REMAPPING DEBATE
Asking "Why" and "Why Not"

SEC concerned about regulating too tightly?

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April 20, 2011 — In the fallout from the financial crisis, the Securities and Exchange Commission has frequently been criticized for its failure to take on some of the country's largest commercial operations. Now, some investor advocates are raising another concern: that, even as much of the work of reforming financial regulation remains incomplete, the commission may be laying the groundwork for efforts to lift regulations and weaken investor protections that apply to smaller and more closely-held companies.

The objections stem from SEC Chairwoman Mary Schapiro's announcement, in a letter to Rep. Darrell Issa, that the Commission is in the process of forming a new Advisory Committee on Small and Emerging Companies. That advisory group, Schapiro wrote, will be one source of information for the Commission's broader effort to "reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection."

While most coverage of Schapiro's letter has focused on the signals it sends about the Commission's oversight of large, closely-held companies like Facebook, some investor advocates worry that, depending on its composition, the advisory group could become an SEC-sanctioned platform for opponents of new financial regulations.

The trouble last time

In particular, critics point to the SEC's last small business advisory committee, convened in 2005, shortly after the Enron and WorldCom scandals prompted passage of the Sarbanes-Oxley law. That group "was a disaster for investors," said Lynn Turner, a former chief accountant of the SEC who now sits on the board of a major public pension fund, and who spoke before the advisory panel. He and others noted the committee's proposal to exempt most so-called "microcap" and "smallcap" companies — which account for nearly 80 percent of publicly listed businesses — from a central provision of Sarbanes-Oxley that required outside auditors to attest to the integrity of a company's financial controls, on the grounds that the requirement was too costly and other rules provided adequate protections.

That sweeping proposal never became law. But the report, said Barbara Roper, director of investor protection for the Consumer Federation of America, influenced the subsequent debate, in which the SEC repeatedly delayed implementation of the rule. And last year, in the Dodd-Frank financial reform law, Congress granted a permanent exemption to companies with market values up to $75 million, and directed the SEC to consider whether to extend the exemption to businesses worth up to $250 million.

"These things take on a life of their own," Roper said.

Critics of the last small business group note that the 21-member committee had only one investor representative, who dissented from the exemption proposal, as did two representatives of accounting firms. In a letter to Schapiro last week, Roper urged that the new advisory group have more balanced representation. But she also questioned the wisdom of appointing the committee at all without "empirical evidence that there is a problem that needs to be solved" with respect to small companies' access to capital.

Concern about potentially broad loopholes

Denise Voigt Crawford, who recently retired after a long career as the top securities regulator in Texas, said she believes small companies do face some unnecessary obstacles in their search for capital. But the SEC, which holds annual public forums on small business capital formation, already has a vehicle through which to address those burdens, she said.

Crawford said she was concerned that a special advisory group might recommend overly broad measures, such as exemptions from disclosure requirements, that would weaken the ability of state regulators to oversee small companies — a worry that she said stemmed from her assessment that the SEC's response to Issa "appears to be political, rather than practical."

Judith Burns, a spokeswoman for the SEC, said the new advisory group would operate on an ongoing basis, while the existing small capital forums meet once a year. But she declined to answer questions about what the advisory committee's membership would look like, or what specific problems it might address that the annual forums do not, saying only that the Commission would have no comment beyond what was in Schapiro's letter.

"Leading with the small business card"

The SEC's latest moves on the small business front come amidst numerous proposals in Congress to scale back financial and other business regulation, many of which, said Marcus Stanley, policy director for Americans for Financial Reform, employ a strategy of "leading with the small business card."

For example, the Small Business Regulatory Freedom Act, introduced in March by Sen. Olympia Snowe, a Maine Republican, would require federal agencies to review the impact of their existing regulations on small businesses, and would give the Small Business Administration power to nullify rules that it deems not to have been adequately reviewed.

A narrower measure — and one more directly related to the SEC — is the Small Company Capital

Formation Act, introduced last month by Rep. David Schweikert, an Arizona Republican. That bill would allow companies to make public offerings of up to $50 million without registering with the SEC, up from the current $5 million. (The legislation would still allow the Commission to require those companies to file audited financial statements, but would not make that step mandatory.)

Questioning SEC's priorities

Investor advocates who are wary of deregulatory proposals generally see the Commission today as more committed to effective regulation than it was in 2006, when the last small business advisory group finished its work. But they also argue that the agency has, in Turner's words, "become very politicized," and so might be inclined to take its cues from Congress, which controls the Commission's budget. (Dodd-Frank called for substantial funding increases for the SEC, though in its final 2011 budget Congress appropriated about $100 million less than that law authorized.)

Whatever the motivation, critics questioned why the SEC was announcing a re-examination of small business regulation when parts of the reform effort are incomplete, in some cases due to limited resources. Roper, for example, noted that the Dodd-Frank law mandated creation of a new Investor Advisory Committee, but that group has been put on hold due to budget uncertainty. "If there's money to do the small company advisory group, there's money to do the investor advisory group, and the one that's required by law ought to come first," she said.

Burns, the SEC spokeswoman, said there is no timetable in place for establishment of the investor committee. She declined to comment on Roper's statement, or to address the broader criticism that the re-examination of small business regulation could divert the Commission's resources from other projects.

The SEC also has yet to adopt final rules about the fiduciary duties of investment advisors and broker-dealers, which Roper described as the biggest investor victory in the Dodd-Frank debate. A staff recommendation on those rules is expected by the end of the year, Burns said.

Also pending is SEC action to enforce another provision of Dodd-Frank, which would make credit rating agencies subject to expert liability for the grades they give to asset-backed securities. After the SEC's announcement that it would allow such securities to be sold without a disclosed credit rating drew critical press coverage and objections from Massachusetts Attorney General Martha Coakley, Schapiro wrote that the Commission is "working on extensive changes to the regulations that would improve several aspects of asset-backed securities regulation" and is "continu[ing] to monitor the issue."

Regardless of how those broader issues are resolved, critics said, the focus on lightening the load on small businesses could prove harmful. "If I'm an investor, it doesn't matter if I'm ripped off by a small company or a big company," said Crawford. "I've still lost my money."

Is the SEC chasing a problem that doesn't exist?

Underlying the debate on the SEC's re-examination of regulations on small and emerging companies is an even more basic question: Are small companies facing burdens in their ability to attract capital that will allow them to expand? And how would we know?=

In a March 22 letter to SEC Chairman Mary Schapiro, Rep. Darrell Issa pointed to the declining number of initial public offerings (IPOs), and a commensurate decline in the number of publicly listed companies, as one sign of weakness in the U.S. capital markets.

In fact, the rate of IPOs has declined dramatically. In the middle of the last decade, the number of new offerings never recovered to their pre-tech bubble levels, and the IPO rate cratered again in the financial crisis. But a number of investor advocates and other market observers have questioned either how significant this trend is, or whether it can be tied to an increase in regulation.

One of the key figures sounding the alarm about the decline in IPOs is David Weild, a senior advisor for the firm Grant Thornton LLP. In a November 2008 white paper, Weild and co-author Edward Kim argued that the soft IPO market — which was leading small, young companies to be acquired by larger firms, rather than raising capital and seeking to grow on their own — was "leav[ing] a lot of shareholder return, economic growth and job formation on the table."

But, they added, "while Sarbanes-Oxley did increase the costs and time required to go public, it is a bit of a red herring in that it is only one factor, and probably not the major factor, in the demise of the IPO market." A bigger role, they wrote, had been played by the shifting economics of the investment marketplace, including the rise of day trading and decimalization.

Similarly, a 2007 Goldman Sachs report argued that a shift in registered listings from the U.S. to foreign exchanges was "a consequence of economic and geographic factors," including global development, more so than regulatory changes within the U.S.

Other observers, meanwhile, questioned the idea that policies should be designed to encourage companies to go public. The late-90s IPO boom, said Barbara Roper, director of investor protection for the Consumer Federation of America, probably led some companies to go public before they were ready to take on the responsibilities to shareholders that step required. That class of businesses, Roper said, then became part of an entrenched pressure group pushing for more lenient rules on smaller public companies.

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The debate may have important implications in shaping decisions about regulation. While he has pointed to other factors to explain the decline in IPOs, Weild, in recent testimony to a House subcommittee, did endorse the Small Company Capital Formation Act, which would allow business to make offerings of up to $50 million without registering with the SEC. But he suggested that the filing of audited financial statements be mandatory for those companies, and that they be required to make periodic financial disclosures that mimic those of registered companies

Investor advocates, though, worry that potential rule changes may represent a slippery slope of excessive deregulation. For example, one group with an interest in relaxed IPO rules might be venture capital firms, which provide funding to small private businesses in hopes of profiting when they go public. As the SEC constructs its new Advisory Committee on Small and Emerging Companies, "the appointment of representatives…who put their self or business interests ahead of investors would be very worrisome," said Lynn Turner, a former chief accountant for the Commission. He cited the potential appointment of representatives of venture capital firms as illustrating the problem.

And Scott Shane, an economist at Case Western Reserve University, said the conversation raised questions about priorities.

While the decline in IPOs was not itself proof of a regulatory problem, it might warrant a closer look, Shane said. But even in a strong IPO market, that tool only helps a tiny fraction of small companies — those with the potential for high growth. For most small companies, access to credit — which is now compromised because of continuing weakness in the housing sector — is a more pressing concern, he said.

"If we're worried about the issues that the SEC is investigating," said Shane, "are we worrying about the most important set of questions related to financing businesses in the US?" The question of how and whether to encourage more IPOs may be important, he said. "It's just that I think you get a bigger impact if you worry about some other things."

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