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Before the House Financial Services Committee, Subcommittee on Capital Markets, Securities, and Investment

Hearing: "The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance"

July 18, 2017

Chairman Huizenga, Ranking Member Maloney, and honorable members of the Subcommittee, thank you for this opportunity to present testimony on behalf of my organization, the Competitive Enterprise Institute (CEI), at this hearing reflecting on the 15th anniversary of the Sarbanes-Oxley Act of 2002.

CEI is a Washington-based free-market think tank, founded in 1984, that studies the effects of regulations on job growth and economic well-being. It is our mission to advance the freedom to prosper for consumers, entrepreneurs, and investors.

In America, we value entrepreneurs and the innovative products and services they bring. It is true that a lucky few entrepreneurs are finding it easier to raise capital through private offerings among wealthy angel investors and venture capitalists, who as members of the wealthy "accredited investor" class are free to buy shares in companies that are not weighed down with many of the regulatory burdens public companies face. So imagine how many more entrepreneurs could launch businesses and grow them if the public markets were more open to them. Unfortunately, many financial regulations imposed over the past 15 years have made access to those markets much more difficult for many fledgling firms.

Much of the recent debate on financial regulation has focused on the Dodd-Frank Wall Street Reform and Consumer Protection Act. However, its predecessor, the Sarbanes-Oxley Act, is still out there and still very much matters. The mandate in the law's Section 404 to audit "internal controls," as interpreted broadly by the Public Company Accounting Oversight Board (PCAOB)—the accounting body created by this law—remains a major concern for nearly every company considering going public on U.S. stock exchanges.

Sarbox, or just simply SOX, as the law is colloquially known, has caused auditing costs to double, triple, and even quadruple for many firms.[1] We can see this by reviewing the filings of Form S-1 that companies considering going public must submit to the Securities and Exchange Commission (SEC). Nearly every S-1 that I have read makes prominent mention of the costs Sarbanes-Oxley imposes on companies seeking to go public. This has resulted in a rush for the exits from U.S. exchanges and very slow traffic at the entrance doors for initial public offerings (IPOs).

The trivial minutiae that Section 404 requires companies and their accountants to document—at high cost—has done little to prevent massive mismanagement or outright fraud at troubled firms. Companies fully subject to SOX rules, such as Countrywide Financial and Lehman Brothers, still published misleading financial reports and imploded in scandal during the financial crisis—which occurred five years after the law was enacted. As Hal Scott, Nomura Professor of International Financial Systems at Harvard Law School, has written, despite the "high costs, it remains empirically unclear whether adherence to SOX 404 achieves its intended benefit: reduced incidence of fraud or opaque or aggressive accounting practices by public companies."[2]

In comparing the public equities markets now versus when SOX was enacted, it becomes apparent that there are significantly fewer public companies in the United States today. This year's slight uptick in IPOs—following a decade-low number of stock offerings in 2016—obscures that over the past 15 years, the number of firms listed on U.S. exchanges has dropped off dramatically. In 2001, the year before SOX became law, there were more than 5,100 companies in which everyday U.S. investors could purchase stock on exchanges like the New York Stock Exchange and NASDAQ. By 2015, there were just 3,700—fewer than during the "bear market" year of 1975, when publicly traded stocks numbered more than 4,700.[3]

Moreover, this drop appears to be a purely American phenomenon. Non-U.S. stock listings rose 28 percent from 1996 to 2012, according to the National Bureau of Economic Research.[4]

President Obama's Council on Jobs and Competitiveness directly fingered SOX when it observed in its Interim Report:

> Well-intentioned regulations aimed at protecting the public from the misrepresentations of a small number of large companies have unintentionally placed significant burdens on the large number of smaller companies. As a result, fewer high-growth entrepreneurial companies are going public.[5]

There are other adverse consequences of entrepreneurs delaying or forgoing taking their companies public. One is job growth, or rather the lack of it. As President Obama's Jobs Council observed, "the data clearly shows that job growth accelerates when companies go public." As the Council and others have noted, 90 percent of a public company's job creation occurs after it goes public.[6]

Another is the diminished ability of the average American investor to build wealth in his or her portfolio. In the early 1990s, 80 percent of companies launching IPOs—including Starbucks and Cisco Systems—raised less than $50 million each from their offerings.[7] Entrepreneurs were able to get capital from the public to grow their firms, while average American shareholders could grow wealthy with the small and midsize companies in which they invested.

Today, however, Sarbanes-Oxley is shutting out average investors from the early growth stages of the next Cisco and Starbucks. A few years after SOX was enacted, 80 percent of firms went public with IPOs greater than $50 million, while IPOs greater than $1 billion have become a normal occurrence.[8] Facebook waited to go public until it could launch an IPO of $16 billion.[9]

Home Depot went public in 1981, when it had just four stores in the Atlanta area. Co-founder

Bernie Marcus has stated repeatedly that he never could have gone public back then had SOX been in place.[10] Home Depot may never have grown into the chain it is today, but even if it had, ordinary investors would not have been able to share in that wealth from that growth.

The good news is that members of Congress from both parties have recognized that smaller public companies should not be subject to all of the same mandates as giant corporations in the Fortune 500. The Jumpstart Our Business Startups (JOBS) Act, signed by President Obama in 2012, gave small and midsize companies a temporary exemption from the SOX "internal control" mandates and carved out a path for companies to raise $50 million or less without fully registering with the SEC.

There is much more to be done, and I urge Congress to pass bipartisan initiatives to allow ordinary investors to build wealth both by expanding exemptions for investment crowdfunding and creating ways for non-wealthy American to qualify as accredited investors.

I also urge Congress to narrow Sarbanes-Oxley's definition of "internal controls" to processes that have proven their effectiveness in preventing fraud.

Finally, I urge the Securities and Exchange Commission to exercise its authority over the Public Company Accounting Oversight Board to narrow its definition of "internal controls."

Thank you again for inviting me to testify. I look forward to your questions.

[1] Monica C. Holmes and Darian Neubecker, "The Impact of the Sarbanes-Oxley Act of 2002 On the Information Systems of Public Companies," Issues In Information Systems, Vol. VII, No. 2 (2006), http://iacis.org/iis/2006/Holmes_Neubecker.pdf.

[2] Hal Scott, "How to Improve Five Important Areas of Financial Regulation," in *Rules For Growth: Promoting Innovation and Growth Through Legal Reform* (Kansas City, Mo.: Ewing Marion Kauffman Foundation, 2011), p. 128.

[3] Andrew Whitten, "Why Are There So Few Public Companies in the U.S.?", National Bureau of Economic Research
http://www.nber.org/digest/sep15/w21181.html.

[4] Ibid.

[5] President's Council on Jobs and Competitivenes, *Taking Action, Building Confidence*, p. 19, http://files.jobs-council.com/jobscouncil/files/2011/10/JobsCouncil_InterimReport_Oct11.pdf.

[6] Ibid.

[7] Ibid, p. 17

[8] Ibid.

[9] Evelyn M. Rusli and Peter Eavis, "Facebook Raises $16 Billion in I.P.O.," May 17, 2012, https://dealbook.nytimes.com/2012/05/17/facebook-raises-16-billion-in-i-p-o/

[10] Bernie Marcus: We Couldn't Start Home Depot Today, Job Creators Network, October 10, 2013, https://www.jobcreatorsnetwork.com/press_releases/marcus-we-ccouldnt-start-home-depot-today/.

About John Berlau

John Berlau is a senior fellow at the Competitive Enterprise Institute specializing in financial and banking regulatory policy. His work focuses on the impact of public policy on entrepreneurship and the investing public. He is a columnist for Forbes.com and has been published in *The Wall Street Journal*, *The New York Times*, *The Atlantic*, *Politico*, *Washington Examiner*, *Investor's Business Daily*, *National Journal*, *National Review*, *Reason*, and many other media outlets. Before joining CEI, Berlau was an award-winning financial and political journalist. He served as Washington correspondent for *Investor's Business Daily* and as a staff writer for *Insight* magazine, published by *The Washington Times*. In 2002, the National Press Club awarded him the Sandy Hume Memorial Award for Excellence in Political Journalism. In 2003, Berlau was a media fellow at the Hoover Institution in 2003. He graduated from the University of MissouriColumbia in 1994 with degrees in journalism and economics.

Relevant Articles

- "Let Small Businesses Fuel Job Growth Again," Forbes.com, January 8, 2016, http://www.forbes.com/sites/realspin/2016/01/08/dodd-frank-smallbusiness/#2340f718fd5b
- "Why the DOL Rule Is Bad for Small Savers," Wealth Management, May 3, 2016 2016 http://m.wealthmanagement.com/commentary/berlau-why-dol-rule-bad-smallsavers
- "CFPB Anti-Arbitration Rule Will Harm Consumers and FinTech," Forbes.com, August 23, 2016, http://www.forbes.com/sites/johnberlau/2016/08/23/cfpb-anti-arbitration-rulewill-harm-consumers-and-fintech/#56ad78105a5b
- "Obama Regulations Aren't the Only Target," *The Wall Street Journal*, December 30, 2016, https://www.wsj.com/articles/obamas-regulations-arent-the-only-trump-target1483053980
- *Free to Prosper: A Pro-Growth Agenda for the 115th Congress*, Banking and Finance chapter https://cei.org/agendaforcongress/finance-2017
- "Five Key Financial Regulation Reforms," *OnPoint* No. 228, Competitive Enterprise Institute, April 25, 2017, https://cei.org/content/five-key-financial-regulation-reforms
- "SOXing It to the Little Guy," *OnPoint* No. 112, Competitive Enterprise Institute, June 7, 2007, https://cei.org/studies-point/soxing-it-little-guy

Relevant Speaking Events

- September 2016, Alternative and Direct Investment Securities Association in Las Vegas
- April 2016, Fundit conference in Las Vegas
- March 2016, South by Southwest Interactive in Austin
- December 2015, Crowd Financing Summit in Washington
- October 2015, Money20/20 conference in Las Vegas
- May 2015, FinTech Global Expo in San Diego
- March 2015, Silicon Valley Crowdfunding Conference in Mountain View, California
- October 2014, CFGE Crowdfund Banking and Lending Summit in San Francisco

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OPINION

Obama's Regulations Aren't the Only Target

By John Berlau
And Daniel Cody

President-Elect Donald Trump and Republican leaders in Congress have pledged to repeal many regulations put in place by President Obama. This would be a good start, but they need to go further. Overregulation didn't start during the Obama administration.

In the spirit of bipartisanship and fostering economic and job growth, Mr. Trump and Congress should remove all regulatory barriers needlessly obstructing America's entrepreneurs, consumers or investors, regardless of which party implemented them. They can start with a law signed and implemented by President George W. Bush.

The Sarbanes-Oxley Act has multiplied audit costs for small firms and slowed IPOs—for what benefit?

In 2002 the Sarbanes-Oxley Act, or Sarbox, was rammed through Congress and signed by President Bush in response to the Enron and WorldCom accounting scandals. But its regulatory burden has fallen heaviest on small and midsize public companies. As noted in a 2011 report from President Obama's Council on Jobs and Competitiveness, "Regulations aimed at protecting the public from the misrepresentations of a small number of large companies have unintentionally placed significant burdens on the large number of smaller companies."

One of Sarbox's most onerous mandates stems from two brief paragraphs that comprise Section 404, which requires that public firms have effective "internal controls." The section itself mandates merely an "attestation" by the outside accounting firm that these controls are effective in preventing fraud.

The law was implemented by the Public Company Accounting Oversight Board, a quasi-public accounting rule-making agency created by Sarbox. Under the PCAOB's boundless interpretation, Section 404 requires full-blown audits of "internal controls" of any company processes that could potentially enable "a reasonable possibility of a material misstatement in the financial statements." This extremely broad standard may encompass all manner of company operations.

Academic studies and annual reports reveal that Sarbox has caused auditing costs to double, triple and even quadruple for many companies. A 2009 study by the Securities and Exchange Commission found that smaller public firms have a Sarbox cost burden more than seven times those of large public companies.

Since Sarbanes-Oxley's enactment, there has been a rush to the exits from U.S. exchanges, and very slow traffic for initial public offerings. Yet Sarbox failed to catch subprime mortgage shenanigans that led to the financial crisis, prompting analysts to question the law's worth even in its stated purpose of preventing financial fraud.

The recent stock-market surge obscures that over the past decade the number of firms listed on U.S. exchanges has dropped dramatically. In 2001, the year before Sarbox became law, there were more than 5,100 companies that investors could purchase on exchanges such as Nasdaq and the New York Stock Exchange. By 2015 there were just 3,700—fewer than during the "bear market" year of 1975, when publicly traded stocks numbered more than 4,700. Meanwhile, non-U.S. stock listings rose 28% from 1996 to 2012, according to the National Bureau of Economic Research.

Another worrying sign is the ballooning size of IPOs in the U.S. In the early 1990s, Starbucks and Cisco Systems had IPOs raising less than $50 million, as did 80% of companies launching IPOs at the time. Both firms' market valuations were less than $250 million when they went public. Entrepreneurs were able to get public capital to grow their firms, and average investors were able to grow wealthy with the firms they invested in.

A few years after Sarbox, however, 80% of firms launched IPOs greater than $50 million, according to the Obama Jobs Council report, and IPOs of greater than $1 billion have since become a normal occurrence.

ALAMY STOCK PHOTO

President George W. Bush with the co-sponsors of the Sarbanes-Oxley Act, Sen. Paul Sarbanes (right) and Rep. Mike Oxley, in 2002.

Facebook waited until it could launch an IPO of $16 billion and had an $80 billion market valuation before it went public in 2012. Many speculate that Uber may not go public until it is worth more than $100 billion.

Yet there are two reasons for optimism. First, prominent Democrats, as well as Republicans, have recognized the burden imposed by Sarbox and have expressed a willingness to tackle the problem. In 2012 President Barack Obama signed the Jumpstart Our Business Startups (JOBS) Act, which exempts newly listed small and midsize public companies from Sarbox's internal control audits for five years after they are listed.

Second, Mr. Trump can do a lot administratively, thanks to a 2010 Supreme Court decision. In *Free Enterprise Fund v. Public Company Accounting Oversight Board*, the court ruled that members of the PCAOB are subject to at-will removal by a majority of members of the SEC. If the existing oversight board refuses to revise its accounting standard to be in line with the statute and call for a simple "attestation" of internal controls, instead of a full-blown audit, a 3-2 majority of SEC commissioners could fire current members of the board and appoint replacements.

By saying his trademark phrase "you're fired" to the PCAOB, Mr. Trump's SEC could clear a path of growth for U.S. firms to expand and tell thousands of workers, "You're hired."

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