auditor could attest under Section 404(b) of SOX. In retrospect, that decision could be reasonably debated. In any event, I would have to agree that, as first formulated, Section 404(b) was unduly costly to smaller companies. But that is now ancient history. As the SEC points out in its lengthy study, Section 404(b) was substantially softened and downsized in 2007, and then Dodd-Frank Act's Section 989G exempted all "non-accelerated filers" from its reach. The costs of Section 404(b) compliance have also come down since the 2007 reforms.

Unfortunately, these changes have not ended its death-by-a-thousand-cuts, and the new attempt in H.R. 6161 would exempt roughly another 1,000 companies (according to the SEC's estimate) with a public float between $75 million and $250 million (plus the unknown number of companies with revenues under $100 million and a public float of over $250 million). That would represent another major retreat from the principle of transparency that long governed our market.

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[10] See Office of the Chief Accountant, supra note 7, at 95–96.

[11] This is because, by adding the $100 million revenues test, H.R. 6161 creates an entirely new test that can be gamed. Also, larger issues generally have greater financial resources and hence more ability to buy back or redeem shares.

Equally important, the SEC's study finds strong evidence that Section 404(b) provides meaningful protections to investors. Specifically, the SEC's study reports that:

1. "Section 404(a) and (b) compliant issuers are less likely to issue materially misstated financial statements than issuers not subject to these requirements."[12]
2. "The rate of restatements . . . was 46% higher among issuers that only filed Section 404(a) reports as compared to those that filed auditor attestations under Section 404(b) during the cumulative four years of compliance with Section 404."[13]

On the other side of the ledger, it had been argued that the passage of Sarbanes-Oxley has led to a significant increase in firms going private or "going dark" (i.e., deregistering under the Securities Exchange Act). But here more recent research suggests that Section 404(b) had little or no effect on decisions to go private or go dark.[14] Indeed, debt investors appear to have sometimes demanded that even when firms went private they still had to remain 1934 Act "reporting companies."[15]

This evidence thus suggests that there are benefits to Section 404. To be sure, there are also costs, but smaller companies were spared these costs if they qualified as non-accelerated filers by Section 989G of the Dodd-Frank Act. Now, the issue is whether medium-sized and even larger companies should be able to escape Section 404.

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[12] Office of the Chief Accountant, supra note 7, at 86.
[13] *Id.*
[14] See C. Leuz, Was the Sarbanes-Oxley Act of 2002 Really This Costly? A Discussion of Evidence from Event Returns and Going Private Decisions, 44 J. Acct. & Econ. 146 (2007); R. Bartlett, Going Private But Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going Private Decisions, 76 U. Ch. L. Rev. 7 (2009).
[15] See Bartlett, supra note 14.

In the wake of the JOBS Act, there is considerable reason to slow the race towards deregulation. We may yet find that in some areas we have gone too far. Nor do we jeopardize our market by moving cautiously. Foreign issuers already have substantially enhanced reasons to consider a U.S. listing (as they can qualify as "emerging growth companies"). The likely beneficiaries of H.R. 6161 will be "Mature Mediocrities," and the case for broadly exempting them in the fashion that H.R. 6161 does has just not been made.