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Written Statement in Support of my Testimony before the Capital Markets and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee on "Legislative Proposals to Improve the U.S. Capital Markets"

I have served as a professor at the University of Tennessee for over 20 years, where I teach accounting, auditing, and corporate governance. In addition to my teaching and research, my remarks are informed by my service on the Securities and Exchange Commission's Investor Advisory Committee, an outside advisory group to the Commission which was statutorily-created as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), and the PCAOB's Investor Advisory Group, which is an outside advisory group to the PCAOB.

I address each of the five legislative proposals that would affect the U.S. capital markets.

SEC Small Business Advocate Act (HR 3784) and Small Business Capital Formation Enhancement Act (not yet numbered)

HR 3784 would establish an Advocate for Small Business Capital Formation within the Securities and Exchange Commission (SEC). In addition, HR 3784 would establish within the SEC the Small Business Capital Formation Advisory Committee. It would appear that HR 3784 is modeled after Section 915 of the Dodd-Frank Act where the SEC's Office of the Investor Advocate was established, and Section 911 of Dodd-Frank which established the SEC Investor Advisory Committee. As a member of the SEC Investor Advisory Committee, and one who interacts with the SEC's Office of the Investor Advocate, I am well positioned to comment on these bills.

A threshold question that Congress needs to answer is whether the interests of small businesses fail to be heard by either Congress or the SEC – that is, what is the problem that this bill is proposing to solve. One can only surmise that the problem is a lack of access to Congress or the SEC and/or the failure of these entities to be responsive to the needs of small businesses. On either dimension, the facts belie the existence of a problem. For example, the Dodd-Frank Act permanently exempted smaller public companies from complying with Section 404(b) of the Sarbanes-Oxley Act, and the Jumpstart Our Business Startups Act (JOBS Act) made numerous changes to facilitate capital formation by smaller businesses and the SEC has effectively

implemented many of the JOBS Act provisions. Moreover, the SEC already maintains an Office of Small Business Policy within the Division of Corporation Finance which, among other activities, coordinates the annual SEC Government-Business Forum on Small Business Capital Formation. Furthermore, the SEC currently maintains an Advisory Committee on Small and Emerging Companies. The Congressional record needs to clearly document the inability of small businesses to seek effective redress of problems through Congress and the SEC, and further indicate why the existing institutional mechanisms – the SEC's Office of Small Business Policy, the SEC Government-Business Forum on Small Business Capital Formation, and the SEC's Advisory Committee on Small and Emerging Companies -- are not adequate to address any problems that might exist.

Assuming that the existence of a problem can be documented, I then turn to problems with the bill as currently drafted. Given the language in HR 3784, the composition of the Small Business Capital Formation Advisory Committee is likely to result in the group essentially be a lobbying group for small businesses – a lobbying group that Congress would have granted a government imprimatur to. The contemplated composition of this advisory committee is officers and directors of smaller companies, professional advisors to these companies, and a very narrow slice of investors in these companies (e.g., angel capital investors, venture capital funds, and private offices). Arguably, the bill contemplates a representative of the broader investor population (appointed by the SEC's Investor Advocate) and a representative of the public interest (appointed by the North American Securities Administrators Association). Interestingly, and problematically, these committee members would not have a vote. Sort of like gerrymandering the composition of a committee. Let's contrast this structure with how members of the SEC Investor Advisory Committee are chosen – the IAC includes representatives of industry participants, investors (including public pension funds, union funds, hedge funds, venture capital firms), investor advocates, academics with widely varying ideological views, regulators, among others. Interestingly, and noteworthy, is that two of the IAC's members are on this panel – testifying for different sides related to these bills. As such, the IAC is essentially ideologically balanced, as each of the five SEC commissioners have four selections. Conversely, the proposed Small Business Capital Formation Advisory Committee would appear unlikely to achieve such ideological balance.

Finally, HR 3784, as well as a number of the other bills being discussed this morning, seem to view any shortfall of capital experienced by small businesses as a problem of demand. That is, small businesses lack capital because these businesses won't seek capital in the public markets due to onerous and high cost regulation. Leaving aside the veracity of this viewpoint, this argument ignores the suppliers of capital – investors. Creating a quasi-lobbying group to seek a more favorable regulatory climate for small businesses may succeed in reducing the cost of regulation, but at the potential cost of greater information risk to investors – less transparent disclosures, a higher incidence of non-GAAP reporting as evidenced through restatements and,

in the extreme, a higher incidence of financial fraud. Such an outcome would actually be counter-productive for small businesses, as capital would either exit the market or would only be available at a much higher cost of capital. Not only would investors not be protected, but capital formation would be impeded rather than enhanced. The optimal regulatory strategy is to balance the costs of regulation against the benefits of regulation, and it seems unlikely that recommendations from the regulated industry would lead to such an outcome.

The Small Business Capital Formation Enhancement Act is quite brief but would require the SEC to review the findings and recommendations of the Forum on Capital Investment, and to publicly disclose what action the SEC plans to take in response. Again, this recommendation appears to be patterned after the requirements in Section 911 of the Dodd-Frank Act related to recommendations of the SEC's Investor Advisory Committee. But there are important differences. As noted previously, the IAC is ideologically balanced and therefore our recommendations almost always involve compromise and represent a consensus viewpoint. This process is painstaking and time consuming so the IAC has only made a modest number of recommendations in its three years of life. Conversely, any individual participant at the Small Business Forum on Capital Investment can make a recommendation, resulting in the SEC receiving an excessive number of recommendations, some of which may be ill-formed and possibly not within the SEC's purview. Requiring the SEC to respond to every recommendation is inefficient and a poor use of taxpayer resources, particularly given the chronic underfunding of the agency.

<u>Due Process Restoration Act of 2015 (HR 3798)</u>

HR 3798 would essentially do two things. First, it would give defendants subject to SEC proceedings before an Administrative Law Judge (ALJ) the option to have those proceedings terminated. If the SEC wanted to proceed, the Commission would have to bring the charges in U.S. District Court. Second, for those proceedings that were heard before an ALJ the burden of proof would be raised – from today's "preponderance of the evidence" standard to a more difficult hurdle, "clear and convincing evidence". This bill is ostensibly in response to a greater number of SEC enforcement actions being heard before an ALJ, and the SEC's supposedly higher success rate before an ALJ than in U.S. District Court (Eaglesham 2015a).

Before changing the SEC's enforcement process, it is important to remember that Congress is the body that made it easier for the Commission to bring certain enforcement actions before an ALJ. First, in the Sarbanes-Oxley Act (SOX) (2002), Congress, in Section 305 of the Act, authorized the Commission to bar an individual from serving as an officer or director of a public company if the individual is deemed "unfit" to serve in those roles. The previous legal standard was "substantial unfitness". Also, prior to SOX, only a federal court could issue such a bar. SOX authorized the SEC to issue such a bar through proceedings before an ALJ. Second, in the

Dodd-Frank Act (2010), Congress, in Section 929P of the Act, authorized the Commission to impose civil monetary penalties in cease-and-desist proceedings. Presumably Congress included these provisions in SOX and in Dodd-Frank because they were needed – that is, the SEC needed greater enforcement tools to effectively police the capital markets. Before Congress acts to change the enforcement mechanism that it has created, quite recently I would add, Congress needs to first conclude, based on rigorous study and analysis, that a problem exists, and that the proposed remedies would solve the problem and would not create even greater problems as a result of any changes implemented.

First, it is not clear to me that a problem exists. Eaglesham (2015a) reports that the SEC prevailed in approximately 90 percent of the cases it brought before an ALJ between 2010 and March 2015 and in approximately 70 percent of the cases it brought in federal court. The difference between the Commission's 90 percent success rate before an ALJ and 70 percent success rate in federal court is arguably the causative factor behind HR 3798. Eaglesham also reports that the SEC has taken steps to provide greater protections to defendants (2015b), and the Commission is bringing fewer cases before an ALJ (Eaglesham 2015c). Congress should tread carefully before trying to fix a perceived problem where that problem may already be solved. Second, if after study Congress continues to believe that a problem exists, it should not underestimate the collateral damage that may be done by changing the SEC's enforcement powers. Giving defendants the right to effectively choose the venue in which they will be tried is unlikely to be in the best interest of society, and will almost certainly make it more difficult for the SEC to deter and punish securities law violations, including fraud. Individual defendants may benefit, but society as a whole may bear the cost. Such a change can only be justified if Congress believes that the SEC is currently bringing too many enforcement actions. This seems unlikely given the wave of fraudulent financial reporting in the early 2000s, and the almost complete implosion of the financial markets later that same decade. Moreover, defining guilt differently in federal court (i.e., preponderance of the evidence) than before an ALJ (clear and convincing evidence, if HR 3798 is adopted) is likely to cause uncertainty and further litigation. Neither is good for defendants or society.

Finally, some would argue that HR 3798 is needed purely on fairness grounds for the accused. Some in Congress may believe that trying a case before an ALJ gives the SEC a "home court" advantage and that federal court is a more neutral forum. But those in Congress making the case that often monied interests (brokers, financial institutions, corporations, officers and directors, etc.) need more fairness need to contemplate why it is not even more unfair for individual citizens to be forced into binding arbitration (Silver-Greenberg and Gebeloff 2015; Silver-Greenberg and Corkery 2015a and 2015b). Could it be that fairness means one thing when it is pursued by those with money and quite another when it is pursued by ordinary citizens?

Helping Angels Lead Our Startups Act (not yet numbered)

This bill (not yet numbered), hereafter referred to as the HALOS Act, would appear to amend Rule 506 of Regulation D so that the prohibition on general solicitation and general advertising would not apply to sales events (a.k.a., demo days, venture fairs, pitch days) that are sponsored by a governmental entity, a college or university, a nonprofit association, an angel investor group, a trade association, or a venture capital association or forum. Rule 506(c) of Reg. D allows broad solicitation and general advertising but all investors in a 506(c) offering must be accredited and the company must take reasonable steps to verify the investor's accredited status (i.e., self- certification is not sufficient).

In my view, facilitating the role of angel investor groups in providing capital to small businesses should be encouraged. These groups typically are knowledgeable and sophisticated and are able to fend for themselves, obviating the need for as many investor protections as are needed by the general public. Moreover, angel investor groups often have direct access to a company's management, facilitating the ability of these groups to fend for themselves. Finally, if the angel investor group was to assume the responsibility for verifying a member's accredited status, a compliance burden would be removed from the small business issuer likely enhancing capital formation.

But what started out as a good bill became convoluted by including governmental entities, colleges and universities, and nonprofit groups among those hosting sales events. Unlike angel investor groups, the typical employees of these entities are not accredited investors and largely lack the knowledge and sophistication to fend for themselves – it is citizens exactly like these individuals that the securities laws are meant to serve. General solicitation and general advertising of sales events to be hosted by governments, universities, and not-for-profits will almost certainly attract unsophisticated and non-accredited investors. Waiving the 506(c) requirement for the issuer to take reasonable steps to verify accredited status for sales events held at these venues will almost certainly expose individuals to financial risks they are not well positioned to take, without the knowledge or skill set to evaluate these risks, and without the broader protections afforded by the normal SEC review and disclosure process. In a nutshell – self-certification is no certification.

Fostering Innovation Act of 2015 (not yet numbered)

This bill (not yet numbered; hereafter referred to as FIA) would extend the waiver of auditor reporting on the effectiveness of an issuer's controls over financial reporting (ICFR) (SOX section 404b) for certain Emerging Growth Companies (EGC) from five years to as long as 10 years. Over the last five years, smaller businesses have already received substantial relief from the requirements of Section 404(b). First, the Dodd-Frank Act exempts public companies with a

market capitalization of less than $75 million from Section 404(b) of the Sarbanes-Oxley Act (SOX). Dodd-Frank's permanent exemption from 404(b) removed approximately 60 percent of public companies from the requirements of 404(b). Second, the JOBS Act waives Section 404(b) for EGCs for five years, or earlier if the EGC obtains a public float of more than $700 million, has gross revenues in excess of $1 billion, or has issued debt in excess of $1 billion. FIA would extend the 404(b) waiver for formerly EGCs as long as their public float is $700 million or less and they have annual average gross revenues of less than $50 million. This extension could last for up to 10 years in total (an additional five years).

Further expanding the number of companies exempt from 404(b) is ill-advised because auditor reporting on ICFR is valued by investors, and because of the substantial benefits provided by auditor reporting to both investors and to companies themselves. In a recent survey by the PCAOB's Investor Advisory Group, 72 percent of surveyed institutional investors indicated that they relied on the ICFR opinion either "extensively" or "a good bit" (IAG 2015).[1]

Over the last five years, a large body of empirical research has emerged that establishes the importance of effective internal controls and the benefits of auditor reporting on internal control (see Schneider, Gramling, Hermanson, and Ye (2009) for a review of this literature). The most persuasive evidence on the value of auditor reporting on internal control comes from a study by Bedard and Graham (2011). Bedard and Graham examine issuers with revenues of $1 billion or less. They find:

- Auditors, rather than management, detect approximately 75% of the unremediated internal control deficiencies. As Bedard and Graham point out, "Importantly, this low level of client detection occurs when clients are aware that auditors will soon follow with their own tests."
- When managers detect the internal control deficiency, they tend to classify the deficiency as less severe, but auditors frequently override those classifications.
- A significant percentage of the internal control deficiencies in the control environment component and related to the revenue account are detected by auditor control testing. This is germane because fraud is often associated with control environment weaknesses and revenue is the account most typically misstated when fraud occurs (Beasley, Carcello, and Hermanson 1999; Beasley, Carcello, Hermanson, and Neal 2010).

Any decision to exempt smaller public companies from auditor internal control testing under Section 404(b) ignores the ample evidence that internal control problems are often most serious in smaller public companies. Doyle, Ge, and McVay (2007) find that issuers with more serious (entity-wide) control problems are generally smaller and younger. In addition, those companies

[1] The surveyed institutional investors had cumulative assets under management of $13.4 trillion.

charged with financial statement fraud by the SEC tend to be relatively small (Beasley, Carcello, and Hermanson 1999; Beasley, Carcello, Hermanson, and Neal 2010). Moreover, Donelson et al. (2015) find a positive relation between a material weakness in internal control and the future revelation of fraud. As Bedard and Graham (2011) conclude, "… the recent exemption of Section 404(b) for smaller U.S. public companies could result in failure to fully realize potential improvements in financial reporting quality in that sector of the market."

Not only do investors benefit from auditor reporting on ICFR, issuers (companies) do as well. Feng et al. (2015) find that companies with inventory-related material weaknesses take longer to sell their inventory and are more likely to have to write off inventory amounts. Companies that fix these inventory-related weaknesses experience increases in sales, gross profits, and operating cash flows. Feng et al. (2009) find that companies with a material weakness in internal control issue less accurate earnings guidance, and given the difficulty that small companies have with analyst coverage, less accurate earnings guidance makes it less likely that analysts will cover the company. Finally, Costello and Wittenberg-Moerman (2011) find that companies with an material weakness in internal control have to pay higher interest rates to lenders and to post additional collateral. Given the precarious nature of small business financing, maintaining and demonstrating effective ICFR, through a "clean" opinion under 404(b), should have the effect of facilitating more advantageous lending to small businesses.

Given the weight of the empirical evidence on the efficacy of auditor involvement in testing and reporting on internal control, exempting more issuers from such auditor involvement seems adverse not only to the interests of investors, but equally to the interests of small businesses who this change is designed to benefit.

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