

Scaling Disclosure and Corporate Governance Rules for Smaller Public Companies

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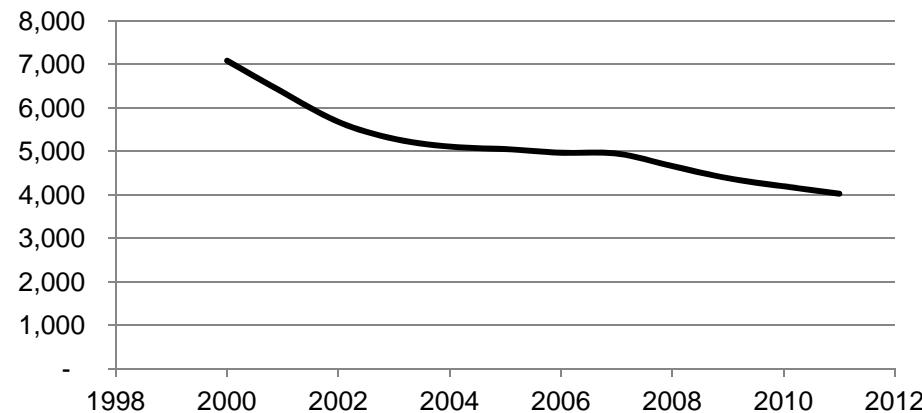
Outline

- 1. Our shrinking capital markets
- 2. Follow up to market structure session
 - We need to let exchanges experiment
- 3. Scaling compliance costs
 - Need to analyze relative to size of firm.
 - More serious cost analysis
 - Quantify fraud losses in dollars
 - More cost effective ways to fight fraud
- 4. Internal Controls (SarbOx §404)
 - Need multiple criteria, not just COSO
- 5. Conflict Minerals
 - Permit “Proposition 65” boilerplate for majority of firms that use *de minimis* amounts of DRC-conflict minerals.
- 6. Crowdfunding: Keep it simple
 - Cigarette warning labels
- 7. Use §36 exemptive authority

Our shrinking public equity markets

- The number of US-domiciled US-exchange listed companies has been shrinking steadily for the last 15 years.
- **The Wilshire 5000 index now has only 3,639 companies as of 5/31/2012**
 - Used to have over 8000 companies!

Domestic U.S. Exchange-Listed Companies



Multiple causes for crisis in capital formation.

- Litigation environment
 - “if you go public, you get sued.”
- Burdens on public companies: SOx etc.
- Market structure
 - No longer have different structure for smallcaps.
 - SEC has imposed a “one size fits all” mentality.
- Less important:
 - Dotcom bust
 - Only 458 dot-com IPOs 1998-2000
 - General economic conditions
 - Decline monotonic even during mid 2000s
 - Mergers

<http://bear.warrington.ufl.edu/ritter>List%20of%20Internet%20IPOs.xls>

Follow on to market structure panel

- We need to allow exchanges to experiment with market structure.
 - Get rid of “one market fits all” mentality.
- Smaller companies need a market structure that provides a rich information environment for investors
 - Need incentives for industry to produce information.
- Tick sizes:
- Let issuer pick the tick size.
 - Issuers have fiduciary duty to shareholders
 - In best position to evaluate tradeoffs of different sizes.
- Let issuers compensate market makers for liquidity
 - It works in Europe without harming investors
- Let issuers levy “12b-1 fees” on each trade
 - Collected like SEC fee by exchanges
 - Used to pay for independent research
 - Used to incentivize liquidity providers.

The scaling question

- How should we decide where to draw the line on exempting smaller companies?
- Answer: Look at costs relative to size of company.
 - Either market cap or total assets
- Anything that increases fixed costs has a disproportionate effect on smaller companies.

How to think about scaling costs

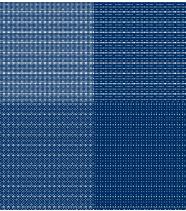
- What is the cost relative to size?
- Example: Regulation with annual fixed cost of \$1 million.
 - For a company with market cap of \$1 billion:
 - 0.1% per year addition to cost of capital
 - For a company with a market cap of \$100 million
 - 1.0% increase in cost of capital.

Example: SarbOx §404

- SEC 2009 Survey: Average cost for companies with market cap \$75 to \$100 million:
 - \$678,000
 - http://www.sec.gov/news/studies/2009/sox-404_study.pdf
 - Note: Original estimate: \$91,000
 - <http://www.sec.gov/rules/final/33-8238.htm>
- Effective burden rate on cost of capital:
$$\$678K/((75+100 M)/2) = .77\%$$
- **This is huge** compared with normal equity cost of capital in 10% range!
- My intuition: Should be overwhelming justification for anything larger than 0.05%

Indirect effects

- Direct cost measurements do not include downstream effects.
- Raising the cost of being public = fewer public companies
- Less access to public markets = fewer exit opportunities for venture investors.
- Fewer exit opportunities = fewer bidders = lower exit returns
- Lower exit returns = Less investment up front
- Less investment = fewer jobs and less economic growth



Need better and more realistic cost benefit analysis

- Traditionally, the cost-benefit analysis has been like the appraisal in a mortgage deal
 - Done after the fact to bless the deal
- Need serious analysis earlier in rulemaking process
- Has any regulation ever been dinged for being too costly?
- Recommendation:
 - Incorporate cost and benefit analysis at the **beginning** of rulemaking.
 - Get more realistic numbers.
 - Hire people with industry experience to do the studies.
 - Incorporate indirect and downstream effects.
 - Perform regular and public ex-post studies on costs and benefits.

Speaking of benefits

- Goals of disclosure
 - Fraud prevention
 - Better economic decisions by investors
- With smaller companies, there is less money at risk and thus less benefit from expensive requirements!
- How much fraud is there really at the smallcap level?
 - Total dollar amount, not just cases.
 - Even if every nonbank OTCBB company was a total fraud, investor losses would be less than one Enron!

Another way to scale disclosures

- Look at total market cap of sector.
- Dramatically reduce requirements (e.g. §404) for the category of firms that sum to less than 5% of total \$15T equity market.
 - Totaling \$750 billion
- Would result in less burden on small businesses and on the SEC.

More cost effective ways to fight smallcap fraud

- One of the first principles of regulation is to choose the most cost effective measures.
- Burdensome disclosures do little to fight smallcap fraud
- More cost effective solutions:
 - Background checks on officers, directors, and promoters
 - Credit reports and criminal record checks
 - Examine transfer agent records to see who is acquiring large blocks from the companies and do background checks on them.

SarbOx §404

- (a) RULES REQUIRED.—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—
 - (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
- (2) **contain an assessment**, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
- (b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be **made in accordance with standards for attestation engagements issued or adopted by the Board**.
 - Any such attestation shall not be the subject of a separate engagement.

Note

- §404 only calls for an assessment. It does **NOT** specify any particular standard.
 - Does NOT specify COSO standards.

The '34 Act also states:

- **3A(f) CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION.**—Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

Scaling SarbOx

- 1. Assessments should not be binary, black and white
 - “effective – not effective”
- How about a report card: A, B, C etc ?
- 2. Why is there only one standard?
- 3. Should have multiple standards appropriate to different size entities.
 - COSO may be appropriate for S&P500, but not smaller firms.
 - **Should have explicitly different standards**
 - Some explicitly geared (and labeled!) for small companies.
 - Midcap standard
 - Smallcap standard
 - Emerging growth standard
- **4. Let firms pick** standard appropriate to their level.
 - Perhaps exchange listing standards or index inclusion could specify the standard
 - To be on NYSE-classic or Nasdaq Global Select: COSO
 - To be in Russell 2000: Midcap standard
 - To be on NYSE MKT (former Amex): Smallcap standard

Actually, firms pick now

- Exchange listed: COSO
- OTCBB and Pinks: No standard
- Note number of firms that have voluntarily deregistered (“gone dark”) to reduce costs:
 - Ohio Art (Etch a sketch)
 - Federal Screw Works (Auto parts)
 - Numerous foreign firms
 - Etc.

Conflict Minerals

- Push for “disclosure-light”
 - Allow boilerplate (“Proposition 65”) disclosure for majority of firms that don’t buy stuff from the DRC:

• In the course of normal business our company from time to time purchases electronic and other equipment from normal commercial sources. These may contain a number of materials from all over the world which may include de minimis amounts of “conflict minerals” such as gold, tantalum, tungsten, and tin. We do not purchase any conflict minerals directly from the DRC.”

JOBS Act Implementation

- Listen to Congress and don't go overboard with rules.
- Remember 3A!
 - Protection of investors
 - Efficiency
 - Competition
 - Capital formation
- Example: Crowdfunding disclosures
 - Keep them simple!
 - JOBS act clearly creates liability for omissions.
 - Create target for maximum length of disclosures.
 - Cigarette label warnings are more effective than 500 page prospectuses.
 - Use Dodd-Frank authority to do consumer testing.

Example of warning label

- This investment is very risky.
- The information given to you about this firm may not be as timely or accurate as for major companies.
- There may not be any market for these securities if you want to sell.
- You may lose all your investment!

Even crowdfunding needs to be scaled

- Congress permitted bigger offerings than some crowdfunding advocates requested
 - But gave SEC much more rulemaking authority.
- Should use §36 authority to permit VERY simple disclosures for smallest offerings!
 - \$1,000 per investor, \$100,000 total offering
 - 1 page registration with SEC
 - 1 page warning to investors

Wield §36 (A) like an axe!

- (1) IN GENERAL.—Except as provided in subsection (b), but notwithstanding any other provision of this title, the Commission, by rule, regulation, or order, may ~~conditionally or unconditionally exempt~~ any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

Summary of recommendations

- 1. Permit exchanges to experiment widely with market structure for small caps.
 - Let issuers pick tick size.
 - Permit compensation for market makers.
 - Permit 12b1 style fees
- 2. Measure cost as percent of firm size.
- 3. For SarbOx: Construct multiple standards
 - Permit issuers to pick appropriate standard
- 4. For conflict minerals: Permit boilerplate for most firms not doing business in DRC.
- 5. Crowdfunding: Think cigarette labels, not fine print.
 - Super simple disclosures for tiny offerings
- 6. Use §36 exemptive authority broadly for smallcaps