



UNIVERSITY of  
DENVER

STURM COLLEGE OF LAW

Testimony of J. Robert Brown, Jr.,  
Lawrence W. Treece Professor of Corporate Governance, Director, Corporate & Commercial  
Law Program, University of Denver Sturm College of Law

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Sarbanes Oxley at 15:

The Success of “Quack” Corporate Governance

Imagine a financial system where investors could not be sure that some of the most widely traded public companies were nothing more than a house of cards, where the system of regulation and governance was sufficiently porous that a massive fraud could be perpetuated at one of these companies without detection by gatekeepers, whether accountants, lawyers or directors, and where employees suspecting financial fraud were blocked from reaching the board of directors with their concerns. Imagine further that, because of inadequate accountability and weak internal controls, investors could not be sure that even the largest public companies had accurate financial statements.

In late 2001, these circumstances were not a matter of imagination but reality. Enron proved to be an \$80 billion Potemkin village, going from the 10<sup>th</sup> largest company to bankruptcy in the course of a few years. The problems, however, were deeper than the need to uncover fraud. In the years following the collapse of Enron, companies would discover errors and be forced to restate their financial statements in record numbers. The crisis demonstrated that the disclosure system could not be trusted to produce accurate and complete financial information about public companies.

Sarbanes-Oxley (“SOX”) sought to reassure investors by strengthening the system for financial disclosure. The legislation did so in a number of innovative ways. A regulator was created to oversee public company accounting firms but, rather than add another government agency, Congress assigned the task to the Public Company Accounting Oversight Board (“PCAOB”), a non-profit corporation overseen by the Securities and Exchange Commission (“Commission” or “SEC”).

Congress strengthened the role of the gatekeeping function of the board, primarily through listing standards applicable to audit committees. Boards were encouraged to add financial expertise through a system of “comply or explain,” something widely used in Europe but, until SOX, not in the US. Information flow to the board was increased and companies had to put in place mechanisms designed to allow employees to make confidential complaints to the audit committee about concerns over financial disclosure.

Agreement on the need to restore investor confidence was widespread and SOX proved to be a truly bipartisan event. The legislation passed 99-0 in the Senate<sup>1</sup> and 423-3 in the House of Representatives.<sup>2</sup> Despite the label of “quack” corporate governance, SOX succeeded in putting in place mechanisms that promoted investor confidence by raising the quality of financial disclosure.<sup>3</sup>

## I. SOX and Financial Disclosure

SOX adopted a number of mechanisms for improving the integrity of the financial disclosure process. The role of gatekeepers was strengthened and responsibility assigned for the development, assessment, and review of internal controls. Officers were required to certify financial statements in quarterly and annual reports. Audit quality was enhanced and penalties for participation in financial fraud and false disclosure were increased.

### A. Disclosure Integrity

SOX strengthened the role of the audit committee, addressed the system of internal controls, and mandated disclosure to shareholders of relevant concerns.

#### 1. Audit Committees

SOX made four broad changes to the audit committee structure.<sup>4</sup> Limited to independent directors, committees were encouraged to promote the financial sophistication of the members.<sup>5</sup> Section 407 required that all public companies include a “financial expert” on the audit committee or disclose the reasons for not doing so. Financial expertise was to be obtained through education or experience and was reflected in an understanding of financial statements

<sup>1</sup> <https://www.govtrack.us/congress/votes/107-2002/s192>

<sup>2</sup> <https://www.govtrack.us/congress/votes/107-2002/h348>

<sup>3</sup> See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L. J. 1521 (2005). See also Stephen M. Bainbridge, *Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure*, UCLA School of Law, Law-Econ Research Paper No. 06-14, University of California, Los Angeles - School of Law, *Date posted to database*: May 1, 2006 (stating that SOX “sacrificed the American economy at the altar of short-term political gain.”). For a response to these critics, see J. Robert Brown, Jr., *Criticizing the Critics: Sarbanes Oxley and Quack Corporate Governance*, 90 Marquette L. Rev. 309 (2006).

<sup>4</sup> Section 303 also required the adoption of rules prohibiting interference with an audit.

<sup>5</sup> Section 407 required the Commission to issue rules requiring reporting companies to disclose “whether or not, and if not, the reasons therefore, the audit committee of that issuer is comprised of at least one member who is a financial expert, as such term is defined by the Commission.” Shareholders must be informed of the persons designated as financial experts. See Item 407 of Regulation S-K, 17 CFR §229.407.

(including their preparation), internal controls, and audit committee functions.<sup>6</sup> Evidence indicates that the use of financial experts has become widespread.<sup>7</sup>

Second, the audit committee received expanded jurisdiction, obtaining “direct” responsibility “for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer”<sup>8</sup> and receiving a guarantee of “appropriate funding.”<sup>9</sup>

Third, SOX enhanced the information that had to be reported to the audit committee. The committee was, for example, required to be told about “significant deficiencies and material weaknesses” in the internal controls.<sup>10</sup> Auditors were required to inform the committee of all critical accounting policies and practices.<sup>11</sup> Listed companies had to put in place a system for allowing employees to provide anonymous complaints about “concerns regarding questionable accounting or auditing matters.”<sup>12</sup> The complaints could alert directors to problems that, at a minimum, required additional investigation.

Fourth, the committee was given an enhanced role in ensuring auditor independence. SOX prohibited independent accounting firms from engaging in certain non-audit services.<sup>13</sup> For those that were permitted, they were conditioned upon audit committee approval and disclosure to shareholders.<sup>14</sup>

## 2. Internal Controls

SOX also sought to promote the accuracy of financial disclosure by strengthening the system of internal controls. Internal controls required to ensure that records were maintained and transactions “fairly reflected.” In addition, controls were to provide “reasonable assurances” that matters were recorded properly, expenditures and receipts authorized, and unauthorized transactions detected in a timely fashion.<sup>15</sup>

Section 404 provided that management had to assess the effectiveness of the company’s internal control over financial reporting on a yearly basis and disclose the assessment to

<sup>6</sup> See Section 407 of SOX. For the definition, see Item 407(d)(5)(ii) of Regulation S-K, 17 CFR §229.407(d)(5)(ii).

<sup>7</sup> *The Sarbanes Oxley Act at 15*, E&Y, 2017, at 9 (noting that “on average, 60% of S&P 500 audit committee members are formally designated financial experts”).

<sup>8</sup> See Section 301 of SOX, codified as 15 USC §78f(m). The requirements were to be implemented as mandatory listing standards by the exchanges.

<sup>9</sup> See Rule 10A-3(b)(5), 17 CFR §240.10A-3(b)(5). A representation that the material has been disclosed to the audit committee must be made in the certification filed by the CEO and CFO. See Item 601(b)(31) of Regulation S-K, 17 CFR §229.601(b)(31).

<sup>10</sup> See Section 204 of SOX, codified as 15 USC §78m(k).

<sup>11</sup> The requirement was added to Regulation S-X. See 17 CFR §210.2-07.

<sup>12</sup> See Rule 10A-3(b)(3), 17 CFR §240.10A-3(b)(3).

<sup>13</sup> See 17 CFR §210.2-01 (auditors are not deemed “independent” to the extent providing specified non-auditing services).

<sup>14</sup> See Exchange Act Release No. 47265 (Jan. 28, 2003) (“The Sarbanes-Oxley Act further requires disclosure in periodic reports of non-audit services approved by the audit committee.”).

<sup>15</sup> Rule 13a-15(f), 17 CFR §240.13a-15(f).

shareholders in the annual report.<sup>16</sup> Intending to ensure that the controls were “designed to prevent or detect material misstatements,” the assessment could not characterize the system as effective to the extent it contained one or more material weaknesses.<sup>17</sup>

The provision also provided that the company’s public accounting firm was required to “attest” to the assessment made by management. As part of the assessment process, therefore, management knew that the analysis would be subjected to third-party review. Presumably the attestation requirement encouraged a more thorough assessment in at least some cases.

## B. Audit Quality Improvement

SOX sought to improve audit quality by enhancing auditor independence and improving auditor oversight.<sup>18</sup> Most significantly, SOX ended self-regulation and created the PCAOB.<sup>19</sup>

Created as a nonprofit corporation and not as “an agency or establishment of the United States Government,” the PCAOB was assigned to “oversee the audit of public companies . . . in the preparation of informative, accurate, and independent audit reports . . .” The Board was given the authority to establish auditing standards and to conduct inspections, annually for large firms, every three years for the others. In addition to assessing the audits, the inspections evaluated “the sufficiency of the quality control system of the firm . . .”

The Board was also received the authority to initiate disciplinary proceedings and impose disciplinary sanctions, including revocation of a firm’s registration with the PCAOB. The hearings, however, were required to be confidential unless the parties agreed otherwise which, as a practical matter, did not occur. Moreover, confidentiality provided incentives for delay. The results of any proceeding could be appealed to the Commission, with confidentiality remaining until the Board’s sanctions were allowed to take effect.<sup>20</sup>

## C. Management

SOX also sought to improve the quality of financial disclosure by increasing the responsibility of officers.

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<sup>16</sup> See Item 308 of Regulation S-K.

<sup>17</sup> Exchange Act Release No. 47986 (June 5, 2003) (“The final rules therefore preclude management from determining that a company’s internal control over financial reporting is effective if it identifies one or more material weaknesses in the company’s internal control over financial reporting.”).

<sup>18</sup> Auditor independence was enhanced through a prohibition on the performance of some non-audit services. The legislation included exemptions for other services, including tax services, but required that they be approved by the audit committee. Rotation of the audit partner was also required. See Section 203 of SOX, codified in Section 10A(j), 15 USC §78j-1(j).

<sup>19</sup> See Section 101 of SOX.

<sup>20</sup> See Section 107 of SOX.

Section 302 required the CFO and CEO to certify the financial statements included in the annual and quarterly reports.<sup>21</sup> The officers had to represent that they had “reviewed the report” and that the report did not, based upon their knowledge, contain any untrue statement of a material fact . . .”<sup>22</sup> The certifications also had to acknowledge that the effectiveness of the system of internal controls had been evaluated and that the auditors and audit committee had been informed of any significant deficiencies.

Section 303 prohibited improper influence of audits. Officers and directors could not take any action to “fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.”<sup>23</sup>

Section 406 required a code of ethics for senior financial officers or an explanation as to why one was not required. The code was designed to promote “honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships” and “full, fair, accurate, timely, and understandable disclosure in the periodic reports. . .”<sup>24</sup> Changes or waivers to the code had to be made public.

SOX also imposed a number of substantive obligations on boards. Section 304 required that where the company restated earnings due to material noncompliance as a result of misconduct, compensation was to be clawed back. Specifically, the CEO and CFO would be required to return any incentive based compensation paid within a year after issuance of the financial statements.<sup>25</sup> In addition, Section 402 of SOX imposed an almost absolute ban on extensions of credit to executive officers and directors.<sup>26</sup> Loans during the Enron era had been made on highly favorable terms<sup>27</sup> and in some cases involved an assumption of risk “that no financial institution was willing to assume.”<sup>28</sup> SOX prevented future reoccurrences by barring the transactions.

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<sup>21</sup> Rule 13a-14, 17 CFR §240.13a-14.

<sup>22</sup> See Section 302 of SOX, codified in Rule 13a-14, 17 CFR §240.13a-14.

<sup>23</sup> See Rule 13b2-2(b), 17 CFR §240.13b2-2(b).

<sup>24</sup> See Item 406 of Regulation S-K, 17 CFR §229.406.

<sup>25</sup> See *SEC v. McGuire*, Litigation Release No. 20387 (D. Minn. Dec. 6, 2007) (noting that the settlement was “the first with an individual under the ‘clawback’ provision (Section 304) of the Sarbanes-Oxley Act to deprive corporate executives of their stock sale profits and bonuses earned while their companies were misleading investors.”).

<sup>26</sup> 15 USC §78m(k).

<sup>27</sup> *Report of Investigation by the Special Investigative Committee of the Board of Directors of Worldcom, Inc.*, Dennis R. Beresford, Nicholas deB. Katzenbach, C.B. Rogers, Jr., March 31, 2003 (“The Company did not have a perfected security interest in any collateral for the loans for most of the time period during which they were outstanding.”). See also *Id.* (“Ebbbers was not required to make regular payments; rather, payments were required only on the Company’s demand, and no payments were demanded. The promissory notes provided that the interest charged to Ebbbers would be equal to the fluctuating rate of interest charged under a WorldCom credit facility, almost always the lowest rate available to WorldCom at the time, and a rate of interest lower than that of Ebbbers’ other outside loans. Moreover, this rate was lower than the average rate WorldCom paid on its other debt.”).

<sup>28</sup> *Report of Investigation*, *supra* note 27.

## D. Enforcement

SOX also included a number of provisions designed to deter wrongdoing.<sup>29</sup> False certifications were subject to still penalties.<sup>30</sup> Destruction of audit records was criminalized<sup>31</sup> and existing prohibitions on the destruction of corporate records were strengthened.<sup>32</sup> Whistleblower protections were included for the first time.<sup>33</sup> The Commission was given the authority to bar individuals from serving as officers and directors of public companies in administrative proceedings.<sup>34</sup>

## II. Looking Forward

SOX addressed serious concerns with the public securities markets. The concerns had reduced investor confidence and had the capacity to threaten the integrity of the markets. Concerns have again arisen over these markets. Some have pointed to a reduction in the number of IPOs and the presence of a large number of unicorns (companies with a value of more than \$1 billion) that have chosen to remain in the private equity markets.<sup>35</sup>

Unicorns have a number of reasons for delaying IPOs. The strength of the private markets provides a degree of flexibility over the timing of public offerings that did not exist in earlier eras.<sup>36</sup> Moreover, with the prevalence of dual class stock structures, founders, rather than private equity funds, likely have greater say over the timing of a public offering.<sup>37</sup> Finally, small investors are not excluded from the markets but can participate in pre-IPO companies through the purchase of shares in various mutual funds.<sup>38</sup>

<sup>29</sup> See Section 807 (amending 18 USC § 1348).

<sup>30</sup> See Section 906 (adding 18 USC § 1350).

<sup>31</sup> See Section 802 (adding 18 USC § 1520).

<sup>32</sup> See Section 802 (amending 18 USC § 1519, the anti-shredding provision).

<sup>33</sup> Section 806 (adding 18 USC §1514A)

<sup>34</sup> Section 1105 (amending Section 21C of the Exchange Act, 15 USC §78u-3).

<sup>35</sup> Corrie Driebusch, *IPO Market Isn't Quite Back as Many Startups Are Still Holding Out*, WSJ, July 5, 2017, ("More than 160 private companies are valued at \$1 billion or more, including ride-hailing company Uber Technologies Inc. and Airbnb Inc.").

<sup>36</sup> Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 Hastings L. J. 445 (2017) ("That is, even if public company disclosure requirements had remained constant over the last three decades, there would likely still be a dearth of public companies today, due to the increasing ease of raising capital privately."). The Commission has taken a number of steps to facilitate the development of the private markets. See Rule 144A, 17 CFR §230.144A. The robust nature of the private markets, therefore, represents a product of regulatory development.

<sup>37</sup> Unicorns often rely on dual class stock structures that leave control in the hand of founders rather than private equity investors. Founders, therefore, may have greater control over the decision to go public and may have less incentive to do so than private investors.

<sup>38</sup> Small investors can participate in the private equity market through mutual funds. See Andrew Ross Sorkin, *Portfolios Are Investing in Unicorns*, DEALBOOK, May 11, 2015 ("While public investors and 401(k) contributors have long complained that they can't get access to shares of hot technology companies before their initial public offerings, that's actually not the case anymore. Fidelity, T. Rowe Price, BlackRock and Janus, among others, have been quietly putting

Public markets remain active<sup>39</sup> and retain their allure.<sup>40</sup> They facilitate secondary trading and allow shares to be used as cash for acquisitions or compensation. The markets continue to provide a unique source of capital for companies with few assets and little history of profitability. Amazon went public in 1997 and raised a mere \$54 million yet today has a market capitalization of about \$450 billion.<sup>41</sup> Snap was able to go public in 2017 despite an apparent lack of profitability.<sup>42</sup>

Private markets also have their drawbacks. Valuations are subjective.<sup>43</sup> Nor do they have in place the same protections that are designed to ensure the accuracy of financial statements.<sup>44</sup> These investments can, therefore, pose substantial risk,<sup>45</sup> some of which are related to inadequate transparency.

The public markets can always be improved. As SOX taught, however, reform should have as the goal the promotion of investor confidence. In considering reforms, the hallmark of the public markets is transparency and disclosure.<sup>46</sup> Investors could benefit from an improved system of disclosure. At the same time, care should be taken with respect to any reform that might impair the system of disclosure or could limit governance rights of shareholders. Neither will promote investor confidence and encourage investment.

#### A. Effective Disclosure

Investor confidence will benefit from improved disclosure. The current disclosure regime is largely based upon Regulation S-K.<sup>47</sup> Much of the regulation was put in place in the 1980s and has not been significantly updated.

The Commission did more recently instigate a review of the disclosure system.<sup>48</sup> Concerns existed, however, that the focus was on disclosure “overload” rather than disclosure

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shares of private companies like Uber, Pinterest and SpaceX into their investment funds, hoping to lift the returns of certain mutual funds.”).

<sup>39</sup> See Driebusch, *supra* note 35 (“Companies making their stock-market debuts in the first half raised roughly \$28 billion, above the first-half average going back the last two decades, according to data provider Dealogic.”).

<sup>40</sup> See Kara M. Stein, Commissioner, SEC, *Lighting Our Capital Markets*, July 11, 2017 (“From 2009 through 2014, investors supplied nearly \$17 trillion in primary capital – providing capital directly to companies in exchange for debt or equity securities.”).

<sup>41</sup> Shares are trading at about \$1000. Amazon has 477,170,618 shares outstanding. See Amazon, Form 10-K, Feb. 2, 2017.

<sup>42</sup> James B. Stewart, *How a Money-Losing Snap Could Be Worth So Much*, NYT, March 2, 2017 (“The company lost \$514.6 million in 2016 and \$372.9 million the year before, according to the prospectus it filed in February. It has lost money every year since it began commercial operation in 2011 and has warned it may never earn a profit.”).

<sup>43</sup> See Mary Jo White, Chair, SEC, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative, March 31, 2016, (“Nearly all venture valuations are highly subjective.”).

<sup>44</sup> *Id.* (“the risk of distortion and inaccuracy is amplified because start-up companies, even quite mature ones, often have far less robust internal controls and governance procedures than most public companies.”).

<sup>45</sup> Moreover, private funds themselves can be highly risky investments. See Ryan Dezember, *From \$2 Billion to Zero: A Private-Equity Fund Goes Bust in the Oil Patch*, WSJ, July 16, 2017.

<sup>46</sup> Stein, *supra* note 40 (“Investors also use the price discovery available in the public markets to determine the value of private companies.”).

<sup>47</sup> 17 CFR §229.10, et seq.

effectiveness.<sup>49</sup> Effectiveness can and should result in the elimination of repetitive disclosure and boilerplate. But effectiveness should have as a first principle the development of a system designed to provide investors with the information needed to make informed investment decisions.

Reform of the disclosure system should focus on both content and delivery. The system of delivery must move from an analogue, to a digital, universe. This may require the reporting of information on a more continuous basis and in a manner that can be accessed easily through machine readable software.

With respect to content, the system needs to be updated. Disclosure should be designed to assist in the assessment of business sectors that did not exist in the 1980s. Moreover, the disclosure system should take into account the interest of long term investors in the sustainability of business models. Whether a result of consumer taste, technology or climate change, disruption to business models can occur today at an accelerated pace. Shareholders should have greater awareness of these risks and efforts at reduction of the risk.

### 1. Effective delivery

Reform in the accessibility and delivery of information may be as important as changes to the content of the disclosure system. Indeed, SOX recognized this need. Section 409 authorized the Commission to require disclosure “to the public on a rapid and current basis” in plain English.<sup>50</sup>

More data should be produced in formats that are machine readable. The use of structured data allows investors to recover large amounts of information in a cost effective manner.<sup>51</sup> In addition, the SEC is currently working on the second generation of EDGAR, the electronic data base for public filings. This is an opportunity for a ground-breaking, generational change in the way information at the SEC is filed and accessed.<sup>52</sup>

### 2. Disclosure Effectiveness

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<sup>48</sup> Exchange Act Release No. 78310 (July 13, 2006).

<sup>49</sup> Keith F. Higgins, Director, Division of Corporation Finance, *Disclosure Effectiveness*, Remarks Before the American Bar Association Business Law Section Spring Meeting, , April 11, 2014 (“So now, I’m going to put the ball in your court and make it clear why I’m talking about disclosure effectiveness to this particular audience today. . . . There is a growing concern about disclosure overload.”).

<sup>50</sup> See Section 13(i), 15 USC §78m(i).

<sup>51</sup> Concept Release, Exchange Act Release No. 77599 (April 13, 2016) (“When registrants provide disclosure items in a standardized data format, investors can more easily search and obtain specific information about registrants, compare common disclosures across registrants, and observe how registrant-specific information changes across reporting periods as the same registrant continues to file in a structured data format.”).

<sup>52</sup> See *The Need for the Cost Effective Retrieval of Information by Investors*, Recommendations of the Investor Advisory Committee of the SEC, adopted July 25, 2013, available at <https://www.sec.gov/spotlight/investor-advisory-committee-2012/data-tagging-resolution-72513.pdf> The IAC recommendation proposed, among other things, that the Commission adopt a “plan to convert information filed with the SEC into tagged data.”



Investors, particularly those with long term investment strategies, are increasingly interested in the ability of companies to maintain their business model in a rapidly changing economy. Shifts in technology, regulation, government policies, and reputation,<sup>53</sup> evolving labor practices and consumer tastes, and the effects of climate change, can threaten a business model.<sup>54</sup> Investors would benefit from a disclosure regime that required more insightful discussion into the sustainability of the company's business model.<sup>55</sup> To be effective, sustainability disclosure would need to include analysis of long term changes and would need to address efforts to reduce these risks.<sup>56</sup>

### 3. Disclosure Modernization

The contents of the disclosure system needs to be modernized. Management's discussion and analysis (MD&A) is one area in need of reform. Disclosure in the MD&A is meant to allow investors to see the company "through the eyes of management."<sup>57</sup> This includes future trends based upon current facts.<sup>58</sup> MD&A has been described as "[o]ne of the most important elements necessary to an understanding of a company's performance. . . ."<sup>59</sup>

The level of disclosure in the MD&A, however, is both inadequate and out of date. One former official of the Commission described the contents as having "too much elevator music."<sup>60</sup> Concerns include boilerplate,<sup>61</sup> repetition,<sup>62</sup> and rote calculations.<sup>63</sup> Academics have

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<sup>53</sup> The Commission has noted this possibility. See Exchange Act Release No. 61469 (Feb. 12, 2010) ("Another example of a potential indirect risk from climate change that would need to be considered for risk factor disclosure is the impact on a registrant's reputation.").

<sup>54</sup> Letter from Bloomberg LP, to the SEC, July 21, 2016, available at <https://www.sec.gov/comments/s7-06-16/s70616-264.pdf> ("Because some of these changes are already causing certain market disruptions (as only a few examples, decline of the coal industry, rapid transformation of the energy industry, increasing use of artificial intelligence in financial information and product development), we believe it is consistent with the SEC's authority and mission to integrate these considerations in rulemaking.").

<sup>55</sup> Sustainability has been defined as the "capacity to endure." See Nancy S. Cleveland, *Sustainability, Share Value, and Reporting*, Sustrana LLP, Sept. 12, 2014.

<sup>56</sup> The Commission could, for example, add a line item requirement that addresses sustainability. For additional discussion of this topic, see Letter to Mr. Brent Fields, Secretary, SEC, from J. Robert Brown, Jr., on the Need for Environmental, Social and Governance Disclosure, Oct. 3, 2016, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2847197](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2847197)

<sup>57</sup> Exchange Act Release No. 26831 (May 18, 1989).

<sup>58</sup> Exchange Act Release No. 48960 (Dec. 19, 2003) ("One of the principal objectives of MD&A is to provide information about the quality and potential variability of a company's earnings and cash flow, so that readers can ascertain the likelihood that past performance is indicative of future performance.").

<sup>59</sup> Exchange Act Release No. 48960 (Dec. 19, 2003) ("One of the most important elements necessary to an understanding of a company's performance, and the extent to which reported financial information is indicative of future results, is the discussion and analysis of known trends, demands, commitments, events and uncertainties.").

<sup>60</sup> *The Roundtable On The Integration Of The 1933 and 1934 Acts*, SEC Historical Society, William O. Douglas Open Meeting Room, U.S. Securities and Exchange Commission Washington, D.C., March 21, 2002 (Statement by Alan Beller, Director, Division of Corporation Finance, 2002-2006), at 126 ("I think that in too many MD&As you could probably take a pretty large portion and put it in the waste basket and you wouldn't lose a lot of value. There is too much elevator music, and not enough really useful analysis.").

<sup>61</sup> Exchange Act Release No. 45312 (Jan. 22, 2003) ("The discussion should be limited to material risks, and, as with MD&A generally, should be sufficiently detailed and tailored to the company's individual circumstances, rather than 'boilerplate.'").

chronicled deficiencies in MD&A.<sup>64</sup> MD&A could be improved by providing for greater specificity.

The section could also address the use of financial metrics that are common to an industry but are not part of the audited financial statements. In the social media space, companies often refer to “user growth” as an important metric.<sup>65</sup> References to “same store sales” also commonly occur in the retail sector. Yet these metrics are not determined on the basis of a uniform formula and therefore do not promote comparability.<sup>66</sup> MD&A could define these terms, facilitating comparability, and require disclosure of trends that were implicated by these metrics.

## B. Financial Statement Quality

Ensuring investor confidence in the accuracy of financial statements was a critical accomplishment of SOX. While some additional costs were imposed on individual companies, the benefits to the market of these changes appears to have been significant.

### 1. Auditor Attestation

Debate has arisen around the application of Section 404(b) and the requirement that auditors “attest” to management’s report on internal controls. The Section requires mandates additional services by the auditor and therefore adds additional cost. At the same time, however, review by auditors increases investor confidence in the quality of the financial statements.<sup>67</sup>

<sup>62</sup> See Jackson M. Day, Deputy Chief Accountant, U.S. Securities & Exchange Commission, *Call Them As You See Them*, AICPA National Conference on Banks and Savings Institutions, November 2, 2000 (“All too often, companies merely repeat, in MD&A, the amounts or disclosures included in the financial statements, or merely recalculate new amounts from those provided in the financial statements. These practices fall short of providing investors with the required disclosures.”).

<sup>63</sup> *Business and Financial Disclosure Required by Regulation S-K*, Exchange Act Release No. 77599 (April 13, 2016) (noting that in the 2003 release, the “staff also discouraged registrants from providing rote calculations of percentage changes of financial statement items and boilerplate explanations of immaterial changes to these figures, encouraging them to include instead a detailed analysis of material year-to-year changes and trends.”).

<sup>64</sup> SV Brown & JW Tucker, *Large-Sample Evidence on Firms’ Year-over-Year MD&A Modifications*, 49 *Journal of Accounting Research* 309 (2011) (“The combined trends of increasing MD&A length and decreasing MD&A modification scores suggest that, over time, managers increasingly use boilerplate disclosure (i.e., standard disclosure that uses many words with little firm-specific or fiscal-period-specific content). Moreover, we find that the price responses to MD&A modifications have weakened over time. These findings suggest a decline in MD&A usefulness in recent years despite the SEC 2003 guidance on improving the MD&A.”).

<sup>65</sup> Twitter, Snap and Facebook refer to “user growth.”

<sup>66</sup> See Howard Schilit, *Financial Metrics Shenanigans*, AII Journal, August 2010 (“because same-store sales fall outside of GAAP coverage, no universally accepted definition exists, and calculations may vary from company to company. Worse, a company’s own calculation of same-store sales in one quarter may differ from the one used in the previous period.”).

<sup>67</sup> See Testimony of Ken Bertsch, Executive Director, Council of Institutional Investors, Before the Committee on Financial Services, United States House of Representatives, April 28, 2017, Hearing on Financial CHOICE Act, at 12 (“We believe Section 404(b) continues to be significant as it provides investors with reasonable assurance from the independent auditor that a company maintained effective internal control over financial reporting. This assurance is an important driver of confidence in the integrity of financial statements and in the fairness of our capital markets.”).

Review also provides management, including outside directors, with a more accurate understanding of the financial condition of the company.<sup>68</sup> Corporate decision making benefits as a result.

Criticism of the attestation requirement with respect to small issuers is easy to understand. The requirement increases out-of-pocket costs. But in fact, the overall benefits to the public markets are significant. Studies indicate that companies not subject to the attestation requirement have a higher rate of restatements.<sup>69</sup> Moreover, a recent study indicates that the benefits of attestation outweigh the costs.<sup>70</sup> Misreporting as a result of faulty internal controls can also deprive corporate officials of accurate information and impair the quality of their decision making.

Efforts have been made to lower the costs associated with these services. The Commission has taken steps to minimize the impact of this requirement on companies going public.<sup>71</sup> Exempting large numbers of companies permanently or for protracted periods of time from the requirement may well have negative consequences to the system of financial reporting and harm investor confidence. Moreover, to the extent that the costs of the review of internal controls increasingly becomes baked into the traditional audit process, the savings from elimination may be far less than expected.

## 2. PCAOB Disciplinary Proceedings

The PCAOB has significantly improved the quality of audits which in turn has improved the quality of financial statements.<sup>72</sup> Moreover, the Board has taken steps to integrate empirical data into the regulatory function<sup>73</sup> and has instituted post-implementation review designed to

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<sup>68</sup> See Weili Ge, Allison Koester, & Sarah McVay, *Benefits and costs of Sarbanes-Oxley Section 404(b) exemption: Evidence from small firms' internal control disclosures*, J. of Accounting & Economics (forthcoming) (“Consistent with these findings, accounting information generated by effective internal control systems is more useful for managerial decision making, and firms that disclose and subsequently remediate ineffective internal controls experience an improvement in operating performance”).

<sup>69</sup> *Internal Controls: SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation*, GAO-13-582, July 2013, at 15 (“Our analysis is generally consistent with a number of studies that have found that exempt companies restate their financial statements at a higher rate than nonexempt companies. These studies suggest that having an auditor attest to the effectiveness of a company’s internal control over financial reporting generally reduces the likelihood of financial restatements.”).

<sup>70</sup> See *Benefits and costs of Sarbanes-Oxley Section 404(b) exemption*, *supra* note 68.

<sup>71</sup> *Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between \$75 and \$250 Million As Required by Section 989G(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, Staff of the Office of the Chief Accountant of the U.S. Securities and Exchange Commission, April 2011, at 2 (“The Commission provided that Section 404 compliance is not required in an IPO and in the first annual report after an IPO”).

<sup>72</sup> *SOX at 15*, *supra* note 7 (“As the 15th anniversary of the Sarbanes-Oxley Act of 2002 . . . approaches, we at EY believe it is important to reflect on the dramatic, positive change in the accuracy of financial reporting and quality of auditing in the United States since its enactment.”).

<sup>73</sup> The PCAOB has set up the Center for Economic Analysis. See James Doty, Chair, PCAOB, Testimony on the PCAOB 2017 Budget and Strategic Plan, Dec. 14, 2016 (“In 2017, we plan to integrate the Center for Economic Analysis with our Office of Research and Analysis, which monitors areas of potential audit risk.”).

“look back at significant rulemakings . . . to evaluate the overall effect of the rule or standard.”<sup>74</sup> With respect to the disclosure of auditing partners, the Board has put in place a search engine that will allow investors to search by engagement partner, audit firm, or public company.<sup>75</sup>

The PCAOB has also used enforcement to improve the quality of audits. In bringing an action, however, the disciplinary proceedings are confidential. Moreover, confidentiality must remain in place during the pendency of any appeal to the Commission. The entire process can take years before violations become public and can encourage delay. Bipartisan legislation has been introduced in the House and Senate to lift this requirement of confidentiality and should be adopted.<sup>76</sup>

### C. Shareholder Proposal Process

Investor confidence will not be enhanced through severe and unnecessary restrictions on governance rights. Such restrictions have been proposed with respect to the shareholder proposal process.<sup>77</sup> Because proposals are precatory, they do not command but merely advise. Proposals, therefore, provide management with insight into the collective views of shareholders. As a result, they represent an important component in the engagement process between managers and long term shareholders.

Nonetheless, proposals have surfaced that would severely restrict the right of owners to submit proposals. Calls have arisen to increase the ownership threshold for submission to 1% of the outstanding shares and to increase the holding period to three years.<sup>78</sup> As a result, eligible shareholders would need to own not 15 shares of Apple for 12 months but 53 million shares for 36 months. Instead of acquiring \$2000 worth of securities, they would need to invest almost \$8 billion.<sup>79</sup> Few shareholders would meet these revised eligibility requirements.

Efforts to reduce these rights have, for the most part, been opposed by shareholder groups.<sup>80</sup> Assertions, therefore, that the limitations will benefit shareholders by improving the

<sup>74</sup> Auditing Standard No. 7, *Engagement Quality Review*, 2016-01, available at <https://pcaobus.org/EconomicAndRiskAnalysis/CEA/Pages/post-implementation-review.aspx>

<sup>75</sup> The search engine is here: <https://pcaobus.org/Pages/AuditorSearch.aspx>

<sup>76</sup> PCAOB Enforcement Transparency Act of 2017, S. 610, 115<sup>th</sup> Cong., 1<sup>st</sup> Sess., 2017 & PCAOB Enforcement Transparency Act of 2016, HR 6251, 114<sup>th</sup> Cong., 2<sup>nd</sup> Sess., Sept. 28, 2016 (amending 15 USC 7215(c)(2) to provide that “Hearings under this section shall be open to the public, unless the Board, on its own motion or after considering the motion of a party, orders otherwise.”), available at <https://www.congress.gov/bill/115th-congress/senate-bill/610/text> & <https://www.congress.gov/114/bills/hr6251/BILLS-114hr6251ih.xml>

<sup>77</sup> Shareholder proposals are governed by Rule 14a-8. 17 CFR §240.14a-8.

<sup>78</sup> The Promise of Market Reform, Reigniting America’s Economic Engine, NASDAQ, 2017 (“Deleting this meaningless dollar threshold and instead requiring that a proposing shareholder hold at least 1% of the issuer’s securities entitled to vote and increasing the holding period to three years, would ensure that shareholder proposals representing the views of a meaningful percentage of the companies’ long-term owners are considered at shareholder meetings.”).

<sup>79</sup> Apple has more than 5 billion shares outstanding. On July 15, 2017, the closing price was \$149.04. A shareholder would have to own approximately 53 million shares to meet the 1% requirement. See Apple, Form 10-K, Sept. 24, 2016, (“5,332,313,000 shares of common stock were issued and outstanding as of October 14, 2016”).

<sup>80</sup> See Testimony of Ken Bertsch, *supra* note 67, at 2-3. Criticism typically comes from non-shareholder groups. See *Modernizing the Shareholder Proposal Process*, Business Roundtable, Oct. 31, 2016 (“For proposals related to

relationship between owners and managers are misplaced.<sup>81</sup> Moreover, calls for additional restrictions on the use of the shareholder proposal rule cannot be explained by excessive use. During the 2017 proxy season, shareholders submitted 827 proposals to public companies, down from the prior year<sup>82</sup> and down from earlier periods.<sup>83</sup>

The proposed restrictions also cannot be justified on the basis of cost. The actual expense of adding a proposal to the proxy statement is likely nominal. With companies already having to draft and circulate the proxy materials to shareholders, an additional proposal adds at most a modest amount of volume.<sup>84</sup> Moreover, these expenses have probably been reduced through the advent of electronic dissemination of proxy materials.<sup>85</sup>

To the extent “costs” also include the expenses associated with efforts to exclude proposals, such amounts are a consequence of management, not shareholder, behavior. Companies can minimize the costs by including the proposal in the proxy statement. Indeed, with the number of no-action requests down from earlier decades, companies seem increasingly comfortable with this approach.<sup>86</sup>

Shareholder proposals have, however, changed in one significant respect. Shareholder support has grown. Governance matters, whether majority vote provisions or shareholder access bylaws, routinely obtain majority support.<sup>87</sup> Similarly, environmental and social proposals have

topics other than director elections, a truly reasonable standard could be to use a sliding scale based on the market capitalization of the company, with a required ownership percentage of 0.15 percent for proposals submitted to the largest companies and up to 1 percent for proposals submitted to smaller companies. Additionally, if a proposal were submitted by a group or by a proponent acting by proxy, the ownership percentage sliding scale could be increased to up to 3 percent.”)

<sup>81</sup> See *The Promise of Market Reform*, *supra* note 78 (“current regulations governing the way shareholders access a company’s proxy statement can poison the company shareholder relationship by amplifying the voice of a tiny minority over the best interests of the vast majority.”).

<sup>82</sup> Elizabeth Ising, Ronald O. Mueller, & Lori Zyskowski, *Shareholder Proposal Developments During the 2016 Proxy Season*, GIBSON DUNN, June 29, 2017 (“For 2017 shareholder meetings, shareholders have submitted approximately 827 proposals, which is significantly less than the 916 proposals submitted for 2016 shareholder meetings and the 943 proposals submitted for 2015 shareholder meetings.”).

<sup>83</sup> The numbers are consistent with earlier periods. See Exchange Act Release No. 39093 (Sept. 18, 1997) (“Between 300 and 400 companies typically receive a total of about 900 shareholder proposals each year.”). In 1982, shareholders submitted 972 proposals. See Commissioner James C. Treadway, Jr., *Shareholder Proposal Rule, Remarks to Edison Electric Institute Seminar on Current SEC Developments*, Washington, D.C., June 23, 1983, at 1, <https://www.sec.gov/news/speech/1983/062383treadway.pdf>.

<sup>84</sup> Proposals and supporting statements are limited to 500 words. See Rule 14a-8(d), 17 CFR §240.14a-8(d). Statements of opposition in contrast are not subject to a space limitation and can be significantly longer than the shareholder proposal.

<sup>85</sup> See Rule 14a-16, 17 CFR §240.14a-16.

<sup>86</sup> In 1983, companies filed 495 requests for no action relief. See Memorandum to John Huber and Linda Quinn from Bill Morley, Re: Shareholder Proposals, Nov. 16, 1983, at 2 (“noting 414 contested proposals in 1983, with 328 letters issued by the Division and 495 contested proposals in 1982, with 315 letters issued by the Division”), posted at the SEC Historical Society, <http://www.sechistorical.org/>

<sup>87</sup> See J. Robert Brown, Jr., Brown, *Corporate Governance, Shareholder Proposals, and Engagement between Managers and Owners*, 94 DU Online L. Rev. 300 (2017).



grown in popularity, receiving around 20% of the votes in 2016.<sup>88</sup> In 2017, environmental proposals received majority support at both Exxon and Occidental. Proposals on board diversity have received levels of support far above earlier eras.

Imposition of substantial restrictions on the use of the rule will reduce the availability of information to management and impair the engagement process between owners and managers. The role of the Commission as “informal arbiter” will be reduced.<sup>89</sup>

Nor will concern over the relevant issues go away. Even without adequate access to Rule 14a-8, shareholders will continue to seek changes with respect to governance practices, environmental policies, and sustainability matters. They will, however, be forced to find alternative mechanisms of influence, whether public campaigns addressing corporate behavior, litigation over the level of disclosure, or inspection requests for documents relating to board oversight. The shift in approach will add cost and uncertainty to the engagement process.

Efforts to justify the restrictions through reference to the use of the rule by small investors is misplaced. Proposals submitted by these investors mostly involve corporate governance topics and mostly receive substantial support.<sup>90</sup> Preventing retail investors from using the rule will deprive them of a significant role in the governance debate and deny all shareholders the right to speak on important initiatives. Moreover, the proposed solution – a dramatic increase in the ownership thresholds – will have indiscriminate effect. Even large institutions will sometimes have difficulty meeting the requirements.

Efforts to restrict the right of shareholders also seem contrary to those who express concern over “activists,” hedge funds and other investors who are alleged to promote short term rather than long term strategies.<sup>91</sup> Companies can address concerns about these investors by improving engagement with long term shareholders.<sup>92</sup> Yet restrictions on the use of shareholder

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<sup>88</sup> See Elizabeth Ising, Ronald O. Mueller, & Lori Zyskowski, *Shareholder Proposal Developments During the 2016 Proxy Season*, GIBSON DUNN, June 28, 2016, at 12 (“Ninety-one of these [environmental and social] proposals have been withdrawn, and 125 of these proposals have been voted on, averaging support of 20.7% of votes cast.”).

<sup>89</sup> Significant reduction in this informal role has, in the past, been opposed. See Exchange Act Release No. 40018 (May 21, 1998) (“a number of commenters resisted the idea of significantly decreasing the role of the Commission and its staff as informal arbiters through the administration of the no-action letter process.”).

<sup>90</sup> James McRitchie is one of the individuals who makes significant use of the rule. Ten of his shareholder access proposals went to a vote between Jan. 1, 2016 through June 30, 2016. They received the following percentages: Apple (32.7%); Kansas City Southern (26.8%); QUALCOMM Incorporated (46.9%); Bio-Rad Laboratories, Inc. (19.9%); CSP Inc. (7.5%); Genomic Health, Inc. (35.5%); Medivation, Inc. (63.5%); Proto Labs, Inc. (71%); SciClone Pharmaceuticals, Inc. (88.2%); and SolarCity Corporation (11.4%). See Annex A, *2016 Proxy Season*, SULLIVAN & CROMWELL, July 11, 2016. See also Dave Michaels, *Republicans Declare War on Corporate Gadflies*, Financial Regulation Newsletter, WSJ, May 5, 2017 (“Mr. Chevedden, for instance, has sponsored 91 proposals since 2007 that garnered more than 50% support, ISS data shows. The average rate of support for his proposals was 39%.”).

<sup>91</sup> *The Promise of Market Reform*, *supra* note 78 (“While the term ‘activist investing’ is complex and some forms of activism achieve worthy goals, the trend toward exerting pressure for short-term gains at the expense of long-term health is concerning. Nasdaq especially believes that the goals, tactics and financial arrangements of activist investors should be examined by policy makers and made transparent to the companies and their other shareholders.”)

<sup>92</sup> See Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Some Thoughts for Board of Directors in 2017*, Dec. 8, 2016 (“One of the most promising initiatives to address activism and short-termism is the emergence of a new paradigm of

proposal process would have the opposite effect by curtailing an effective mechanism of communication between management and long term shareholders.

Similarly, some critics of Rule 14a-8 favor private action over prescriptive rules in determining governance standards. The shareholder proposal rule is the primary mechanism for shareholders to initiate private action. Restricting the use of the rule will likely weaken private action and result in increased pressure for prescriptive rules.

### III. Conclusion

Reforms are needed in the capital markets. More can be done to facilitate innovation and transparency.<sup>93</sup> Reflecting the lessons learned from SOX, these markets can best benefit from reforms designed to increase investor confidence.

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corporate governance that seeks to recalibrate the relationship between corporations and major institutional investors in order to restore a long-term perspective.”).

<sup>93</sup> *The Promise of Market Reform*, *supra* note 78 (“A central reason for the success of U.S. capital markets is that American public companies are among the most innovative and transparent in the world.”).