THE COST OF BEING A PUBLIC COMPANY IN LIGHT OF SARBANES–OXLEY AND THE FEDERALIZATION OF CORPORATE GOVERNANCE

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND INVESTMENT

OF THE

COMMITTEE ON FINANCIAL SERVICES

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THE COST OF BEING A PUBLIC COMPANY IN LIGHT OF SARBANES–OXLEY AND THE FEDERALIZATION OF CORPORATE GOVERNANCE

Tuesday, July 18, 2017

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
SECURITIES, AND INVESTMENT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Bill Huizenga [chairman of the subcommittee] presiding.

Members present: Representatives Huizenga, Hultgren, Duffy, Stivers, Wagner, Poliquin, Hill, Emmer, Mooney, MacArthur, Davidson, Budd, Hollingsworth; Maloney, Sherman, Lynch, Scott, Himes, Ellison, Foster, Sinema, Vargas, Gottheimer, and Gonzalez.

Ex officio present: Representatives Hensarling and Waters.

Chairman HUIZENGA. The Subcommittee on Capital Markets, Securities, and Investment will come to order. Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Today's hearing is entitled, "The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance."

I now recognize myself for 3 minutes to give an opening statement

I find it extremely concerning that the number of publicly traded companies is approximately half of what it was just 20 years ago. Since 2000, the average number of IPOs has dwindled to 135, compared to more than 450 annually in the 1990s. It is important to note that there has not been a corresponding downtrend in the creation of new companies over this same period.

According to an Ernst & Young publication in 2016, there were only 112 initial public offerings or IPOs. This should be concerning to every single member of this committee, regardless of one's political affiliation.

While there are many factors as to why the number of public companies has declined, the main challenges that I continue to hear about are how difficult it is to go public and how difficult it is to remain public as a company.

The Securities and Exchange Commission has estimated that the initial regulatory compliance for an IPO costs a massive $2.5 million, followed by ongoing compliance costs of $1.5 million annually.

The Sarbanes-Oxley Act of 2002 (SOX), in addition to other Federal corporate governance regulations, resulted in significant costs to a company that a company must consider when making the decision to go or remain public.

The extensive corporate disclosure regime that public companies must navigate is not only costly, but it also exposes potentially sensitive information that can be used by competitors, and increases a company's litigation risk. We need to balance certain information the regulators and investors need to know with what is proprietary information.

I find it extremely troubling that during the tenure of former SEC Chair Mary Jo White, the SEC seemed more interested in pursuing highly politicized Federal corporate governance mandates than its core mission. Instead of working to protect investors, maintaining fair, orderly and efficient markets, and helping to facilitate capital formation, it seemed the SEC focused on exerting societal pressure on public companies to change their behavior through disclosure rules such as the conflict minerals and pay ratio rules. That, in my opinion, is not the proper role of the Securities and Exchange Commission.

I look forward to working with SEC Chairman Clayton to refocus the SEC and advance a more expansive capital formation agenda. Let's continue to build upon the successes of the bipartisan JOBS Act by further modernizing our Nation's securities regulatory structure to ensure free flow of capital, job creation, and economic growth.

It is time to get the Federal Government working to ensure that American businesses are able to raise the capital they need to expand, support innovation, and reward hard-working Americans.

I look forward to hearing from our witnesses today.

And the Chair now recognizes the ranking member of the subcommittee, the gentlelady from New York, Mrs. Maloney, for a 5-minute opening statement.

Mrs. MALONEY. I thank the chairman for holding this important hearing on Sarbanes-Oxley, and a series of important oversight hearings.

But I also think it is important to remember why we passed Sarbanes-Oxley in the first place. It was in response to an enormous wave of corporate scandals. Huge, well-known, respected companies like Enron and WorldCom had been reporting fraudulent earnings. And when their frauds were exposed, they went from investment-grade companies to bankrupt within a matter of months, rocking our markets and losing the savings of thousands of workers

I have always said that markets run more on confidence than on capital. And these scandals destroyed investors' confidence in our markets. Many investors decided if they couldn't trust the financial statements of companies like Enron and WorldCom, then they couldn't trust any company's financial statements anymore.

So Congress had to step in to restore investors' confidence in our markets and in the accuracy of corporate financial statements. Sarbanes-Oxley did impose Federal corporate governance requirements on companies, but this was necessary because these corporate governance changes affected the accuracy of financial statements that were governed by SEC regulations. And the Federal Government has regulated financial statements for public companies for over 80 years.

Corporate governance issues have long been split between the States and the Federal Government. Ever since the Great Depression, and the Securities Act of 1933 and the Exchange Act of 1934, certain companies have been subject to Federal regulation, so this is absolutely nothing new.

Companies that have a certain number of shareholders—today the threshold is 2,000—have been subject to SEC disclosure rules for over 80 years. These companies are known as reporting companies and there are over 9,000 of them in the United States. Corporate governance issues that affect financial reporting for these SEC-regulated companies can and should be handled at the Federal level.

This is especially true when a corporate governance issue affects the reliability of a company's financial statements because the most basic confidence that investors need is confidence in the accuracy of a company's financial statements.

As an investor, if you are going to commit your capital to a company, you need to know at a minimum how much money the company already has, how much it is expected to make every quarter, what its normal day-to-day operating costs are, and how much it already owes to other creditors.

If investors can't have a basic level of confidence in these financial statements that the numbers are accurate and any major caveats are disclosed, then they simply won't commit their capital to that company.

Some of the requirements of Sarbanes-Oxley relate to corporate governance issues, such as the requirement that public companies have independent audit committees, the requirement that companies maintain effective internal controls over financial reporting, and the requirement that CEOs and CFOs personally certify the accuracy of their financial reports.

We can remember the hearings we had here where CEOs and CFOs said they had no idea what the financial statements of their companies were. This was technically a federalization of a corporate governance issue. But it was necessary because these corporate governance issues affected the reliability of financial statements that were regulated under the SEC disclosure rules.

The question as always is, where do we draw the line? Which corporate governance issues are best handled at the State level and which at the Federal level?

This is an ongoing exercise, and I welcome the opportunity to hear the testimony today and to review the current corporate governance regime to determine if we need to draw the line in a different place.

I have a letter from the Council of Institutional Investors, which represents major pension funds across our country, and I ask unanimous consent, Mr. Chairman, to submit it in the record.

Chairman HUIZENGA. Without objection, it is so ordered.

Mrs. MALONEY. Thank you so much, and I look forward to this hearing.

And I yield back. Thank you.

Chairman HUIZENGA. The gentlelady yields back.

The Chair now recognizes the vice chairman of the subcommittee, Mr. Hultgren from Illinois, for 2 minutes for an opening statement.

Mr. HULTGREN. Thanks, Mr. Chairman.

I am sure that this statistic or something very similar will be cited a number of times today, but I would like to make sure to highlight it as well: The number of U.S. public listings fell from 8,025 in 1996 to 4,101 in 2012, whereas non-U.S. listings increased from 30,734 to 39,427. In other words, while new listings rose 28 percent overseas, they fell 49 percent in the United States. This is a serious problem.

The evidence of regulatory burden has been mounting, and it is important that this committee fight for healthy public markets. The JOBS Act was pivotal to this work, but it was only the beginning, especially as Dodd-Frank requirements continue to be implemented and as these are compounded with existing disclosure requirements for public companies

This is why I co-sponsored the Fostering Innovation Act, sponsored by Kyrsten Sinema and Trey Hollingsworth of this committee, to extend the temporary exemption for an additional 5 years for certain emerging growth companies.

Chairman Huizenga's Congressional Review Act Resolution, now signed into law, nullifying the Dodd-Frank-mandated Resource Extraction Disclosure Rule from the SEC was also a key part of this committee's work to address new Dodd-Frank burdens on public companies. There is a lot more work to be done by this committee and the SEC to this effect.

For example, I was pleased to see the June 29th announcement from the SEC's Division of Corporation Finance that it will be permitting all companies to submit draft registration statements for review on a non-public basis. I hope this popular JOBS Act provision contributes to a more robust public market.

Personally, I have been focused on the need for reforms to the SEC's Rule 14a-8. It has clearly been hijacked to achieve social objectives, which may have some merit, but have nothing to do with investor protection or capital formation.

I look forward to the recommendations coming from our witnesses on this issue and others, and I yield back.

Chairman HUIZENGA. The gentleman yields back.

Today, we are welcoming a great panel here that I think is going to give us some great insight. First and foremost, we have Mr. Tom Farley, who is president of the New York Stock Exchange. He joined NYSE in November of 2013 when ICE acquired the New York Stock Exchange and Euronext.

Next, we have Mr. John Blake, who is the senior vice president of finance for aTyr Pharma. His background includes a medical device company and a semiconductor company, so he has some broad experience, and he is a certified public accountant as well.

Mr. Tom Quaadman is the executive vice president of the Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce. Mr. Quaadman also holds a degree from New York Law School.

And then we have Professor J. Robert Brown, who is the Lawrence W. Treece professor of corporate governance, and director of the corporate and commercial law program at the the University of Denver Sturm College of Law. He has also been an arbiter for FINRA.

And last but not least, Mr. John Berlau is a senior fellow at the Competitive Enterprise Institute. Mr. Berlau is an award-winning journalist in both the financial and political fields, and he is a contributing writer for Forbes.

We welcome all of you here today. We appreciate your time, and your effort in being here.

And with that, Mr. Farley, you will be recognized for 5 minutes for your opening statement. And without objection, all of your written statements will be made a part of the record.

STATEMENT OF THOMAS W. FARLEY, PRESIDENT, THE NEW YORK STOCK EXCHANGE (NYSE)

Mr. FARLEY. Thank you, Mr. Chairman.

Chairman HUIZENGA. Thank you.

Mr. FARLEY. Thanks for having me back. And thank you, Congresswoman Maloney, and all the members of the subcommittee. On behalf of the New York Stock Exchange, we appreciate you having us here to discuss these important issues, and in fact, thank you.

We have submitted our written testimony, so I am just going to hit a few of the Cliff Notes, and in fact, try to make it shorter because your comments were all so on the mark.

Great entrepreneurs and the dynamic companies that they create are the lifeblood of our economy. They create jobs. They stimulate wages. And they create investment returns for all Americans, not just a privileged few.

I grew up down the street from here in Prince George's County, in Bowie, Maryland. And I witnessed firsthand the impact that these incredible entrepreneurs can have.

In 1996, Kevin Plank founded Under Armour from the trunk of his car right here in Prince George's County. And the business grew with fits and starts for 10 years. But it wasn't until 2005, when they took Under Armour public, that the explosive growth really ensued.

The company went public at a valuation of $600 million, and ultimately topped $15 billion. I would go home to crab feasts and holidays and there were stories aplenty about, "Hey, I have a job, a great job at Under Armour," or "I invest in Under Armour stock and I am making dough to be able to put our family in a better place." Or even just, "I am wearing Under Armour clothes and I take great pride in it."

I saw how people were able to provide a better life for themselves because of a great company like Under Armour. The fact of the matter is that story is dormant. It is dead. There has not been a story like that in 10 years.

You see, young dynamic companies used to go public. In the 1980s, the 1990s, even in the 2000s, the early 2000s in the early days, think Apple and Microsoft, and more recently, Netflix, Salesforce, Google, Chipotle, and many other examples, but not one has done that since 2007—a company valued at a billion and a half or less, a U.S. operating company that has achieved evaluation north of $10 billion.

Clearly, there is something something wrong there and and we should all address it.

You mentioned that IPOs are down dramatically, Chairman Huizenga, but I will just reiterate that the 1990s, as you pointed out, were a great time for IPOs. In fact, the minimum number of IPOs was 350 in a given year here in the United States. In the current 10-year period, the maximum IPO number is 250, not 350.

So what can we do about that? We propose that we think of it in three different ways. First, let's end regulatory mission creep. Second, let's level the playing field for listed companies, particularly vis-a-vis serial litigants and proxy advisory firms. And third, let's really focus on small to mid-sized businesses.

So first, just briefly, with respect to regulatory mission creep, Congresswoman Maloney is absolutely right. Sarbanes-Oxley was put in place for a set of very good reasons and it was done in a bipartisan fashion. And the idea of Sarbanes-Oxley was, let's put these internal controls in place.

The issues came about because not only did it put internal controls in place, but it required that an external auditor-for-hire come in and verify them, attest to them. It created a quasi-governmental organization, the PCAOB, which for 15 straight years has expanded the scope of Sarbanes-Oxley.

And all these just put such a great cost on corporate America. And actually the benefits are not entirely clear. The data doesn't show clearly that we have reduced fraud or greatly inspired confidence, but what is clear is we have far fewer public companies.

And so our recommendations with respect to Sarbanes-Oxley are that first, we do away with the requirement that auditors attest to the internal controls. That is something that exists today under the JOBS Act for EGCs, and we are suggesting, let's extend it to all companies. Second, let's narrow the definition of internal controls under Sarbanes-Oxley. And third, and most importantly, let's require that the PCAOB not pass new rules and regulations that could in any way burden public companies.

Second, level the playing field. There are hundreds and hundreds of shareholder class action lawsuits every year, as many as 500. The preponderance of those, or a majority of those, are questionable in nature.

Our recommendation is that in this country we move to a loser-pays model, much like in the U.K.: If you lose your shareholder class action lawsuit, you pay the legal fees.

This would still allow a voice, which is very, very important for shareholders, even small shareholders who have been harmed. But it would limit it to the most meritorious cases.

Second, let's level the playing field vis-a-vis proxy advisory firms. Let's require them to register with the SEC and be transparent about how they manage their many conflict of interests, but also how they go about evaluating companies. This is a real sore point for listed companies.

Finally, reduce the burden on small to mid-sized companies. And I have 10 seconds left, so I will do that quickly.

Chairman HUIZENGA. Or we can wait until questions.

Mr. FARLEY. Yes, I think I will just hit it in Q&A. Essentially, we think we should extend the the emerging growth company (EGC) qualification under the JOBS Act, to not just end at 5 years, to hit any company that meets those characteristics.

Thank you, I look forward to Q&A. Sorry for running over, Mr. Chairman.

[The prepared statement of Mr. Farley can be found on page 81 of the appendix.]

Chairman HUIZENGA. All right. The gentleman's time has expired.

Mr. Blake, you are recognized for 5 minutes.

STATEMENT OF JOHN BLAKE, SENIOR VICE PRESIDENT, FINANCE, aTyr PHARMA, INC.

Mr. BLAKE. Thank you, Mr. Chairman, and Ranking Member Maloney. I appreciate the subcommittee's work to support small businesses and ensure they have access to efficient liquid public markets, a vital component of the biotech capital formation ecosystem

As a senior vice president of finance of aTyr Pharma, a small public biotech in San Diego, I can attest to the utmost importance of public capital. Since the JOBS Act was enacted 5 years ago, we have seen more than 200 IPOs in our industry alone.

aTyr undertook a successful IPO in May 2015 using key provisions of the JOBS Act. But neither going public nor being public is easy. Roadblocks exist that can divert capital away from science, reduce investor confidence, hamper long-term value creation, and distract a company from its core mission.

These barriers reduce the viability of capital formation in our public markets to fund life-saving innovation. In some instances, they lead companies to stay private longer or opt for a merger rather than an IPO. In others, a company still goes public but sees its precious capital syphoned off for compliance burdens.

Many smaller issuers must allocate a disproportionate amount of resources, including staff and legal costs, to operate as a public company. The attention of management is often distracted by external forces that have the potential to influence shareholders, often at odds with the goal to create long-term value and help patients.

I am encouraged that the subcommittee is holding today's hearing to examine the impact of such roadblocks on smaller public companies. And I support the work you are doing to bolster America's capital markets for growing innovators.

In particular, I want to thank Representatives Sinema and Hollingsworth for introducing their Fostering Innovation Act.

The JOBS Act's 5-year exemption from SOX 404(b) is a perfect example of how very targeted relief has saved millions of dollars from compliance activities and instead directed those funds towards science and innovation activities that allow growing biotechs to provide benefits to patients and shareholders. This bipartisan bill builds on the success of that provision.

The auditor attestation required by SOX 404(b) is very helpful to shareholders of larger organizations with complex internal control environments often spanning geographies, diverse accounting systems, and multiple product lines.

However, such attestation is not useful to investors in emerging pre-revenue companies. Since many biotechs will still be in the lab when their 5-year exemption expires, the Fostering Innovation Act extends the exemption in a very targeted way.

The continued cost-savings in the bill are vital because every dollar spent on a one-size-fits-all burden is a dollar diverted from the lab. I also support Congressman Duffy's Corporate Governance Reform and Transparency Act.

I want to be clear that I believe proxy advisory firms play an important role in the health of our capital markets. I believe that greater transparency, accuracy, and engagement with smaller issuers can only further benefit shareholders.

Proxy advisory firms' outsized influence on emerging companies can be uniquely damaging to small, growing biotechs, especially in light of conflicts of interest and opaque standard-setting processes. Their one-size-fits-all approach diverts resources and distracts company management. Mr. Duffy's bill to regulate proxy firms would be a welcome change from a status quo whereby companies contort themselves to satisfy proxy advisors.

Shareholder value is also impaired by the manipulative actions of some short-sellers. I believe honest short-selling plays a necessary role in the health of our capital markets and can aid liquidity and price discovery.

However, the lack of transparency around shorting has given rise to manipulative behaviors that disincentivize long-term investment in innovation. Protected by the absence of any disclosure requirements, short-sellers have discovered that the unique biotech business model enables them to easily orchestrate a short-term stock drop.

Long-term biotech investing is already a risky prospect so introducing further uncertainty discourages investors and ultimately harms the viability of capital formation in our markets. I believe that there should be a short disclosure regime complementary to the existing long disclosure requirements.

Short transparency would shine a light on manipulative behaviors and ensure that investors have the full range of information they need. The JOBS Act has shown the strong impact of a policymaking drive toward capital formation and away from the one-size-fits-all burdens and outsized emphasis on the short term in our industry.

I applaud the subcommittee for considering further initiatives to support small business innovators, and I look forward to answering any questions you may have.

[The prepared statement of Mr. Blake can be found on page 59 of the appendix.]

Chairman HUIZENGA. Thank you.

Mr. Quaadman, you are recognized for 5 minutes.

STATEMENT OF THOMAS QUAADMAN, EXECUTIVE VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

Mr. QUAADMAN. Thank you. Thank you, Chairman Huizenga, Ranking Member Maloney, and members of the subcommittee. We appreciate the continued focus of this subcommittee on issues regarding business creation and growth.

Public companies are an important source of strength, growth, innovation, and resiliency for our economy. While the United States remains the gold standard for public companies, we are entering the third decade of a decline of public companies in the United States.

That number started to go down in 1996, 4 years before the tech bubble burst, and has gone down 19 of the last 20 years. In fact, the IPO markets have not recovered from the burst of the tech bubble.

But the gains and great strides of the Reagan and Clinton Administrations have been wiped out. We have roughly the same number of public companies today as we did in 1982, despite the fact that the population has grown by 40 percent and real GDP has increased by 160 percent.

For entrepreneurs today, staying private or being acquired are as viable options as going public. There is no one cause for this decline, but I think there is a two bucket-set of issues that we need to look at.

One is benign neglect, and that is the inability of policymakers to move forward on important issues. We have a lack of proxy advisory firm oversight, a rise of a small number of gadflies who are monopolizing the shareholder process, a failure to reform proxy plumbing in 14a-8 rules. And we have a disenfranchisement of retail investors in director elections and shareholder proposal votes.

The second bucket deals with intrusive intervention. From the New Deal until 2002, corporations were governed by a combination of state law and corporate bylaws. Federal security laws were for disclosure of information for investors to engage in reasonable decision-making.

That system was built upon a foundation of 150 years of State laws which has allowed directors and shareholders to develop diverse governance structures to fit the needs of the business.

The passage of Sarbanes-Oxley has thrown that system out of balance. To be clear, Sarbanes-Oxley was passed to address a crisis which needed to be dealt with, and there are some good things in Sarbanes-Oxley. However, putting the merits and demerits aside, the most far-ranging consequence of Sarbanes-Oxley was the federalization of corporate governance.

The Dodd-Frank Act ran through that door and that trend is continuing unabated today. Special interest activists are using the boardroom to push political agendas, and the Federal Government is acquiescing. As an example, the conflict minerals rule is a use of securities laws to try and resolve a foreign affairs and human rights crisis.

The Reg-K concept release, which has some very, very good things in it, has opened up the door for environmental social governance or ESG issues to enter into the boardroom. If you are an emerging growth company with $500 million in revenues today, if you were to go public it would cost you $2.5 million, or about 5 percent of your revenues.

What are you going to get for going into the public capital markets? $1.5 million in recurring compliance costs. You are buying shareholder proposal fights, director fights, and increased liability. Those are the reasons why Michael Dell, several years ago, said he would want to put all those issues aside so he can manage and grow his company.

This situation must be reversed. SEC Chair Jay Clayton has made these issues a priority. And we encourage all stakeholders to work with him on those issues. Congress has a role. I believe that the Duffy bill on proxy advisory firm oversight is an important step forward to rebalancing this system.

The business community also has its own responsibilities. The business community must resolve issues like board diversity on its own before we have government mandates.

We must also enhance the power of the States. As an example, this month, Delaware, under the leadership of Governor Carney, is going to authorize the use of block chain for proxy plumbing. The SEC has yet to read comment letters that were submitted 7 years ago on its proxy plumbing concept release.

And at the Chamber we are also issuing our own constructive proposals. Yesterday, we joined with other members of the Corporate Governance Coalition for Investor Value and sent a letter to the SEC, asking the SEC to move forward on its resubmission threshold rulemaking petition to deal with the gadfly issue.

Next week we are going to issue a set of 14a-8 reforms, and later this summer or early fall we are going to issue a new IPO report to build upon the successes of the JOBS Act.

So Chairman Huizenga, again, thank you for this hearing, and I look forward to any questions you may have.

[The prepared statement of Mr. Quaadman can be found on page 87 of the appendix.]

Chairman HUIZENGA. Thank you very much. We are on a roll with people yielding back.

Professor Brown, you are recognized for 5 minutes.

STATEMENT OF J. ROBERT BROWN, JR., LAWRENCE W. TREECE PROFESSOR OF CORPORATE GOVERNANCE, DIRECTOR, CORPORATE AND COMMERCIAL LAW PROGRAM, UNIVERSITY OF DENVER STURM COLLEGE OF LAW

Mr. BROWN. Thank you, Mr. Chairman, Ranking Member Maloney, and members of the subcommittee. NASDAQ, in its recent Blueprint on the Capital Markets stated that, "We have the most innovative and transparent markets in the world." I agree with that assessment.

But what exactly does that mean? Amazon went public in 1997, raising $48 million, although confessing that profitability wasn't in sight. In hindsight, purchasing shares in Amazon may seem obvious, but back then it wasn't.

Two years later, Webvan, a grocery delivery company, raised 7 times the amount of money as Amazon in an IPO. Webvan looked more like the future than Amazon. It wasn't long before Webvan was bankrupt, and Amazon was on its way to issuing 450 million shares and obtaining a market capitalization of almost a half a trillion dollars—a success of the capital markets.

So to me, "innovative" and "transparent" means capital markets that encourage investors to invest without knowing whether they are investing in Webvan or Amazon. It is about investor confidence in our capital markets and willingness to take risks.

In 2001, this confidence was in doubt. Enron, at one time the 10th largest company in the United States, proved to be a Potemkin village. Investors could not trust the financial statements issued by even our largest public companies.

In that environment, SOX, in a remarkably bipartisan fashion, stepped in and implemented much-needed reform. SOX strengthened the role of the board, particularly the audit committee, improved the quality of audits, and increased the responsibility of top officers for financial statements through certification and providing for the clawback of their performance-based compensation if based on false financial statements.

SOX went further. SOX also emphasized the importance of internal controls, the backbone of financial statements, by assigning responsibility for creating them, reviewing them, and assessing them. And all of these changes had one thing in common: They promoted investor confidence in financial disclosure.

The topic of reform of the public markets has returned. Some have phrased the relevant question as, how can we lower the cost of public company status? In my opinion, that is the wrong question.

SOX teaches that the most important question is, how can we enhance investor confidence in our public markets? Any proposed reform that may impair investor confidence should be viewed warily.

Cutting back on auditor review of internal controls falls into that category. So does the imposition of substantial restrictions on shareholder proposals.

Those who seek to restrict the use of shareholder proposals often criticize activists, those investors deemed to focus on the short term. The best way to confront those with a short-term horizon is to engage with those who take a longer-term view

Shareholder proposals provide management with the collective views of shareholders, whether on governance matters such as shareholder access, or on environmental matters where this year proposals addressing environmental matters received majority support at Exxon and Occidental.

Proposals can be an important component of the communication process between companies and their long-term shareholders. Substantial restrictions on the use of shareholder proposals will weaken, not strengthen, these relationships

That is not to say that reform of the public markets is not important. The hallmark of the public markets is transparency, and transparency comes from disclosure. The system of disclosure needs to be updated. We need to move from an analog to a digital universe in how information is filed and accessed.

We need to modernize the system of disclosure, one that was largely written in the 1980s before anyone had even heard of something called the Internet, much less social media or artificial intelligence.

But I would add that the starting point of disclosure reform is not disclosure overload, but disclosure effectiveness, that is, providing investors with the information that they need to be willing to purchase shares whether in Webvan or in Amazon. Thank you, and I look forward to your questions.

[The prepared statement of Mr. Brown can be found on page 66 of the appendix.]

Chairman HUIZENGA. Thank you.

And Mr. Berlau, you are recognized for 5 minutes.

STATEMENT OF JOHN BERLAU, SENIOR FELLOW, COMPETITIVE ENTERPRISE INSTITUTE

Mr. BERLAU. 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, a Washington-based free market think tank. It is our mission to advance the freedom to prosper for consumers, entrepreneurs, and investors

Despite the conversation on more recent financial regulation from laws such as Dodd-Frank, the Sarbanes-Oxley Act of 2002 still very much matters.

The mandates to audit internal controls from the law's Section 404, as interpreted broadly by the Public Company Accounting Oversight Board or PCAOB, the accounting body created by this law, are still a primary concern for companies considering going public on U.S. stock exchanges.

In reading through S-1s, the forms that companies file with the Securities and Exchange Commission when contemplating going public, I still always see prominent mention of the cost Sarbanes-Oxley imposes on being a public company.

Auditing costs imposed by SOX are some of the biggest drains on these firms. However, some of the biggest costs SOX imposes are to middle-class American investors looking to build wealth in their investment portfolios. This is the primary reason the law should be overhauled.

In the early 1990s, then-small firms such as Starbucks and Cisco Systems were able to get capital from the public to grow, and middle-class investors grew wealthy with them.

Before SOX, 80 percent of the firms going public had IPOs of less than $50 million, which included Starbucks and Cisco Systems and, as Professor Brown mentioned, Amazon, which was $48 million.

However, a few years after SOX, 80 percent of firms went public with IPOs greater than $50 million. This is a big change for small and mid-sized public companies, which now face additional hurdles when raising capital. However, it is middle-class investors who have been most harmed by being almost totally shut out of this early stage of growth of America's fastest growing companies.

Instead, these financial opportunities are being snapped up by the accredited investor class that has the freedom to buy shares in companies that aren't weighed down with much of SOX and other mandates.

Directly fingering SOX, President Obama's Council on Jobs and Competitiveness observed that well-intentioned regulations aimed at protecting the public from 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.

SOX has also had adverse consequences on the lack of job creation. As President Obama's Jobs Council and others have noted, 90 percent of a public company's job creation occurs after it goes public.

This is important in comparing the public equities markets before and after SOX because when you look at those, the first thing that is apparent is that despite a recent uptick in IPOs, there are far fewer public companies today.

In 2001, the year before SOX became law, there were more than 5,100 companies listed on exchanges such as NASDAQ and the New York Stock Exchange. By 2015, there were just 3,700.

This is a purely American phenomenon because from 1996 to 2012, non-U.S. stock listings rose 28 percent, according to the National Bureau of Economic Research.

The good news is that with the Jumpstart Our Business Startups Act (JOBS Act), Members of Congress from both parties have realized that smaller public companies should not be subject to all of the mandates of Fortune 500 companies.

However, there is much more to be done, and I urge Congress to pass bipartisan initiatives to allow middle-class investors to build wealth by expanding exemptions for investment crowdfunding and creating ways for non-wealthy Americans to qualify as credited investors.

And I would also urge Congress and the SEC to narrow the definition of internal controls to processes that have been proven to prevent fraud.

Thank you, again, for inviting me to testify, and I look forward to any questions you may have.

[The prepared statement of Mr. Berlau can be found on page 54 of the appendix.]

Chairman HUIZENGA. Thank you very much. I appreciate that. And with that, I will recognize myself for 5 minutes for questions.

First, I want to start out by saying that I wholeheartedly understand and agree that the scandals leading into Sarbanes-Oxley required action.

And there is a lot of debate about the details of Sarbanes-Oxley both at the time when it was passed and now. But it seems like the time is ripe after 15 years to give it a thorough review.

One of the concerns I have is that companies are staying private or, interestingly enough, we are seeing them reverting back to being private after they had been public.

And I think ultimately the question is, why is this important? And it is not for the board of directors. It is not for the corporate management that we need to asking this.

But I think, as Mr. Berlau just pointed out, and it is such a great phrase that I wrote it down, the "accredited investor class," not Mr. and Mrs. IRA, have caught most of the uptick in the stock market recently. Why? Because we are having such a limited number of these companies going to public ownership.

And that leads many of us to be saying, look, Wall Street is doing just fine—no offense Mr. Farley; I know you facilitate that, and it is needed—but this is why Main Street is struggling.

And if we don't have that focus, as Mr. Berlau was just pointing out, that focus on that low, moderate, hardworking taxpayer who is trying to save up, to put kids through college, and get themselves retired, and to catch a little bit of that upswing, if we are not even giving them that opportunity, we have a duty and an obligation to remove those barriers or lower those barriers.

And I think that is certainly the motivation of why we are doing this and one of the reasons why I think we can be successful, because I anticipate that we have great commonality in that.

Now, Mr. Farley, in your testimony, you mentioned that over the last 15 years, compliance and administrative costs have adversely affected those IPOs.

So what specifically—you had started your three points on mission creep of regulators and the level of the playing field. Small and mid-sized companies need to be the focus and maybe those EGCs, so would you care to expand on that for a moment? And then I want to move onto another question.

Mr. FARLEY. Can you restate the question? I'm sorry, Mr. Chairman.

Chairman HUIZENGA. Sure. Just, what specifically can Congress do as we are looking at these compliance costs and administrative costs for these public companies for which we—it is $2.5 million, according to the SEC, to become public, and $1.5 million a year to remain public.

Mr. FARLEY. And just quickly, I wholeheartedly agree with your comments about accredited investors. Again, I go back to, I live in New York City in the Village, but I always spend time here in P.G. County.

There are a lot of accredited investors that I meet up in Manhattan. I have yet to meet one in Prince George's County who has benefited from explosive growth of a private company.

What can Congress do? Just to reiterate what I said, but hopefully do it quicker, with respect to Sarbanes-Oxley, eliminate the requirement that an auditor attest to the internal controls. That is very costly, and that is something that could potentially scare a private company off from going public.

In addition, narrow the definition of internal controls, or at a minimum have a review of that periodically to make sure it is not expanding.

And also, similarly related, make certain that the PCAOB, with their annual or every other year pronouncements, are not expanding the scope of Sarbanes-Oxley.

I would finish by saying that with respect to small companies, there are actually two things to consider: the JOBS Act works quite well; and the Emerging Growth Company (EGC) onramp that was provided is very helpful. Let's expand that. Let's not have it end at 5 years. Let's have it exist for all small companies that are public.

Chairman HUIZENGA. Okay. I have just a moment here, and I want to move on quickly, maybe questioning the motivations of why we are wanting to refocus the SEC. And, as I said in my opening statement, disclosure rules such as conflict minerals and pay ratios have embodied sort of these special interest groups, what they want to see in these corporate disclosures from political spending and climate change and child labor, human trafficking—all important issues.

But even Chair Mary Jo White sat here and said, "That is not their strength. That is not their sweet spot." In fact, in 2014 the SEC, in a letter response from myself and Mr. Hensarling and Mr. Garrett at the time, said, "Since 2011, the SEC staffers have spent 7,196 hours at the cost of $1.1 million solely to write the pay ratio rule."

That's 7,000 hours that could have been put towards a secure market, that could have been put towards making sure that we have the investors protected. And to me, and very quickly, do any of these provisions really provide any material information to investors? That is what I want to know.

Mr. Berlau, Mr. Quaadman, Mr. Farley, very quickly, and then I will expend my time.

Mr. BERLAU. Yes, Mr. Chairman. I don't think the internal controls, which is the costliest one that I have looked at—the problem is internal controls can be defined broadly.

But even a set of—in one case, a set of office, who has the office keys can be determined as having the internal control. So I don't really think this is necessarily the kind of information that investors want to know.

Chairman HUIZENGA. Mr. Quaadman?

Mr. QUAADMAN. Yes. To the disclosures you were talking about, they don't provide material information for investors. They actually cause problems within the boardroom.

Just one example, pay ratio. The City of Portland has now passed a tax based on the pay ratio disclosure. So they are now going to tax that pay ratio. And that proposal is beginning to follow around the soda tax. So I think it also shows how those disclosures can be used in harmful ways as well.

Chairman HUIZENGA. And Mr. Farley, quickly?

Mr. FARLEY. The sad reality is that as we expand disclosures dramatically, it actually makes them less approachable for the everyday investor. In fact, you referred to a 20-year period, Chairman Huizenga, where the number of public companies went down by half. The median word count of the average disclosure doubled during that period, and there have been studies that show they are less understandable than they ever have been.

Chairman HUIZENGA. I am well over my time. I appreciate that, and thank you for the indulgence.

With that, the Chair recognizes the ranking member of the full Financial Services Committee, Ms. Waters of California, for 5 minutes.

Ms. WATERS. Thank you very much. I appreciate this discussion. And Professor Brown, I heard you loudly and clearly when you basically agreed with Ken Bertsch, the executive director of the Council of Institutional Investors, who wrote, "The number of U.S. IPOs has little to do with overregulation, and the U.S. capital market for emerging companies is vibrant.” But thank you for your comments on that subject.

But I really want to talk about activist investors. Republicans continuously claim that special interest groups and activist investors are abusing the SEC shareholder proposal rules to advance their own goals at the expense of the company and its management.

However, it is my understanding that shareholder proposals may serve an advisory role and are mostly successful at encouraging dialogue between shareholders and management. Is that your understanding as well, and do you believe that proposals can have a significant, positive impact on companies?

Mr. BROWN. Thank you for that question. I know I spoke loudly. I come from a family of 7 kids, and if you didn’t speak loudly, you weren’t heard. So I may overdo that sometimes.

The discussion in here about what information is important to shareholders, I can tell you one way to figure that out: Look at what shareholders are voting for. When you look at these shareholder proposals, an enormous number of them in the governance area get majority support from shareholders.

And when you look at the ones on environmental proposals, I think as I mentioned in my remarks, two of them got majority support at Exxon and Occidental. That is no small feat. So what these votes are telling you is shareholders want this information.

We can debate in here how important we feel it is, but these returns that are coming in on these shareholder proposals are telling you what shareholders want.

And more and more of these social policy kind of proposals, they are averaging around 30 percent. So it is not a majority on average, but that is a lot of shareholders who still want it.

And then I would just add finally, that these proposals are almost always advisory. They are not commands. They don’t tell the board, you must do something. They just say, here is our opinion on this issue, and they leave it to the board to decide what to do with that information. They are providing the board with information. And I think as a fiduciary, as a director, that is information that you want to hear.

Ms. WATERS. Thank you very much. And as you stated in your testimony for this hearing, ensuring investor confidence in the accuracy of financial statements was a critical component of SOX. Can you describe some of the most significant factors affecting the reliability of financial statements prior to the Sarbanes-Oxley Act?

Mr. BROWN. I think that SOX did a remarkable job in restoring faith in financial statements. And they did it through strengthening gatekeepers. They did it through creating a regulator which, by the way, was very creative.

It was a nonprofit corporation. It wasn’t a typical bureaucracy. I think they did it by encouraging officers to want to have more accurate information by having to certify the financial statements. So, SOX took a lot of steps.

But I also want to emphasize improvement in internal controls. This is the backbone of financial statements. If you can’t have controls in place to make sure you are recording your transactions properly, you are not going to have accurate financial statements.

If you take an auditor at the Big Four down to the Monacle for a couple of drinks and you ask them, what do you think about this whole review of the internal controls? Some of them might admit that the review of the internal controls can be more important than the audit itself in making sure that the financial statements are accurate.

Ms. WATERS. Thank you very much. I yield back.

Chairman HUIZENGA. The gentlelady yields back.

With that, the Chair recognizes the vice chairman of the subcommittee, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thanks, Mr. Chairman. And thank you all so much for being here. I appreciate your testimony, Mr. Quaadman. It's good to see you again. I appreciate you being here, and I appreciate you testifying today.

I would like to hear a little bit more from you about the damaging effects of SEC's Rule 14a-8 and the Chamber's renewed effort to bring about some reform that will allow public companies to focus on material disclosures.

The Chamber just submitted a petition for rulemaking regarding resubmission of shareholder proposals failing to elicit meaningful shareholder support back in 2014, but it was never taken up under the prior leadership of the SEC.

Section 844 of the Financial CHOICE Act proposes a number of meaningful reforms. Your testimony, I think it was on Page 9, mentions that the Chamber will soon release a set of proposals to reform SEC Rule 14a-8, and I am certainly looking forward to reviewing those.

I wonder if we could get a sneak preview of those recommendations? This subcommittee has heard some important ideas for reform, such as revisiting the resubmission thresholds, with which I definitely agree. So I am eager to hear what else we can do.

Mr. QUAADMAN. Sure. So number one, just with the resubmission threshold issue for a second, we have a very small number of what are known as gadfly investors, five or six individuals who literally submit hundreds of proposals over a period of time. And that has frustrated the rights of the majority.

So if you are getting proposals that are getting very low support, it costs the company investors time and money. So the proposal that we have actually set forth there is actually based off of Chairman Arthur Levitt's proposal from the Clinton Administration SEC on how to deal with those issues.

The other issue, too, in terms of 14a-8 reforms, Chair White, a few years ago, in what is known as the Whole Foods decision, basically abdicated the role of the SEC to be the gatekeeper, the umpire, as to what proposals should go forward or not. And this was after a long period of time where the SEC staff was allowing more and more political disclosures to come through.

I think 30 percent is different than 70 percent. If 70 percent or 80 percent or 90 percent of shareholders don't want to have something disclosed, that means they don't want to have it disclosed. And if they don't want to have repetitive proposals going forth, this is something that needs to be addressed.

So this is one of the issues that I raised in my opening statement as to the cost and burden that go along with that, which shareholders don't want.

Mr. HULTGREN. Yes. On a similar note, Mr. Quaadman, on page 80 your testimony mentions the importance of the SEC, the PCAOB and the FASB agreeing to a common definition of "materiality" in financial reporting. I wondered if you could please explain the importance for establishing a common definition? And do you have any specific recommendations for how the committee can facilitate this work?

Mr. QUAADMAN. Yes. The Cox Commission back in 2008 had actually issued a set of very far-reaching reforms as to financial reporting. They were never acted on because of the financial crisis.

One of the proposals that was at the center of that is that the SEC, the FASB, and the PCAOB have differing definitions of "materiality," which actually leads to standard setting that doesn't necessarily match up. If you take a look at some of the recent PCAOB standards that they have done, the differences there between them and FASB have not made for good enforcement.

So FASB, to its credit, has actually put out a proposal to have a definition of "materiality" that matches up with the Supreme Court definition in *TSC Northway*. And they have come under attack by special interest investors because they would rather have as much disclosure as possible.

But when you talk to FASB, they will tell you if you go in and talk to, let's say an insurance company, an insurance company is not going to need an accounting standard around or a disclosure around inventory because they don't sell inventory. That is something that you are going to look at Macy's for.

So I think to get all three entities on the same page is actually something that is going to help investors in the long run.

Mr. HULTGREN. Great, thank you.

Quickly, Mr. Berlau, thanks for being here as well. Your testimony recommends that Congress narrow the SOX definition of internal controls to processes that have proven their effectiveness in preventing fraud.

In an effort to establish some goal posts, I wonder if you could provide some examples of currently established processes of internal controls that are not effective?

Mr. BERLAU. There was the Wall Street Journal report of the auditor requiring the company to document who has the office keys. The problem is Sarbanes-Oxley didn't define internal controls, and then the PCAOB has its own very broad definition.

And so the SEC should exercise that authority over the PCAOB that it has, but Congress should act, too, to actually ensure that this doesn't waste companies' and shareholders' time. And I can get back to you on the—

Mr. HULTGREN. Great. We will follow up if that is okay? My time has expired. Thank you all very much for being here. We appreciate it.

Chairman HUIZENGA. The gentleman's time has expired.

The ranking member of the subcommittee, the gentlelady from New York, Mrs. Maloney, is recognized for 5 minutes.

Mrs. MALONEY. Thank you Mr. Chairman.

Professor Brown, I would like to ask you about the decline in the number of IPOs in the U.S. in recent history. Some people have claimed that companies are not going public anymore because regulations have made it too onerous for public companies.

Yet, as you know, 74 percent of the decline in U.S. public companies from its 1996 peak occurred prior to 2003 and the passage of Sarbanes-Oxley. And the total number of U.S.-listed companies has stabilized since the 2008 crisis, ranging between 4,100 to 4,400, while the number of foreign companies listed and listing in the U.S. has increased.

Isn't it true that the JOBS Act actually encouraged companies to stay private longer? In the JOBS Act we increased the threshold when companies became subject to SEC regulation from 500 shareholders to 2,000, which clearly makes it easier for companies to stay private longer.

And we made it easier for private companies to sell securities to sophisticated investors, which allows them to raise capital without going public, plus the availability of capital, the low interest rates have all contributed. So isn't some of this decline in the number of IPOs an intended consequence of the JOBS Act?

Mr. BROWN. Thank you, Congresswoman Maloney. I don't think that there is any question that part of the explanation for the number of public companies is the vibrancy of the private markets. There is a lot of capital sloshing around in the private markets.

I also don't think that there is any question that one of the reasons that the private markets are so active is because of regulatory change. I think there have been a lot of things that have facilitated activity in the private markets.

You point to a couple of them in the JOBS Act. We just heard earlier in testimony why accredited investors are getting these deals and ordinary investors are not. Well, one of the things the JOBS Act did was permit general solicitations to accredited investors. They facilitated that dynamic to take place. So I agree with that.

I also think that some of the concern over the public markets was because in 2016, we had a particularly low number of public offerings.

But in the first 6 months of 2017, we have already had more public offerings and raised more capital than all of 2016. So I think we have to also be careful in looking at our data points in sort of assessing how these markets are doing, relatively speaking.

Mrs. MALONEY. Okay. And I would now like to ask Tom Farley, president of the New York Stock Exchange—thank you for keeping the name—you noted in your testimony that you were concerned about the decline in the IPOs. And what are the public policy benefits of having more companies go public rather than staying private?

Mr. FARLEY. Sure, thank you. The public policy benefits are primarily twofold, Congresswoman. First, I give you the example of my father. Defined benefit pension plans, which, by the way, is the way the world is going generally, are going away. And so someone like my father and the millions and millions like him cannot invest in Airbnb in the private market in any meaningful way, but he can invest in a company that goes public like Under Armour in 2005. The very wealthy, they can invest in Airbnb.

That, to me, is a societal issue, number one. Number two, public companies create more jobs. Anywhere from 75 to 90 percent of all jobs created by public companies, depending on the time period you look at, are created after the point they go public.

And perhaps more importantly, the inflection point of job creation lifts off when they are a public company. But those are the tangible reasons why it is a public policy good.

There is also the psychological element, which is the aggregate market cap is going up. The number of companies is going down. That says that only big companies find it easy to be a public company, and there is an issue with small to mid-sized companies.

To have a really great free enterprise system, we want it to work for all companies. We want it to work for big companies, small companies, the real estate brokerage in Manhattan or the hair braider in Harlem.

Mrs. MALONEY. Okay. Very quickly, Professor Brown, as you know, companies frequently complain about Section 404(b) of Sarbanes-Oxley, which requires auditors to attest that companies have effective financial controls in place. What is your assessment of how effective 404(b) has been?

Mr. BROWN. I think that Section 404(b) and attestation is critical. I think that it better ensures the accuracy of financial statements. And I think accurate financial statements benefit investors. They can make better decisions. Maybe they will pay a higher price for shares because they are less concerned about financial risk or the risk that the financial statements are false.

It benefits officers because they make better decisions when they understand the finances of their own company and the accuracy of their own records. And it benefits independent directors, who have a fiduciary duty to know how the company is doing.

And I would just add with independent directors, it is not easy for them to go to their own company and say, hey, can you get this attestation done, because it looks like they don't trust their officers. It is better to just have that be a requirement so that the independent directors know this step is being taken and they can be more certain of the accuracy of their financial statements.

Mrs. MALONEY. Mr. Quaadman, very quickly, what are your thoughts on Section 404(b)?

Mr. QUAADMAN. So 404(b) I think, one, you need internal controls for businesses to grow from small to large, but two things. One is for smaller companies, those costs need to be scalable, but number two, and there has been an ongoing issue with existing public companies where their internal control costs over the last several years, particularly amongst middle-market companies, has gone up by over 300 percent.

This is partially because the PCAOB forgets that "public company" are the first two words in its name, and they don't bring in the public companies to talk about what critical audit issues are. And that has led to a breakdown as to what a balanced system should be.

When Jim Schnurr was the Chief Accountant at the SEC, we opened up a dialogue with him, and with Chair Doty, to try and address these issues, and we did to some degree, but we are going to continue to do so. And we are actually, later this year, going to issue a proposal with some ideas as to how to actually address those issues.

Mrs. MALONEY. That would be very helpful. My time has expired, thank you.

Chairman HUIZENGA. The Chair recognizes the chairman of our Housing and Insurance Subcommittee, Mr. Duffy, for 5 minutes.

Mr. DUFFY. Thank you, Mr. Chairman, and I want to welcome the panel. Thank you all for being here today. For many of you, I want to thank you for the kind comments you have made on our corporate Governance Reform and Transparency Act.

As many of you know, we introduced this in the last Congress. Congressman Carney, now Governor Carney, and I worked closely together on this proposal. We had wide bipartisan support from across the aisle. This language is now included in the CHOICE Act. We hope that we will get good movement not just here in the House but also in the Senate.

But I want to drill down a little bit with our panel and just, again, I want to hear Mr. Farley and Mr. Blake, any concerns that you have about the transparency, the competition, and the accountability of our—basically there are two proxy advisory firms that now operate today.

And Mr. Quaadman, too, if you want to jump in?

Mr. QUAADMAN. Sure. There is not a lot of transparency. Let me just put it that way.

Mr. DUFFY. So there is not a lot of transparency?

Mr. QUAADMAN. Yes. Glass Lewis is a black box. And while there is some ability to, let's say, engage with ISS, that has actually been a problem as well. So I think we need to look at it in two ways.

One is, and I think this is what your bill drives at and what the SEC tried to do a little bit with their 2014 guidance, is there needs to be a process for how those firms actually develop their recommendations. And those recommendations need to be linked back to the fiduciary duty and economic return of their clients.

I think there are also additional problems that your bill addresses as well is the conflicts of interest of both of those firms was each of those firms have different conflicts of interest. ISS was going in the consulting business, Glass Lewis being owned by an activist investor.

So I think oversight is important and I think it is a way to actually bring some rationality into proxy advice.

Mr. FARLEY. I would just highlight that this, too, is a small company versus large company issue. We recently had about 25 listed companies gather at the New York Stock Exchange to talk about issues that were giving them difficulty, and this was one of them we discussed.

And what we learned is that it is much more painful for the small companies because, for example, the proxy advisory firms will have this opaque process. They will come up with an opinion, and they will publish it at times without consulting the company or notifying them of what their process is or what their results are.

And it will be published with some errors. We are all human. We all make errors from time to time. But because they haven't run it by the company that is now out in the market, and it is very difficult for a small company without a public relations machine to be able to correct that information.

And so that is why we are advocating for more transparency in terms of the processes of those proxy advisory firms, as well as more collaboration from them with those companies that they are opining on.

Mr. DUFFY. Mr. Blake?

Mr. BLAKE. Thank you, Mr. Duffy. I appreciate the work you are doing in this area. I have to echo Mr. Quaadman and Mr. Farley's comments. It really is an issue with the smaller issuers, especially around the transparency and the engagement that they have with the smaller issuers.

Their methodologies tend not to be published and we have to go through a process to discover what the methodologies are in order to comply with them. And the resourcing, which I think your bill addresses for the proxy advisory firms to engage with the smaller issuers is very important.

We want to be able to engage in a dialogue and at least explain our side of the story in terms of what our governance policies are and our executive compensation policies are.

Mr. DUFFY. But if you look at these two main proxy advisory firms, and we look back in 1987, institutional investors had 46 percent of our market. Now they have grown to 75 percent of the market. What role do proxy advisory firms have on corporate governance? It is substantial, isn't it?

Mr. QUAADMAN. Yes.

Mr. DUFFY. And then, do they have the best interests of shareholders in mind? And does their one-size-fits-all benefit shareholders or negatively impact shareholders?

Mr. QUAADMAN. Let me actually give you one example with that. With the passage of Dodd-Frank and through a lot of work of members of this committee, there is a provision in there on say-on-pay votes where investors and shareholders are supposed to determine the frequency of those votes, 1, 2, or 3 years.

And what had happened, of course, for a proxy advisory firm, is if you have an annual vote there is a pecuniary interest in doing that. So of course the advisory firms immediately came out and said, no, there needs to be an annual vote. And of course that is exactly where it all then went.

So shareholders were disenfranchised, Congress' intent was overruled, and the advisory firms profited from that.

Mr. DUFFY. That is right. So they made a recommendation that helped their bottom line but wasn't in the interest of the shareholders—

Mr. QUAADMAN. Correct.

Mr. DUFFY. —per your example. We get a lot of stories that come our way, but stories from one specific proxy advisory firm, ISS, we got one that came in that said, we heard this is the ISS calling one of the companies. We heard you had a negative recommendation.

And this, by the way, the recommendation isn't even out yet. We heard you have a negative recommendation. Oh, by the way, do you want to buy our consulting services?

And there is supposed to be a firewall between the two divisions, but when their recommendation isn't even out yet and here the offer is coming in to buy our services, that gives us some concern. That is like Vinny saying, "Oh, I heard you were robbed last night. Do you want our protection services?"

It is outrageous and I think this is, per your testimony, ripe for reform. And I am getting tapped down right now, but I look forward to any other input you might have on how we could improve our product and get this across not just the House and the Senate, but improve corporate governance and the transparency and accountability of proxy advisors.

I yield back.

Chairman HUIZENGA. And yet somehow, the gentleman managed to get another 20 seconds. Okay.

[laughter]

With that, the Chair recognizes the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman. The Enron scandal broke right at the same time that I first entered Congress 15 years ago. And as I recall, there was just great fear and anxiety after Enron went down.

But right after that, the most startling thing happened: Arthur Andersen, a 100-year-old company, disappeared, collapsed overnight, which garnered great fear, and that was the move that Oxley dealt with, how can we quickly eliminate this fear and move to confidence? And that was done.

But Mr. Farley, I have just been listening back and forth on the 404 situation, and I tend to think that you basically agree with me that Sarbanes-Oxley institutionalized transparency in financial reporting and boosted confidence in the public markets, which reduced that fear.

Yet, in your testimony you highlight that Section 404 has a specific example of one part of Sarbanes-Oxley that has disproportionately impacted small and mid-sized companies.

So there is some air in the middle of this because it is my understanding that Section 404 requires issuers to publicly publish the scope, the adequacy, and the truth of their internal control structure and procedures for financial reporting.

It just seems to me that Section 404 is vital to instilling that confidence, to reducing that fear and transparency in our markets and getting that confidence back. To me, Section 404 seems pretty important and perhaps the premier piece of Sarbanes-Oxley that will prevent another Enron or Arthur Andersen.

So I value your insight on this and could you address that error that is in there? It seems to me that on the one hand, you are saying positives about Section 404, but you come and show some weaknesses as far as the small and mid-sized firm. Would you clarify that?

Mr. FARLEY. Yes, and as usual, Congressman, I think there is probably more agreement on this issue between you and I than disagreement. It is a tricky one.

And what I mean by that is you are right. There were tremendous scandals that did undermine investor confidence. And they were really lousy. It was Enron, WorldCom, and there were repercussions for those scandals. People went to jail in both cases.

In fact, there was a very tragic suicide that came about as a result of that. So there were consequences, but yet those consequences don't solve that investor confidence issue. That really dented investor confidence.

So the idea of, let's put in place Sarbanes-Oxley to inspire investor confidence, that made sense at the time and it was 98 to 0. But as Chairman Huizenga said, you always want to go back and you want to—in the Senate it was 98–0—you want to go back and you want to look at these things from time to time and do you want to say did they work?

And that is where I am suggesting to you and your colleagues that there are some issues. The New York Stock Exchange is not advocating we abolish Sarbanes-Oxley, nor is it advocating we abolish Sarbanes-Oxley 404.

Mr. SCOTT. I don't want to lose my time here.

Mr. FARLEY. Yes.

Mr. SCOTT. Give me some examples of where it hurts the small and mid-sized firms?

Mr. FARLEY. Sure. I had breakfast last week—I don't think he would mind my sharing this anecdote, but this happens all the time, Congressman; I could give you a list of them—with the CEO of Shake Shack, Randy Garutti. And I said, "How is it going?" And he said, "It is okay, but I spend a lot of my time staying in compliance with Sarbanes-Oxley 404 a lot more than I otherwise would have thought."

And he said, "Look, we are a small company. You think of us as a big company with a big brand, over $350 million in revenue, which makes us a small public company. And having to implement 404, put the internal controls in place, verify that they work and have them attested to by an accounting firm is difficult for us."

Actually, the last part he didn't go through all those specific instances, but he said complying with it and complying with all the applicable regulations are very difficult. Those sort of conversations I have over and over again, which is why we focused on small to mid-sized businesses in our testimony.

Mr. SCOTT. Do you advocate taking some kind of legislative action to Sarbanes-Oxley to address the concerns of these small businesses?

Mr. FARLEY. We do, in two ways. One, we are recommending that we eliminate the auditor attestation requirement for all companies. And in the absence of that for small companies, we are advocating that we extend the EGC benefits that exist today for all, without an arbitrary 5-year time duration.

Mr. SCOTT. Thank you.

And thank you, Mr. Chairman, for that extra 40 seconds. Thank you.

Chairman HUIZENGA. I am paying for my earlier sins, yes, of allowing myself to go long.

But with that, I recognize the chairwoman of our Oversight and Investigations Subcommittee, Mrs. Wagner from Missouri, for 5 minutes.

Mrs. WAGNER. Thank you, Mr. Chairman, and I thank you all for appearing today to discuss issues that affect the cost of being a public company, particularly around corporate governance issues and the growing trend of special interests using the Federal securities laws to advance their own agendas.

This has increasingly led, as we have heard outlined by most of our witnesses, more time and resources having to be directed toward dealing with these issues which typically have nothing to do with long-term shareholder value.

As a result, small businesses that are considering going public increasingly are being deterred, as Mr. Farley has spoken about, due to the unfavorable corporate governance climate.

Mr. Quaadman, why do you believe, just as a 30,000-foot argument here, these special interests have been able to become more active in the corporate governance space?

Mr. QUAADMAN. Part of it is, and this is the conversation we were having with Mr. Hultgren earlier, that the SEC to some degree has allowed it. So when they have stopped being that umpire in terms of shareholder proposals where they have allowed more of these issues to come in, that has allowed these things to seep through.

I also think, as I said in my testimony, Sarbanes-Oxley sort of kicked the door open, but then Dodd-Frank rushed through. So we started to see a lot of disclosures and a lot of issues start to come in.

And I think we are at the cusp now where ESG issues, so environmental, social, and governance, are now beginning to pick up steam and there have been some efforts, particularly from Europe, to try and bring that over here. But I think we need to be very, very careful with it because those issues are in the eye of the beholder and very often investors just don't want them in the boardroom.

Mrs. WAGNER. The SEC and Congress have recently turned to the disclosure system to address social, political, and environmental issues that are irrelevant to reasonable investors' investment in proxy-voting decisions, and while important on some level, are more efficiently, and I think effectively, addressed through other means.

As a result, investors today receive voluminous, complex information that is often immaterial to their investment or voting decisions. Could you please elaborate, Mr. Quaadman?

Mr. QUAADMAN. You have to take a look at, there are various cottage industries that are beginning to form up around ESG. I took a look at one report from one group and they had two different disclosures from similar companies: one that dealt with the reduction in fuel costs; and then another dealing with a reduction of CO2.

So they said, the first company that was talking about reduction in fuel costs really should have a different type of disclosure. But the thing is that first disclosure dealt with the bottom line, which is what investors care about.

And that is, I think, where we are getting away from the fact that those are the issues that a long-term investor cares about.

Mrs. WAGNER. And let's turn to materiality. What is the current definition of "materiality" used by the SEC to determine what should or should not be disclosed to an issuer?

Mr. QUAADMAN. You need to go to Justice Thurgood Marshall's decision in *TSC Northway* where what he basically said that you need to take the total mix of information that will allow for a reasonable investor to make a decision.

And then he goes on to say it is not everything. It is just what is a reasonable amount of information to do that.

Mrs. WAGNER. Should it be changed or updated?

Mr. QUAADMAN. No, it should not, because that is what investors have hung their hat on for decades.

Mrs. WAGNER. If the definition of "materiality" were to be expanded, say to require disclosures of information that might be important to any investors, what would be the practical impact or what are we saying is the practical impact?

Mr. QUAADMAN. You can take it through its logical extension that you would want to know what the trade secrets are of Apple for their new iPhone 8, which of course is ludicrous, because then how is Apple ever going to be able to make any money off of that? And there is a group of people, particularly within the the investor advisory committee in the SEC, who are trying to push for a fraud definition of "materiality" which would overturn *Northway* and effectively everything that is disclosable at that point.

Mrs. WAGNER. And does expanding the scope better protect investors?

Mr. QUAADMAN. No. No, it actually will drive investors—

Mrs. WAGNER. Well, why not?

Mr. QUAADMAN. It will drive investors and companies out of the public markets into the private markets. I think we have to take a look at while stock buybacks have been a cause celebre for some—

Mrs. WAGNER. Yes.

Mr. QUAADMAN. —it is a massive reallocation of capital away from the public company markets. We have disadvantaged one part of our capital market system for the sake of the other. And we need to have balance there.

Mrs. WAGNER. I agree. Thank you, Mr. Quaadman, very much. Mr. Chairman, I yield back.

Chairman HUIZENGA. The gentlelady yields back.

The Chair recognizes the gentleman from Massachusetts, Mr. Lynch, for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

I want to thank the witnesses again for helping us with this issue, and thank you, Mr. Chairman, for holding this hearing.

Professor Brown, so let's go back. We have the Enron situation and WorldCom, Tyco International another one, instances where especially with Enron, Arthur Andersen was actually in collusion with Enron.

That is why they went out of business. So they were hiding a lot and conducting some fraudulent practices there where investors were not able to understand truly what the financial underpinnings for that company was.

And remember at the time we had just gone through energy industry deregulation and so Enron took advantage of all that deregulation and perpetrated a huge fraud, billions of dollars in fraud against the American investors. So that is why we have what we have now.

Now, I understand the costs, especially for my smaller and midsized companies is excessive. How do we strike that balance where we want to maintain the integrity and the reliability of the financial information that we get from these companies? We want to make sure that they are being honest with us and accurate. Yet, we don't want to pummel them and cause them to have these huge massive costs.

I am encouraged that I see some—there are a couple of firms out there now that have cloud-based, Internet-based accounting systems that help you with compliance.

I think that DNA Technologies, which is a private company, they don't even have to comply, but they have adopted some of this cloud-based technology to make it a little bit less expensive.

How do we strike that balance where we get the information that we need to make prudent investment decisions and yet try not to overwhelm, as Mr. Quaadman has said, these growing companies and give them some air to breathe? How do we strike that balance?

Mr. BROWN. It is a fair question. And, of course, we can see these costs. They are real. It is harder to see the benefits. They are a little bit more broad-based so it is sort of hard to analyze this.

I talked to an auditor who audits smaller companies, and what he told me was—he said because of the $75 million break where when you go above it you have to do the attestation and below it you don't. He said that when we have these smaller clients we lose them at $75 million because they look at us and they say, well, you don't know how to do the attestation. I have to get a bigger firm.

Mr. LYNCH. Yes.

Mr. BROWN. So, sometimes we put in regulatory reforms and that actually increases the cost. If they could stay with their small auditor, maybe the cost structure for the attestation by that small auditor would be cheaper because there would be more competition in the marketplace.

Mr. LYNCH. What about the frequency of compliance? I know in some other areas, rather than have people file yearly, we allow them to file every 18 months. And their financial situation does not necessarily change that drastically over an 18-month period.

Can we look at changing the interim between filing requirements to maybe reduce by a third what the cost might be to a company? Although I don't want to get away from the attestation piece where the auditor has to actually come in and say, okay, this was done properly.

I think if we lose that—there is not enough accountability in the system as it is. Nobody goes to jail, nobody admits wrongdoing; there are massive payoffs and fines, but nobody admits wrongdoing. You really do need accountability. Is there a way that we can reduce the cost by spreading out the period of compliance filings?

Mr. BROWN. I will say also, kind of consistent with what you just said, human nature. If you are inside a company and you are responsible for internal controls, and you know somebody from the outside is going to come in and look at them, you are going to do a better job.

Mr. LYNCH. Yes.

Mr. BROWN. So there is this effect, this broad-based effect from the notion that the third parties are coming in. I think it is a risky thing to start reducing the frequency of disclosure. I think that is something that for investors, will potentially make them less interested in these smaller companies. And we don't want to create that dynamic either.

Mr. LYNCH. Yes, well, just I want to put this out there. I am willing to work with my colleagues across the aisle to try to figure out a way to reduce costs, and with our panelists I know we get differing opinions. I would like to maintain the integrity of our markets and the information that the public gets regarding these companies.

Thank you, Mr. Chairman, for your indulgence, and I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

The gentleman from Arkansas, Mr. Hill, is recognized for 5 minutes.

Mr. HILL. Thank you, Mr. Chairman. I appreciate the panel being here today.

I had a really fun event yesterday. I was up at the opening of the NASDAQ with a mid-cap company from my home district that was celebrating 20 years in the public markets. And they went public back in 1997. I think the market cap was in the $50 million range or so, something that many companies wouldn't do today.

They wouldn't be able to absorb the kind of IPO costs of $2 million or $2.5 million or more and then the annual ongoing costs that are sort of the regulatory regime that we have today if they are not a unicorn-type company that has really low traditional maybe corporate administrative costs, and so going public is really a capital raising-only activity. I appreciated Professor Brown's comment about Amazon in that regard in terms of the last 20 years.

But for a normal business, and certainly a community bank would be considered sort of a normal cost basis business, I am not sure it would be as good.

On SOX, having been an independent director under SOX in a public company and looking at it, to me I like the independent director aspects of it. Professor Brown, I liked the financial reporting.

I don't mind the attestation. I would tell everybody that is still redundant. We all attested to the financial statements as public company officers before we had to sign yet again another page to that effect.

And I love the attitude of, let's have more saber-toothed tigers on our compensation committees—I think that is great—instead of college roommates. I think that would be wonderful, but I don't think you can get that done through statute very effectively.

So, a couple of questions that struck me probably following up on my friend, Mr. Lynch. Mr. Berlau, if you would talk a little bit about your views on 404 from the standpoint of, is there a way under AICPA rules or through peek-a-boo that we could tailor 404 rules?

We talk a lot in this committee about tailoring of bank regulations between community banks and the G-SIFI giant Wall Street global banks. So instead of, like, changing reporting dates could we just have the peek-a-boo direct auditing standards change between scope on companies? What are your views on that?

Mr. BERLAU. Yes. I think there are several things that can be done. And it is kind of ironic that it was accounting scandals that prompted SOX, and yet it has been also been called the "accountant's full employment act," because of all the work it creates for them.

The word is, as you pointed out, attestation that is actually in the law Sarbanes-Oxley in Section 404. The PCAOB has—Public Company Accounting Oversight Board—has interpreted that to mean a full-blown audit and has a very broad definition of the term "internal control."

So I think there are things Congress can do to narrow that definition. I think the SEC should exercise the oversight that the Supreme Court gave it in *Free Enterprise Fund* v. *PCAOB,* to have it narrow the definition and also to say an attestation does not necessarily mean a full-blown audit—

Mr. HILL. Yes.

Mr. BERLAU. —like you audit the numbers.

Mr. HILL. I think that kind of scoping would be good and sort of a common-sense approach. I know in the JOBS Act, and in subsequent bills here, we have supported raising the market cap that it is even applicable for. And I am not opposed to those ideas, but maybe a longer-term solution is that kind of scoping where either through the auditing standards or, as you say, through the level of attestation that we are requiring a public accounting firm to put their name on, which means then they are going to do an audit, which in fact means you are double auditing companies.

Another suggestion, maybe Mr. Quaadman on this, what about the idea that once I have 3 years of attestation on 404 standards that maybe that attestation. I still self-certify, I still sign as an officer, but maybe that audit attestation is every other year or every 3 years, again, sort of like a bank exam scope?

Mr. QUAADMAN. Yes.

Mr. HILL. I think that is again where my friend Mr. Lynch was going with his line of questioning. What are your thoughts on that?

Mr. QUAADMAN. I think that is an important step forward. I think it is also important to remember that the audit profession has done a lot here, too. But if an auditor is inspected by the PCAOB and there is a problem with that audit, that partner's career is over.

Mr. HILL. Right. Right.

Mr. QUAADMAN. So I think we have to remember that as well.

Mr. HILL. Right. Thank you.

I yield back, Mr. Chairman.

Chairman HUIZENGA. The gentleman's time has expired.

The Chair recognizes the gentleman from Illinois, Dr. Foster, for 5 minutes.

Mr. FOSTER. Thank you. Thank you, Mr. Chairman, and to the committee and I want to say I am very impressed at the bipartisan thought that is going into this.

I am a proud co-sponsor of the Fostering Innovation Act—I think our side's co-sponsor is Kyrsten Sinema—but it is an example of really the sort of sensible tweaks that should be made, because this is, in the end, a matter of balance.

I would like to return for a second to the question of internal controls. We have heard arguments that these should be narrowed and things like keys to the business may or may not be worth pushing.

Though you have to think about the case of Coca-Cola. If they lose their magic formula and it gets posted on WikiLeaks, there could be a big hit, because they happen to maintain that.

Another area, related area, that maybe we could think about broadening and strengthening has to do with cyber security, insider threats. This is a huge deal. The market value of firms like Yahoo were just crushed because when it became public that a large fraction of their accountholders had been hacked, which hurts the market value of companies enormously.

Pharma startups are regularly under cyberattack suspected from the Chinese, by companies that are trying to steal their intellectual property which is often the only thing that they have that is worth anything.

And so I was wondering, particularly in the area of cybersecurity, if maybe internal controls, the definition of internal controls and the way they are audited should possibly be strengthened a little bit given the huge risk that makes to the actual valuations of companies? Does anyone have any comments on that?

Mr. BLAKE. I am happy to jump in here. Cybersecurity was an issue that we looked at in our last round of internal control testing in our company. And really, if you look at the pronouncements on internal controls it really allows for a risk-based application of how you evaluate your internal controls, and so that is where it really centers on what you identify as key controls.

Cybersecurity would fall under IT general controls in that framework. And for us as a small biotech company, our risks of cyberattack or releasing personal information are pretty limited. Even when we receive patient data, it is de-identified data. It does not have the patient's name or identifiable information.

So when we evaluated that risk we actually determined that it was very low, and that we didn't need to purchase cyber insurance, for example. So from a practical standpoint, when you look at the smaller issuers, it is important to look at what types of data that they are exposed to.

Mr. FOSTER. Any other comments on—

Mr. QUAADMAN. Sure, Mr. Foster, thank you. That is a great question. I think cyber is probably the most vexing and complicated issue the boards are dealing with. I think, along the lines of a year ago, and I think we need to have a dialogue between the PCAOB, COSO, the SEC, and the national security agencies and businesses on how to best address these issues.

Very often with cyber, if you take a look at the traditional norm with corporate governance issues, it is to disclose. However, there are other forms or other agencies in the government that sometimes don't want businesses to disclose.

So I think you are right to see if there is a way to maybe work to get proper internal controls in place, but then also to make sure that we have an appropriate regime that balances the need for the governance issues that we need to address, as well as the national security issues that we need to address as well.

Mr. FARLEY. I agree. It's a hugely important issue. I am glad you bring it up. We wouldn't be in favor of new federally-mandated internal controls. However, we do think there is an opportunity for Congress to be very helpful in just allowing for more information sharing between the agencies and companies and companies within the same industry. Thank you for bringing the issue up

Mr. FOSTER. All right, yes. I was just thinking if there was some—if you only have the attention to devote to the value of a company that the typical investor in a publicly held company would have, if there was just a simple standardized thing that they are not doing massively stupid and lazy stuff on cybersecurity.

I don't know how that would be just because, obviously one line of code can make the best—you can have all the best systems in place and then oh, but where we didn't do this particular update and the Heartbleed bug has made us completely vulnerable.

And so it is very hard to guarantee that you are never going to be vulnerable to this sort of stuff. And yet if you have a bunch of people running obsolete versions of Windows on their laptop, and these are your research scientists going home and completely making all of your core I.P. vulnerable to anyone on the Internet, it is a problem.

And I'm trying to understand, if there is at least a basic set of standards that could be used to judge compliance with internal controls. Anyway it is just—and so I wanted to bring it up.

Just one last question quickly, this decline in the number of publicly held companies, I was wondering if it has ever been studied whether high-net-worth people keep more of their money in privately held companies compared to middle-class investors, because what we are seeing here may simply be, my guess is that is very true, that very wealthy people put a lot more of their money through private equity venture capital and so on into nonpublic firms, and we might just be seeing a reflection of the fact the wealth is piling up at the top in this country. Is anyone aware, has that issue been studied and looked at quantitatively?

Mr. QUAADMAN. Not that I am aware of.

Mr. FOSTER. I urge you to have someone take a look at it.

Chairman HUIZENGA. It sounds like you have gotten a homework assignment.

The Chair recognizes the gentleman from Ohio, Mr. Stivers, for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman. I appreciate you having this important hearing and I appreciate all the witnesses being here.

And I have a couple of questions for Mr. Quaadman. First, under the JOBS Act and a few other changes that have happened, we have seen companies be able to stay in private hands longer and not go public, and if I am asking the wrong person this question, other people can chime in.

What impact does that allowing those companies to be in private hands longer have on the company's valuation and growth potential?

Mr. QUAADMAN. Yes, so let me just take that in a couple different ways. Number one, I thought Ernst & Young issued, and I think Chairman Huizenga raised this at the beginning of the hearing, a very thoughtful report on the decline of public companies in private markets.

Look, the JOBS Act did two things: it liberalized the private markets; and it also tried to make it easier for business to go to the IPO markets. I think on liberalizing the private markets, it certainly did so. I think we need to do more work in terms of the IPO process.

We have seen an explosion in the number of unicorn businesses, so those private businesses that are a billion dollars or more. I do agree with many of the other comments of my fellow panelists here that unfortunately, I think benefits accredited to investors, and it actually shuts out retail investors. So I think it is a matter of—

Mr. STIVERS. And that is the next part of my question, what does it mean to the average investor who doesn't have the net worth, or other things to be an accredited investor?

Mr. QUAADMAN. When a company goes public there is an economic growth positive that comes with it. So the Kauffman Institute looked at the IPOs from 1996 to 2010 and found that 2.2 million jobs were created. There is a wealth aspect that comes along with that, and there is also a revenue growth. So there are multiplier economic benefits that accrue with that.

Mr. STIVERS. Great.

Does anybody else have any input there?

Mr. BERLAU. Yes. I think if the number of public companies keeps shrinking, you could have a very real issue of too many dollars from retail investors chasing too few stocks, which could have some negative effects.

Small and mid-cap companies can be a part of a diversified portfolio because in large part because of the regulatory burden, you are depriving middle-class investors from having these in their portfolio like they could have with Amazon and with Home Depot.

And I think if you liberalize the public markets, you would get some entrepreneurs who would choose that rather than if it would give them another option if they don't want to put up with venture capitalists, the high demands like you see on Shark Tank.

Mr. STIVERS. Sure. And Mr. Quaadman, one follow-up question. So, obviously we all care about, and I am glad that this committee is shining light on the additional burden and compliance that might discourage some companies from going public.

I am curious. There seems to be a fight or a disagreement about whether private capital markets have grown as a result of Sarbanes-Oxley or independent of Sarbanes-Oxley. Do you have an opinion on that?

Mr. QUAADMAN. I think what we have done is—look, if we are going to have an economy that is humming, we need to have both private and public markets that are operating optimally.

I think what we have done is we have sort of squeezed down on the public company model in a way that has shifted resources over to the private markets, not necessarily because the private markets were all that more attractive, but because we have actually created some disincentives on the public company side.

So I think that is what our argument would be, is that we need to have a rebalancing of that. And I do think we need to take a look at it, particularly in terms of corporate governance, of how do we get back to maybe more of a balanced system where the States in that State-competitive model have actually allowed for a lot of diverse systems that work, rather than have a one-size-fits-all system that is more European, that hasn't had the same economic benefits there.

Mr. STIVERS. Sure. And I think that gets to my final question of, what components of Sarbanes-Oxley represent the biggest cost or compliance challenges, especially that might be felt more acutely by smaller companies? And how can we create the balance that you are talking about that ensures the integrity and ensures that we have both public and private capital?

And I have given you 12 seconds to answer, Mr. Blake.

Mr. BLAKE. Okay. So I will go quickly here. I just want to echo some of the comments that were made about 404 and Sarbanes-Oxley. It certainly served its objectives in restoring investor confidence, but in terms of saving costs, especially for the smaller issuers, the 404(b) requirement for auditor attestation is exactly the right solution in terms of relief of cost and when striking that balance.

I want to remind everyone that under the guidelines, officers of the company—I sign off on the 302 certification that says we have effective internal controls. We are also under the application of 404(a).

Mr. STIVERS. Is there a level of company at which we should make that divide, change that level of where, especially for the medium-sized company?

Mr. BLAKE. Certainly.

Mr. STIVERS. And I know I am out of time, Mr. Chairman.

Mr. BLAKE. Certainly. The emerging growth companies under the JOBS Act, the relief for an additional 5 years would be a great place to start.

Mr. STIVERS. Thank you. I yield back the balance of my nonexistent time, Mr. Chairman.

Chairman HUIZENGA. The gentleman yields back.

With that, the Chair recognizes the gentleman from Connecticut, Mr. Himes, for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman. And thanks very much for the interesting discussion; I really appreciate it. I have been interested in this for a long time. I was a supporter and helped with the JOBS Act, and I think it has done some pretty good things. Some of our worst fears have not materialized.

But at the time, I was very, very concerned with the way facts were presented and the way analysis was done, because this is important. And so I just want to highlight one fact, which is we talk about declines in numbers of publicly traded companies.

Almost all of the decline that we have seen since the dot-com bubble, 1995–1996, 75 percent of the decline actually in the number of public companies occurred prior to the passage of Sarbanes-Oxley. In other words, the dot-com peak was 8,000 and some 3,000 companies went away as a result of the deflation in that bubble prior to Sarbanes-Oxley.

We have seen a fairly slow decline since then, which I guess is worthy of consideration. But I have two questions, and by the way my numbers come from an Ernst & Young report. This is not the "Democratic Research Service" producing this.

Section 404(b), we hear a lot about it, very interesting question—another fact, since 2005, just to use that as a baseline, the number of public company material financial statement restatements has gone down 90 percent from 460 restatements in 2005 to 51 restatements in 2016. And the net income involved in those restatements has gone down from $6 billion of aggregate net income restated in 2005 to $1 billion.

That is pretty dramatic. And that has to be a big deal. I am going to ask that as a question. When the number of restatements—I am an investor and I have much more confidence, not just in the number of restatements that are likely to occur, but in the dollar value—that is 404(b). Is that not really worth something? And I am not pointing that at anybody. I am just saying there is some real value there.

Mr. BROWN. In my opinion, it is. And I would add to that statistic that in the first 2 years after 404(b) was put in place, there were 1,000 restatements each year, I think when 404(b) was put in place, I think when we had this attestation requirement for the first time.

So for the first time, third parties are coming in to the company and saying, let me see how you do this. We found a lot of mistakes.

And then what happened was, after these procedures were put in place and they were there for longer and longer, the number of restatements went down. I think that is a good piece of evidence of why investors should have greater confidence in our financial disclosure system.

Mr. HIMES. Okay.

Mr. Blake?

Mr. BLAKE. So, two points. One is I think we should also take into consideration what investors care about. And our shareholders have never asked me in any one-on-one meeting or any setting, for that matter, if we are 404(b)-compliant. What they care about in our setting is our cash balance, our cash runway, and what we are going to do in terms of our clinical development plans.

Mr. HIMES. Do you have net income?

Mr. BLAKE. No.

Mr. HIMES. Okay. You don't have net income. I cited a net income figure. I was in the business for a long time. Investors care about net income.

Mr. BLAKE. Absolutely.

Mr. HIMES. I am not going to argue with you. I take your point. I actually think there is some balance here. But I am struck by that, $6 billion in net income restatements prior to Sarbanes-Oxley down to $1 billion. There is some value there.

Mr. BLAKE. Yes, absolutely, and I wholeheartedly agree with you that 404(b) serves a purpose for larger organizations. I have been at an earnings-driven company, and it is important if you have a large footprint geographically with complex accounting systems, lots of lines of code that need to be evaluated, personnel.

I have a staff of five in accounting in my organization. I have been in organizations where there are over 4,000 finance staff. So there is a big difference in the level of internal control audit necessary for that company versus us.

Mr. HIMES. Okay. Thank you. I have one other question that just really interests me. We haven't talked a lot about something that I hear.

I have a lot of private equity in my district. I hear this from private equity folks, and I certainly hear it from public-company CEOs, which is the incredible focus of the investor, the public market investor, on quarter-by-quarter earnings and the disincentive that puts on somebody like you, Mr. Blake, making a 3-year investment that may look pretty tough next quarter and the quarter thereafter.

So my question is, is there anything we can do about that? And as public policymakers, is there anything we should do about that?

Mr. BERLAU. Yes, Congressman Himes, I can, and it is a very good question. I think we should give public companies the option of, if they want to, doing it like they do in Europe and do it every 6 months instead of every quarter and let investors decide. There is, I think, data to show that it does make companies more short-term-oriented.

Mr. HIMES. Is there a public policy rule there?

Yes, Mr. Quaadman?

Mr. QUAADMAN. No, I was just going to say, Congressman Himes, Tom Donohue gave a speech in 2005 asking companies to move away from quarterly earnings guidance because there are studies that CFOs and company management are going to start to make decisions that don't make long-term economic sense for a company in order to hit that target.

So I think if we are going to foster long-termism, that is something that needs to be addressed.

Mr. HIMES. Thank you.

And I thank you, Mr. Chairman, and I yield back.

Mr. STIVERS [presiding]. Thank you.

The Chair will recognize the gentleman from Minnesota, Mr. Emmer.

Mr. EMMER. Thank you to the Chair. And thanks to the panel for being here today. It is interesting. I haven't been here all that long, but I think on this issue, this should not be a partisan issue at all. This is really an American issue.

And when it comes to domestic economic policy, like so many things that we deal with here in Congress, we seem to have a problem with the well-intentioned, bipartisan, one-size-fits-all law that was passed for purposes that, again, are not partisan.

Everybody wants full disclosure. Everybody wants people to enter the marketplace and be able to participate on a level playing field, no matter how big that individual or company is or how small.

But it seems that the law that was passed for well-intentioned purposes, now we have some experience with it, it is showing us that there are some issues. And people have to acknowledge, and I think we are, on both sides of the aisle, acknowledging that this is important.

But it is not just about the economic growth that we get from a company when it goes public. And I think one of you testified, maybe it was you Mr. Quaadman, about how the majority of the jobs are created after a company goes public.

It is not just the jobs that follow. This is about, to me, the modest or small or beginning investor. It is about them getting the opportunity to participate and potentially prosper in the marketplace. We heard testimony today about the decline of public companies in this country. I think the statement has been that today we have half as many public companies as we did some 20 years ago

In Minnesota, we are still home to 17 Fortune 500 companies. We have a history in our State of inventors, of innovators, of visionaries. Some argue that we haven't been launching our new ideas, our start-up companies into public offerings the way we should be

There was a May 2015 article in our Minneapolis Star Tribune that was entitled, "Star Tribune 100: Signs Point to a New Round of Companies Going Public." According to that article, this was the only IPO of a Minnesota company in 2015. And it had been the first since 2009, so almost 6 years

Now, it said in that article that the biggest difference between the Star Tribune 100 in 2015, and the Star Tribune 100 ten years earlier was, "There are fewer small companies with between $50 million and $200 million in annual revenue rising through the ranks."

Now a year later, and remember the headlines said, "more public offerings looks like more public companies are in the offing," a year later, in May of 2016, our Star Tribune reported on a company called Tactile Systems as being the first Minnesota company in a year to try to go public.

And that article pointed out that we only had 7 companies in Minnesota between 2011 and 2016 that made public offerings or went public. John Potter, a partner in Minneapolis' office of PricewaterhouseCoopers, and an expert on mergers and acquisition activity, was quoted in that article. And he was saying that there is no shortage of companies with the size, scale, and value, but they have found capital elsewhere.

So Mr. Quaadman, I will start with you, and maybe Mr. Berlau, you can weigh in. This is a matter of marketplace fairness. Where does the beginning investor enter if these start-up companies are staying private and they are getting it from wealthy investors as opposed to somebody who is trying to enter the marketplace?

Mr. QUAADMAN. Yes. That is a problem we have been talking about this morning where I think those investors have been shut out. I think there has been a prevailing thought that while they invest in mutual funds or they invest in other vehicles, then they sort of get the benefits that way. Well, if those retail investors want to be able to benefit from a company going public, they should be able to do so

And I believe that Chair Clayton actually raised this as an important priority of his in his New York Economic Club speech last week. And this is an issue that he wants to tackle.

There is one other issue I want to just sort of throw out there, but this is probably the subject of another hearing. We also have a big problem on the other end where there has been Census Bureau data. There is an interesting study by the Economic Innovation Group about how dynamism is failing on the other end, that we are no longer creating businesses at the very start. And that has not recovered since the 2008 financial crisis.

So we have it on the one end where we are not creating public companies anymore. We are actually declining. We are also not creating new businesses at that rate.

And it is a problem because if you take a look at the Fortune 100 today, 20 of the Fortune 100 were started from 1975 to 2000.

Mr. EMMER. Right.

Mr. QUAADMAN. So we are no longer creating that backfill, and we are actually losing the innovative edge we have always had.

Mr. EMMER. Thank you.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the gentleman from Minnesota, Mr. Ellison, is recognized.

Mr. ELLISON. Thank you, Mr. Chairman, and Ranking Member Maloney. I am here to recognize that maybe the decline in publicly traded companies could be a problem for reasons that people on both sides of the aisle have identified. But I am not yet persuaded that Sarbanes-Oxley is the reason. I am here to give you guys a chance to convince me otherwise.

I am looking at this chart up here, and according to this chart, as you can see, if you look at, say, the 1990s and up until, say, 2000, so that is a steady decline upward when it comes to the ROI for U.S. companies. You see a drop there in 2000, right before 2002, which is the dot-com bubble.

But then you see after Sarbanes-Oxley is passed, it goes back up again until the mortgage collapse. And then it sort of starts going back up again, and then we have seen that steady decline.

My point is this would suggest to me that maybe Sarbanes-Oxley is not the problem. If it is a problem that we need more publicly traded companies, shouldn't we fix the thing that is causing the problem?

Next slide, please? Now, I am curious about this. I was wondering whether or not mergers was one of the problems. Whether and how, sort of just other potential reasons because I would like to help fix the problem.

But I would like to know exactly what is the heart and soul of why we have seen this drop, because I buy your argument that if John and Jane Doe need be able to go—it is easier for them to invest in a publicly traded company than some private equity thing which they are never going to hear of or get invited to be a part of.

So based on this chart, the last one, and whatever else you know, why is Sarbanes-Oxley the cause of the drop in publicly traded companies? And by the way, I want you to know on the front end, as a proud, bleeding heart liberal, I did vote for the JOBS Act because it was proven to me that smaller startups might need to be able to get reduced costs so that they can onramp a little cheaper to be an IPO.

Do you want to take that one on, Mr. Blake?

Mr. BLAKE. Sure. So at least my view is that Sarbanes-Oxley is not the single cause—

Mr. ELLISON. Thank you.

Mr. BLAKE. —of the decline in the delisting or incentives to go public. However, it is one of the components to it. And it certainly is a barrier to entry, so to speak, from a compliance cost perspective, especially for a small company wanting to—

Mr. ELLISON. Right, Mr. Blake. But it does have the benefit of stopping some of the harms that led to it.

Mr. BLAKE. Absolutely.

Mr. ELLISON. Look, I will tell you, regulations are going to stop some things and maybe even good things. But they are going to hopefully prevent some really bad things, too.

Mr. BLAKE. That is right.

Mr. ELLISON. And so—

Mr. BLAKE. And just to provide some color, so what does an internal control environment look like at a company like ours? I am the sole check signer for the entire company. I sign every single check.

And so we have a footprint, as I mentioned, of five accounting staff. And then the investors ask us about three financial metrics. Certainly, I am not suggesting that the financial statements are not important. But I am suggesting that the relative importance of 404(b)is probably much lower than—

Mr. ELLISON. Mr. Farley, could you take about 30 seconds to answer my question, if you can? Because I do want to see if Professor Brown or Mr. Quaadman wants to get in or Mr. Berlau?

Mr. FARLEY. I will do it very quickly.

Mr. ELLISON. Yes.

Mr. FARLEY. A number of comments have been made today about the benefits of Sarbanes-Oxley. I agree. And a number of comments have been made about the difficulty with complying with Sarbanes-Oxley and the high cost, and I agree with that as well.

So we are not suggesting—I don't think anyone has suggested, let's do away with Sarbanes-Oxley. It is just a good time to look at it and say, is it having an impact? And the mergers line that is so big on there?

Mr. ELLISON. Yes.

Mr. FARLEY. Companies are merging because two companies complying with Sarbanes-Oxley is twice as expensive as one.

Mr. ELLISON. Yes.

Mr. FARLEY. And so that is part of what is driving it.

Mr. ELLISON. Mr. Brown, do you have any take on this?

Mr. BROWN. Yes.

Mr. ELLISON. Is this where, if we say that the drop in publicly traded companies is a problem, what does Sarbanes-Oxley have to do with fixing the problem?

Mr. BROWN. Yes. I think Sarbanes-Oxley had a positive effect. But I want to just say what you are raising, which I think is the most critical issue, I think there is lots of agreement in this panel, in this room, that if there is a regulatory thing out there that is harming the markets and not benefitting investors, we should get rid of it. We all agree with that. We want liquid, innovative markets.

But what I am afraid of is, like 404(b), we could pull that out or reduce its use or something and learn, in fact, it doesn't increase the number of public offerings, but it does reduce our confidence in our financial statements.

So part of what you are asking is, is SOX the problem? So I think we really need to work hard at identifying what, if anything, is the problem before we take steps to fix it.

Mr. ELLISON. I agree. I think that is all the time I have. Thank you, gentlemen.

Chairman HUIZENGA. The gentleman's time has expired.

The Chair recognizes the gentleman from New Jersey, Mr. MacArthur, for 5 minutes.

Mr. MACARTHUR. I thank the Chair. And thank you all for being here.

Mr. Quaadman, the Chamber represents what, 2 million, 3 million businesses? Public? Private?

Mr. QUAADMAN. Both.

Mr. MACARTHUR. Big? Small?

Mr. QUAADMAN. Both.

Mr. MACARTHUR. All industries?

Mr. QUAADMAN. Yes.

Mr. MACARTHUR. Is it fair to say you are agnostic about capital structures? That whether they are public or private is all good by the Chamber as long as American business is prospering and growing and thriving, it is all good by the Chamber?

Mr. QUAADMAN. And that is why I had mentioned in an earlier answer that we need to have balance. If we are going to have an efficient economy, we need to have both private and public capital markets operating efficiently.

Mr. MACARTHUR. And I agree with that. So this question keeps coming up, why a 50 percent decline in public offerings over a period of time. I can think of two major advantages, major, major advantages to being public, or to investing in a public company as opposed to private.

One is liquidity. That is a big deal for people. You want to buy a new car or send your kid to college or buy a home or do whatever, it is nice to be able to sell that stock quickly and get your cash and do what you want to do with it. So liquidity is a big, big issue.

And valuation gets a pop from liquidity. Maybe a third. I don't know. I have seen lots of different statistics.

So being able to get money and being able to have it be worth more, get that stock being worth more, are two major motivations for public offerings and public investment. And yet, despite those major incentives, it is going the other way.

Mr. QUAADMAN. Yes.

Mr. MACARTHUR. And so I think it is a fair question to ask what in the regulatory environment might be driving that? Is there anything else that you can think of that would be driving it, in terms of major themes, not nets, but major themes that would be driving this trend?

Mr. QUAADMAN. I think you need to take—and this is what I was talking about earlier in my opening statement. You need to take a look at the basket of issues there. So if you take a look at the disclosures, you take a look at some of the financial reporting issues or some of the incongruities that exist with the PCAOB.

You take a look at other issues, even financing issues. What it has done is it has loaded down the best system we have ever created that still works well for existing public companies. If you are large, existing public companies, you can engineer and spend your way out of it.

But what it does at the end of the day is it creates barriers of entry for businesses to go public. And that is why, even though the decline in public companies has been small, the IPO market has never really recovered from the tech bubble bursting.

So I think Sarbanes-Oxley is a component of it. But it is one of many different reasons that, when they interact, cause those barriers of entry.

Mr. MACARTHUR. So it is a cumulative effect.

Mr. QUAADMAN. Correct.

Mr. MACARTHUR. I would ask you this, and then maybe Mr. Farley as well. Mr. Berlau suggested in his opening remarks that it is really the investor of moderate means who suffers the most because people who are accredited investors always find a place to put their money

And they find investment opportunities that maybe are not available to investors of moderate means who now don't have the same capacity to access these liquid, higher valuation markets.

Would you both agree that—or Mr. Blake, too, you can weigh in—it is investors of moderate means who seem to suffer the most from that?

Mr. BROWN. Yes.

Mr. QUAADMAN. Yes. And when I was talking benign neglect in my opening statement, it was really that the SEC has ignored retail investors.

Mr. BLAKE. Yes, and I would also agree. And you can argue that the accredited investors have access to those private company valuations that get that pop when they achieve liquidity and valuations in public markets.

Mr. MACARTHUR. I think one thing I am hearing this morning that is striking me is there is maybe no one piece of Sarbanes-Oxley that is driving this or at least that is driving it so clearly that you could put a marker there.

But there is a cumulative effect of this environment we have created that makes it difficult for private companies to want to go into that. And it is robbing investors of moderate means of opportunity.

And maybe I will finish with this, one thing that strikes me is, Sarbanes-Oxley creates a framework where companies have to put information out there and then have to explain it.

There is an adage in politics: When you are explaining, you are losing. I think it is even more so with business because they are forced to explain things that are very, very difficult to get into. And every explanation raises more and more questions.

I guess I would end with, it seems to me after listening to testimony, that it really is incumbent on us to try to lift some of this burden from our business environment. I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

The gentlelady from Arizona, Ms. Sinema, is now recognized.

Ms. SINEMA. Thank you, Mr. Chairman.

My first question is for Mr. Blake. Under the JOBS Act, emerging growth companies are exempt from certain regulatory requirements for 5 years after their initial IPO.

And one of the requirements that emerging growth companies are exempt from is Sarbanes-Oxley's Section 404(b) which, of course, requires public companies to obtain an external audit on the effectiveness of their internal controls for financial reporting.

In an effort to ensure that costly regulations don't stand in the way of success for biopharma and other companies on the cutting edge of scientific and medical research, Congressman Hollingsworth and I recently introduced the Fostering Innovation Act, which is our bipartisan legislation that temporarily extends the Sarbanes-Oxley Section 404(b) exemption for an additional 5 years, just for a small subset of emerging growth companies.

And as you know, these companies have an annual average revenue of less than $50 million and they have less than $700 million in public float.

So my question for you, Mr. Blake is, in your opinion, if enacted, how would this very narrowly targeted legislation benefit emerging growth companies, specifically biopharma companies, as they work to develop life-saving medicines?

Mr. BLAKE. Thank you, Ms. Sinema, for that. And we, of course, support the Fostering Innovation Act. It would have a very real impact on our bottom line. Every dollar saved on compliance costs can be repurposed for hiring a scientist, putting it into an experiment in the lab, or adding more patients to our clinical trials.

And just to give you a flavor of what that compliance cost would be for our profile, I think it is very targeted legislation that would affect the profile of companies that we live in. We will still be in the lab, beyond the 5-year exemption in clinical trials.

The costs probably would increase anywhere from $100,000 to $250,000, from my estimates. Our current audit fees are approximately $270,000. That could go up anywhere from 50 percent to 80 percent. We would increase our internal control consulting fees by approximately $50,000.

So if you start to look at this, it could be over 5 years of that exemption and a $1.25 million cost savings. And that is very real in terms of running clinical trials.

And then if you look at the 200 companies in our space that have gone public under the JOBS Act and aggregate that savings over 5 years, that could be hundreds of millions of dollars in compliance cost savings that would actually be directed towards helping patients.

Ms. SINEMA. Thank you. And Mr. Blake, a follow-up question. For the very specific subset of emerging growth companies targeted by the Fostering Innovation Act, the reporting requirement is costly and, I believe, unnecessary because management is still required to assess internal controls.

A number of the emerging growth companies, by definition, have limited public exposure. But if the company or a majority of its shareholders determine that an audit was beneficial, would they be able to obtain an external audit on the effectiveness of their internal controls for financial reporting under this legislation?

Mr. BLAKE. Yes. Absolutely. It is certainly optional. And that is the way the proposal is written. If any stakeholder—that could be a shareholder, that could be a lender—would like the auditor attestation, you could certainly incrementally request that of your auditors and pay for it.

Ms. SINEMA. Thank you, Mr. Blake.

I have a question now for Mr. Quaadman. As part of the JOBS Act, Congress directed the Securities and Exchange Commission to amend Regulation A to allow small companies to raise up to $50 million in offerings, exempt from full SEC registration. These amendments, known as Regulation A-Plus, exclude certain potential issuers, including Exchange Act reporting companies.

As a result, thousands of companies that already meet the SEC's high disclosure requirements are ineligible to use Regulation A-Plus to cost-effectively raise the funds they need to grow and hire. In your opinion, would it be beneficial for SEC reporting companies to be able to access Regulation A-Plus?

Mr. QUAADMAN. Yes. And first off, I thank you and Mr. Hollingsworth for introducing that bill. We support anything that is going to drive more liquidity to smaller companies. So we think this would be a positive step in the right direction. And we also support other issues such as pieces of legislation such as venture exchanges as well.

Ms. SINEMA. Wonderful. Thank you, Mr. Chairman.

And thank you Mr. Quaadman.

I yield back.

Chairman HUIZENGA. The gentlelady yields back.

With that, the Chair recognizes the gentleman from Ohio, Mr. Davidson, for 5 minutes

Mr. DAVIDSON. Thank you, Mr. Chairman. And thank you to our witnesses. I have really enjoyed your testimony. And it is an honor to talk with you today. Prior to coming to Congress, I built a small group of manufacturing companies and ran into some of these challenges.

As you look at what you are up against with the prospect of capital structure out there, it seemed that the government had an increasingly important role to play in what was a pretty small company. I think we had about seven people in the accounting group when I left.

And so the kinds of controls that would be applied are very different. I am encouraged by some of the dialogue I have heard here just talking about Reg-A. Reg-D, however, draws this line between accredited investors and sophisticated investors.

And for the average guy, at the end of the day, it is their money. So I am just curious, what is the premise? What have you seen in terms of market participation by people who aren't considered accredited investors?

What is the important distinction there—Mr. Farley, maybe, as an operator of an exchange?

Mr. FARLEY. I don't have an answer.

Mr. DAVIDSON. No answer?

Mr. QUAADMAN. I will take a crack at that. I think this committee has actually done, I think, a lot of good work in looking at where the lines in terms of a credit investor should be. And I think what we want to do is we want to be able to look at it in such a way that there are only going to be certain financial products that some people are going to be able to handle. And they should be the only ones to invest in it.

I think one of the things that Mr. Schweikert, when he was a member of this subcommittee, actually put on the table, which I thought was a good debate was, do we need to move those lines? And I think we need to do that.

One of the issues that we have also raised with the SEC in terms of the JOBS Act implementation—and this is why I do think economic analysis is an important tool, is for the SEC to also do an analysis 3 years out, after the regulations have been put in place to actually see how it is working, if there are issues, as you are sort of raising. Where there are problems do we need to address them or not? Or do we maybe need to liberalize things a little more?

Mr. DAVIDSON. Yes, thank you. And so you highlight Congressman Schweikert's bill. I am passionate on the same topic, things that—it seems to me that it is really just the main effect of these accredited investors, sophisticated investor definitions are to create deal flow for bigger people.

The reality is that if we still believe in capitalism, which is what we are trying to access, then we believe it is people's money. I don't know that any of you are subject matter experts on lottery systems, but we don't stop people from spending money on lottery tickets. And clearly the risk of losing your capital in the lottery is much greater.

So, what are some of the reforms that you look at that could draw the line? If you have a Ph.D. in physics and you are developing the product and the intellectual property but you just graduated, you are not going to meet the current thresholds of accredited investors. Are we trying to protect that guy from owning shares of a company?

Mr. QUAADMAN. Yes. I think where we need to start, and this also goes to Mrs. Wagner's question about materiality, is we need to start with *TSC Northway* and its progeny, the Supreme Court cases and other cases where the courts have talked about the basic skills that an investor needs.

And I think if you take a look at that and then you sort of look at the income levels but also the educational levels, that is where we really need to start to look at who is it that we have left outside the box that maybe should be inside the box?

Because I think what we have also done is we have been looking at investors in some ways in terms of a 1970s or 1980s model. And I think we have much more of a sophisticated investor base than we used to have, and I think we need to recognize that.

Mr. DAVIDSON. Correct. And just as an example, charter financial analyst, somebody could finish that. They know as much about materiality as we can assess anyway in terms of exams and credentials. But currently they would also potentially be excluded from this.

So these are things that I hope we can expand to and I hope we can do it in a bipartisan way. But I guess the last piece I would talk about is with respect to cause and effect. I don't think it got enough attention in your answer.

What is driving mergers? Well, the cost of compliance, not just Sarbanes-Oxley, but it is rationale. So to look at the fact that well, there is more merger activity and say, Sarbanes-Oxley is not a cause, you are looking at the regulatory hurdle being there as maybe one of the factors to be able to say that, gee, this is the root cause.

But the reality is, as I think you alluded to, capital is going to find a return. We hope that it finds a return here in the United States of America. And I hope to participate with my colleagues in doing that.

Mr. Chairman, I yield back.

Chairman HUIZENGA. The gentleman yields back.

The gentleman from California, Mr. Sherman, is recognized.

Mr. SHERMAN. Thank you. The gentleman from New Jersey has unfortunately left, but he argued that when you are explaining, you are losing, which is a campaign adage, therefore we shouldn't force companies to disclose what they would have to explain.

It is true that is a campaign adage, but I would hope that the level of honesty and disclosure that we find in the public markets for securities is not designed to parallel the level of honesty in disclosure we find in successful political campaigns.

So he says when you are explaining, you are losing. No. When you are disclosing, investors are winning. When you are explaining, investors are winning.

Now, there is a thinking here in Washington that if people are eating more pepperoni pizza, it must be because somebody dropped a bill or passed a regulation. Not everything is Washington. Yes, there has been some decline at times in the number of public companies.

Maybe that is because the people running companies are tired of the tyranny of the quarterly report, the hostile takeover, and the high frequency trading.

I have talked to so many businesspeople who say, look, I have a long-term plan and I don't want to have to justify my quarterly numbers. Then you look at the 2008 crash and I say, I don't want to be part of that.

So there are a lot of reasons to stay private that have nothing to do with Sarbanes-Oxley, a bill that was passed 15 years ago in this House—432 to 3. And I understand why we spend a lot of time in this room attacking Dodd-Frank. Dodd was a Democrat. Frank was a Democrat.

This was Oxley's bill. I am surprised that this is the focus, but—

Chairman HUIZENGA. Will the gentleman yield?

Mr. SHERMAN. If you will give me some more time, sure I will—

Chairman HUIZENGA. I have been pretty generous with the gavel. But—

Mr. SHERMAN. Yes.

Chairman HUIZENGA. —the intent of this hearing is to explore after 15 years of a, as I had—and I know you weren't here when I had acknowledged this, and the ranking member had talked about this. There was a very difficult time that prompted this response.

The question that I and others have is, okay, 15 years into it, and when we are seeing some other things there may have been circumstances that have changed, why would we not explore that?

So please don't misinterpret this as we are trying to repeal and replace Sarbanes-Oxley the way that some have argued that Dodd-Frank should be.

Mr. SHERMAN. I couldn't—I agree with you. Any bill can be improved. I am not just referring to this hearing. I have seen Sarbanes-Oxley beat up again and again, but any bill can be improved.

I was here when Sarbanes-Oxley was written and we were not on Mount Sinai.

It did not come to us in golden tablets. And even Dodd-Frank, which after all has two Democratic authors, did not come to us on golden tablets. Any bill can be improved, and I am glad that is the focus of these hearings.

Looking at Dodd-Frank, 74 percent of the decline in U.S. public companies from the peak in 1996 occurred to prior to 2003 when Sarbanes-Oxley was passed. The total number of U.S. companies has stabilized since 2008, ranging from 4,000 to 4,400, while the number of foreign companies listing in the United States has increased.

And I think it is the foreign companies that give us the test here. Over the last 20 years, 90 percent of foreign companies choose to list in their home market. That makes sense. But there are some companies that say they want to list somewhere other than their home country. Where do they pick?

Of those companies that decide to list outside their home market, the U.S. is the favored venue with almost twice the listings of its closest competitor. So what does this tell us?

Companies abroad who could list in Moscow or Panama, or if they think the regulations are too tough, there there is St. Kitts, they have all chosen the Sarbanes-Oxley choice by a 2:1 ratio over the chance to have no regulation or very little regulation.

Apparently companies choosing, choose the system where investors have the protection and can invest in confidence. And of course there are only two U.S. companies that have chosen to list abroad in 2016.

Then the other reason we have seen a decline in public companies is private capital is more available. We have had a growth in venture capital. We have had low interest rates, and in this room we wrote the JOBS Act to make it easier to stay private, and now we are here criticizing the fact that more companies aren't public.

As the gentleman from Connecticut pointed out, financial statement restatements have declined to almost one-tenth of their frequency in the years immediately following the passage of the Act in 2005.

There were 459, or the gentleman from Connecticut says 260, restatements, last year 51. So I want to focus then not on the cost of these internal control reviews, but on the benefits.

Professor Brown, a new study from the University of Washington and Georgetown University of 5,300 smaller companies that are exempt from 404(b) found that they saved $338 million in audit costs because they were exempt, but they lost $856 million that they would have earned if they had better internal and better remediated their internal controls.

Are you familiar with this, and are companies exempt from 404(b)? Do they have a bone to pick with us because by exempting them we have deprived them of this push to get the internal control that would have saved these companies $856 million according to the study?

Mr. BROWN. Congressman, I think that study shows how hard it is to try to quantify these things. It puts this $388 million cost, total cost on these 404(b) things, attestations.

The truth is, I think they are overstating it, because what they are doing is they are looking at companies that go from exempt to non-exempt and probably they are changing auditors and probably going to a more expensive auditor so all of that cost is not necessarily the 404(b).

So they may be overstating the cost. But what they are also doing is saying when you don't have good numbers you don't make as good of business decisions in your own company.

And there is a cost associated with that as well, so they try to quantify that. So it may well be that by exempting companies out of 404(b), we are not doing them any favors.

Mr. SHERMAN. Mr. Chairman, I like the focus of these hearings if it is to improve Sarbanes-Oxley, and I think that is what the focus is, and I yield back.

Chairman HUIZENGA. The gentleman yields back.

The gentleman from Indiana, Mr. Hollingsworth, is recognized for 5 minutes.

Mr. HOLLINGSWORTH. I thank the panelists for being here this afternoon and I appreciate the dialogue and honest discussion about some of the challenges as well as some of the opportunities that we face.

Representative Sinema and I have worked on both the Improving Access to Capital Act as well as the Fostering Innovation Act, and specifically 404(b) is talked about quite a lot here.

Mr. Blake, in your understanding of our Fostering Innovation Act, is there anything that absolutely bars you from pursuing a 404(b) audit and compliance if you so elected to?

Mr. BLAKE. Not at all.

Mr. HOLLINGSWORTH. Right.

Mr. BLAKE. If we elected to have the internal control audits performed, we could do that.

Mr. HOLLINGSWORTH. So if the cost of equity capital went up significantly in not doing a 404(b), you could make the business decision to say, we should pursue a 404(b), lowering our cost of equity capital because it makes sense for our business to do so?

Mr. BLAKE. Absolutely.

Mr. HOLLINGSWORTH. All right. Apologies to Mr. Sherman, I have not read the Georgetown report, but the $338 million that was gained through savings but according to them $856 million that is lost, I guess my question for Mr. Quaadman is, is it the job of the Federal Government to sit in the boardroom of these companies and tell them what they should pursue and what they shouldn't pursue in order for them to make an economic decision that makes business sense for them?

Mr. QUAADMAN. No. The board is going to make the decision they feel is best for the company with the business judgment rule, and the market ultimately is going to decide if they made the right decision or not.

Mr. HOLLINGSWORTH. So ultimately the owners of that business, the ones who have those dollars at stake are the ones best suited to make the decision on whether they should pursue this extra level of compliance, which may, in fact, according to this study at least, serve to save them money or lower their cost of equity capital? It is not the Federal Government's job to sit in their boardroom and tell them what they should and shouldn't do with their own money?

Mr. QUAADMAN. Yes. I think it is an issue, like—it is an issue where the board should make those decisions.

Mr. HOLLINGSWORTH. Right.

Mr. QUAADMAN. I think we need to take a very strong look at other issues such as management guidance that needs to be updated.

Mr. HOLLINGSWORTH. Right.

Mr. QUAADMAN. I think there are a number of other issues at the PCAOB that need to be addressed.

Mr. HOLLINGSWORTH. Right. One last comment before we go to fostering innovation. Again, this is a narrow fix. We are not saying everybody should be exempt from 404(b). Certainly, larger and larger companies are growing more and more complicated, operating around the world.

There are some safeguards that might need to be in place for them, but this is a very, very small fix focused on companies with less than $50 million in revenue and $700 million in float.

And like Mr. Blake has attested to, the opportunity for them to deliver more dollars to cures and fewer dollars to compliance represents a real opportunity for a more dynamic company for the opportunity for us to realize those cures over the long run. So I continue to be supportive.

In addition to that, I want to turn my attention—Mr. Ellison had presented a couple of charts here earlier and I had recognized them from a Credit Suisse report about the declining number of U.S. companies.

And certainly Credit Suisse does talk about mergers being a case, but I wanted to read two or three sentences from just below those charts that were omitted. "Overall, it appears that the benefit of listing has declined relative to the cost and only larger companies can bear the cost of being public."

And then just after that it says, "The cost of being public has gone up," which means that it makes sense only for larger companies to list. "The population of companies eligible to list falls as the size threshold rises. Thus, the median age of companies has risen dramatically over the last 15 to 20 years."

I think with the evidence that we have seen today it is hard to argue that those aren't accurate statements just below those charts that were presented.

So I wanted to talk a little bit about how companies might be able to access capital, especially once they are public and reporting to the SEC.

Mr. Quaadman and I have done some work on Regulation A-Plus, which has been talked about here. And I am just a believer in giving companies many different opportunities and avenues by which they can raise money and they can make, again, the decision that suits them best for what they want to pursue. Can you talk a little bit about Reg-A-Pluses,' I guess, the context for that and the setting by which companies might make the decision to pursue that less than $50 million offering?

Mr. QUAADMAN. Yes, it is actually one of the great innovations of the JOBS Act is that we were restricting the ability of smaller companies to raise capital.

Mr. HOLLINGSWORTH. Right.

Mr. QUAADMAN. So with the changes that were made to Reg-A, Reg-A-Plus with the JOBS Act, we have actually liberalized that, and I think the interesting innovation that you are pursuing with Representative Sinema is to actually now extend that to listed companies as well.

So I think it is going to help provide liquidity to the smaller public companies as well as smaller private companies.

Mr. HOLLINGSWORTH. Again, no part of this legislation says you have to follow Reg-A-Plus rules and only offer it this way. All we are doing is providing more and more avenues for companies to be able to elect what is in their best interests and their ownership's best interest.

Mr. QUAADMAN. Correct. It is voluntary and the marketplace will decide if that is a successful venture or not.

Mr. HOLLINGSWORTH. I love it. I say it in here all the time. Sam Walton used to say, "People choose with their feet and their wallets." And I just want people to have the opportunity to choose.

With that, I yield back, Mr. Chairman.

Chairman HUIZENGA. The gentleman's time has expired.

The gentleman from North Carolina, Mr. Budd, is recognized for 5 minutes.

Mr. BUDD. Thank you, Mr. Chairman.

And again, thank you to the panel.

So Mr. Quaadman, as my colleagues have mentioned, we are seeing a decline in the attractiveness of equity markets for raising capital. This has a twofold negative effect: one, on the companies that can't access the market; and two, on the investors who just don't get the returns.

Is the fact that more and more offerings are private actually driving the creation of two parallel markets, one lower return for the average middle-class investor, and the other for more sophisticated investors and the wealthy? I think we have talked about that today, but if you could elaborate on that?

Mr. QUAADMAN. Yes. We have certainly seen, and this is why I said I think we have seen where for a variety of different reasons the government has sort of put the thumb on the scale of public markets and sort of kept that down a bit. And I think that has hurt the democratization of wealth in that it has not allowed for retail investors to be able to access and enjoy the benefits of an IPO.

And I am very heartened to see that Chair Clayton, the new SEC Chair, has actually said that is a priority that he wants to address.

Mr. BUDD. Okay. So in one way, if we see these highly regulated markets and lower IPOs, that actually worsens income inequality?

Mr. QUAADMAN. It does that and it harms economic growth overall.

Mr. BUDD. Okay, thank you.

Mr. Blake, there is a great deal of concern on our side about frivolous shareholder proposals making it into the companies' proxy statements. So let's say that a proposal that management believes is unhelpful for the company's ability to create long-term value for its investors or its shareholders, and that makes it onto the ballot.

Walk us through the process that management uses to make the case that it is unwise, that it increases cost to management? Tell us about how that affects the company's resources and focus?

Mr. BLAKE. I can speak a little bit generally. I haven't dealt with that firsthand, but certainly the proposals that are able to get on the ballot may or may not be in the interests and long-term value creation of the company.

And you certainly want to keep management's attention and mind share focused on the core aspects of the business, whether that be running clinical trials, helping patients, getting our drug approved, ultimately are the core focus of management.

So any issues that are brought onto the ballot that can distract from that are bad for the shareholders.

Mr. BUDD. In general, how did that make it on and then once they are on and it is against the best interests of the shareholders economically, for instance, how do we get those off or how do you get those off?

Mr. BLAKE. I don't have any firsthand experience with that process.

Mr. BUDD. You don't have that firsthand experience. Anybody else?

Mr. Quaadman, have you had to study that?

Mr. QUAADMAN. No, I have not.

Mr. BUDD. Thank you.

Mr. Berlau, looking towards some of these additional disclosure requirements from the SEC in regards to conflict minerals, which we mentioned earlier, and payments to government regarding resource extraction, which we were fortunate enough to overturn with a Congressional Review Act a few months ago, does that require staff resources at the SEC to enforce?

Mr. BERLAU. Yes. I think it really does divert the SEC from its core mission of investor protection when it is pursuing certain social agendas, however noble they may be. The conflict minerals has also had other negative consequences.

The New York Times has reported that by acting as a backdoor tariff for some of the materials like gold and tin from the Congo and adjoining areas, some companies are just avoiding the Congo and regions near it because there is no way for them track whether they might have gotten gold that has been used 5 times or tin that might have come from the Congo. So it is actually impoverishing the regions.

Mr. BUDD. But for the fact that the SEC actually requires resources of the SEC to enforce this?

Mr. BERLAU. Yes.

Mr. BUDD. And you would say—and then—

Chairman HUIZENGA. Will the gentleman yield for one second?

Mr. BUDD. Of course.

Chairman HUIZENGA. We had talked about the CEO pay ratio and that the SEC's estimate is they had over 7,000 manhours put into that. The response from a couple of years earlier about conflict minerals was over 20,000 hours.

And if you extrapolate 7,000 hours was over a million dollars, 20,000 hours means over $3 million of the SEC's resources were put into that one specific rule. And I yield back.

Mr. BUDD. Thank you, Mr. Chairman. That is very relevant, and it actually answers my next question, does it cause extra expense for companies to comply with, so the answer is obviously yes.

But do you think they add to the problem of information overload for investors?

Mr. BERLAU. I think very much so. There are other ways. You don't have to mandate disclosure necessarily for concerned investors to find out or to engage in a dialogue with a company. It is just that the SEC's core mission should be investor protection.

If you could indulge me, I wanted to—the point about whether Sarbanes-Oxley was the cause of some of the decline or how much of a factor it was, there have been companies that have actually said they are delisting or deregistering because of Sarbanes-Oxley, including British Airways and the small restaurant chain Max & Erma's. They gave that as their primary reason for delisting from American markets.

Mr. BUDD. Thank you very much. I am out of time, but it seems that it doesn't help companies, it doesn't help investors, obviously. And then when we refer to the conflict minerals, it does not help those developing nations. So we can see where we stand in much-needed reform for this. Thank you very much.

And I yield back.

Chairman HUIZENGA. The gentleman yields back, and thank you for your indulgence in recognizing me there briefly as well.

I would like to thank our witnesses today. This has been, I think, very illuminating, very helpful as we are exploring this and doing this review of 15 years under Sarbanes-Oxley.

We do have a little bit of business here. Without objection, I would like to submit the following statements for the record: a statement from the Business Roundtable; testimony of J.W. Verret, assistant professor at Antonin Scalia Law School, George Mason University, and "The Misdirection of Current Corporate Governance Proposals."

Testimony also by Mr. Verret, assistant professor, about, "The Conflicts Between Institutional Investors and Retail Investors and Using Federal Securities Laws to Regulate Campaign Finance."

And also an article by Mr. Verret, "Federal Versus State Law, the SEC's New Ability to Certify Questions to the Delaware Supreme Court."

Then we also have an article by Mr. Verret again, "Uberized Corporate Law Toward a 21st Century Corporate Governance for Crowdfunding and App-Based Investor Communications."

And then finally, a publication by J.W. Verret, "Chapter 16, Ending the Specter of Federal Corporate Law."

So without objection, those will be submitted.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And with that, again, thank you, gentlemen, for your time and your effort in being here, and our hearing is adjourned.

[Whereupon, at 12:36 p.m., the hearing was adjourned.]

A P P E N D I X

July 18, 2017

COMPETITIVE ENTERPRISE INSTITUTE

Testimony of John Berlau, Senior Fellow, Competitive Enterprise Institute

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
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- *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

THE WALL STREET JOURNAL.

Friday, December 30, 2016

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."

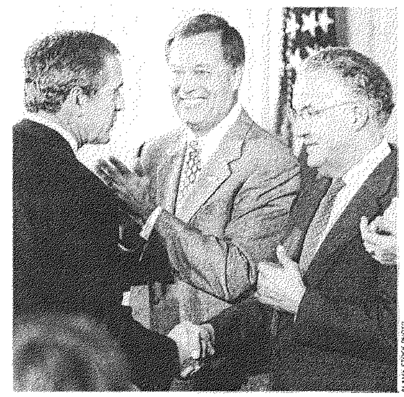
One of Sarbox's most onerous mandates stems from two brief paragraphs that comprise Section 404, which requires that public firms have effective "internal controls." The section itself mandates merely an "attestation" by the outside accounting firm that these controls are effective in preventing fraud.

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.



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.

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. 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."

Mr. Berlau is a senior fellow at the Competitive Enterprise Institute (CEI), a Washington-based free-market think tank. Mr. Cody is a former CEI research associate.

Biotechnology
Innovation
Organization

John Blake

Senior Vice President of Finance
aTyr Pharma, Inc.

On behalf of the Biotechnology Innovation Organization

Before the United States House of Representatives Committee on Financial Services,
Subcommittee on Capital Markets, Securities, and Investment

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

July 18, 2017

Executive Summary

- aTyr Pharma is a clinical-stage biotechnology company based in San Diego, California. The Biotechnology Innovation Organization (BIO) represents aTyr and 1,100 other innovative biotech companies, the vast majority of which are pre-revenue small businesses.
- aTyr undertook a successful IPO in May 2015 using key provisions in the Jumpstart Our Business Startups (JOBS) Act. In the five years since the JOBS Act became law, 212 biotech companies have gone public as emerging growth companies (EGCs).
- A healthy public market is key to funding the search for innovative, next-generation medicines and maintaining the U.S. as a global leader in 21st century industries like biotechnology.
- BIO supports policies to build on the success of the JOBS Act that *increase* the flow of capital to innovative small businesses and *decrease* capital diversions from the lab to unnecessary compliance burdens.
- Costly compliance burdens that do not protect investors and external actors that do not prioritize long-term value creation can disincentivize public capital formation and make it difficult for growing biotechs to succeed on the public market.
- <u>BIO supports the Fostering Innovation Act</u>, which would extend the JOBS Act's Sarbanes-Oxley (SOX) Section 404(b) exemption for an additional five years for former EGCs that maintain a public float below $700 million and average annual revenues below $50 million.
- <u>BIO supports the Corporate Governance Reform and Transparency Act</u>, which would provide for SEC oversight of proxy advisory firms and foster accountability, transparency, responsiveness, and competition in the proxy advisory firm industry.
- <u>BIO supports enhanced short selling transparency</u> in order to shine a light on manipulative trading behaviors that disincentivize long-term investment in innovation.

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Testimony of John Blake

Good morning Chairman Huizenga, Ranking Member Maloney, and Members of the Subcommittee. My name is John Blake, and I am the Senior Vice President of Finance at aTyr Pharma, a clinical-stage biotech company based in San Diego, California.

aTyr is a small business with just 66 employees, all of whom are dedicated to our ongoing search for therapies to treat a variety of severe and rare diseases using our knowledge of Physiocrine biology, a newly discovered set of physiological pathways. By focusing on immune pathways in disease, we believe our therapeutic candidates have the potential to restore patients to a healthier state, achieve homeostatic balance, and ultimately lead to improved clinical outcomes. To date, the company has generated three innovative therapeutic candidate programs in three different therapeutic areas. Our first product candidate is designed to treat rare muscular dystrophies with an immune component. Our second therapeutic candidate is a potential therapeutic for patients with rare pulmonary diseases. Finally, our third program is a preclinical research program in a third therapeutic area.

aTyr's story is mirrored across the biotech industry. The Biotechnology Innovation Organization (BIO) represents aTyr and over 1,100 other innovative companies making similar progress on the path toward medical breakthroughs. These groundbreaking companies – over 90% of which are pre-revenue small businesses – are at the forefront of an all-consuming effort to combat and cure diseases, treat patients and provide relief to their families, and save lives in the U.S. and around the world.

In order to fund the decades of research that it takes to develop a single breakthrough medicine, growing biotechs turn to a range of both private and public investors. Because biotech R&D is undertaken without the benefit of product revenue, small business innovators are entirely dependent on external capital to finance the $2 billion biotech development pathway. Capital formation, to put it lightly, is of paramount importance in our industry.

In 2015, aTyr raised $86 million through an IPO to fund Phase 1b/2 clinical trials for our first product candidate. Before our IPO, we had raised $172 million in venture financing over 10 years, for a grand total of over $250 million raised since 2005 – and we are likely still years away from presenting a drug candidate to the FDA for final approval, a time period during which we will remain steadfastly free of product revenue.

The prodigious capital requirements of cutting-edge biotech research, as exemplified by aTyr's financing story, make the work of the Subcommittee extremely vital to the industry's success – and, ultimately, to the health and well-being of the patients we serve. The Jumpstart Our Business Startups (JOBS) Act, passed five years ago with bipartisan support in both the House and Senate, is a shining example of the impact that targeted policymaking can have on biotech capital formation. The law has supported more than 200 biotech IPOs through its smart combination of increased access to capital and a decreased regulatory burden for growing companies. I am encouraged that the Subcommittee is considering ways to build on the JOBS Act's successes by continuing to support the growth of small business innovators on the public market.

Though the public capital markets are an essential component of the biotech financing ecosystem, roadblocks that decrease the capital potential of an offering, reduce long-term liquidity and investor confidence, or distract a company from its core mission have the potential to deter or delay necessary offerings. For instance, burdensome regulations like

Section 404(b) of Sarbanes-Oxley (SOX) divert innovation capital away from the lab, while external forces like proxy advisory firms and manipulative short sellers increase costs and deter vital investment. These barriers, and others, reduce the viability of the public market as a capital formation option for emerging biotechs, ultimately harming issuers, investors, and patients alike. Given the importance of public capital formation for life-saving innovation, I am hopeful that the Subcommittee can take action to enact regulatory and corporate governance policies that bolster America's world-leading capital markets and prioritize both capital formation and resource efficiency for innovative small businesses.

SOX 404(b) and the Fostering Innovation Act

Regulatory costs are a key incentive for companies to stay private rather than brave the public markets. Despite the positive economic benefits of IPOs (namely, a sharp increase in job creation), many private small businesses choose to deter or delay their offering because of the high costs of being a public company. For companies like aTyr that do not have the luxury of remaining private and must go public in order to fund our research, expensive regulatory requirements siphon innovation capital from the lab, diverting funds from science to compliance on a quarterly and annual basis. Disclosure burdens and other compliance metrics obviously offer protections for investors, and BIO strongly supports appropriate investor safeguards. However, costly one-size-fits-all requirements do not benefit companies or their investors, and BIO supports efforts to institute right-sized regulations that do not impose unnecessary expenses on growing innovators.

As the Subcommittee examines the impact of SOX in light of its 15th anniversary, I would encourage it to consider ways to reduce the cost burden of the law – and particularly of Section 404(b), which has a uniquely damaging impact on smaller biotechs. The requirements of Section 404(b) provide important protections for investors in large, multinational, revenue-generating corporations, but applying the same requirements to biotech small businesses with few employees (most of whom are scientists and medical professionals) diverts funds from and ultimately delays scientific progress.

Section 404(b) requires an external auditor's attestation of a company's internal financial controls that provides little-to-no insight into the health of an emerging biotech company – but is very costly for a pre-revenue innovator. The most direct policy impact of the JOBS Act has been the five-year exemption from Section 404(b), a vitally important reform that allows small public companies to choose how to allocate scarce investor funds. This optional allowance has been utilized by virtually all of the emerging growth companies (EGCs) in our industry, with the support of our investors.

Biotech investors demand information about the growth-stage companies in which they invest – and spend countless hours learning as much as they can about the company's science, the diseases it is treating, the patient population its drug candidates will target, its FDA approval pathway, and a hundred other variables that will determine the company's ultimate success or failure. Indeed, the testing-the-waters process created by the JOBS Act has been so successful for the biotech industry because it allows companies a platform to disseminate *more* and *more detailed* information to potential investors. But the information that these investors want and need does not align with what is required by SOX – and yet virtually all biotechs are subject to this one-size-fits-all mandate that can cost them over $1 million per year once their EGC exemption expires.

Thanks to the JOBS Act, aTyr has been able to spend dollars on R&D and job creation over the last two years that otherwise would have been earmarked for SOX compliance, and we still have three years of IPO On-Ramp eligibility remaining. However, it remains the case that the biotech development timeline is a decades-long affair. It is extremely likely that aTyr will still be in the lab and the clinic when our EGC clock expires – which is to say that we will still not be generating product revenue. At the dawn of year 6 on the market, we estimate that our compliance costs will nearly double, an increase that will be paid for with valuable innovation capital that would be better-used covering clinical trial and research expenses.

Most biotechs that went public under the JOBS Act will find themselves in the same predicament in the next several years – still reliant on investor capital to fund their research, but facing a full-blown compliance burden identical to that faced by commercial leaders and multinational corporations.

To address this problem, Reps. Kyrsten Sinema (D-AZ) and Trey Hollingsworth (R-IN) have introduced the Fostering Innovation Act (H.R. 1645), which would extend the JOBS Act's SOX 404(b) exemption for certain small companies beyond the existing five-year expiration date. This important bill recognizes that a company that maintains the characteristics of an EGC but has been on the market beyond the five-year EGC window is still very much an emerging company.

The Fostering Innovation Act would apply to former EGCs that have been public for longer than five years but maintain a public float below $700 million and average annual revenues below $50 million. These small businesses would benefit from an extended SOX 404(b) exemption for years 6 through 10 after their IPO. The additional five years of cost-savings would have the same impact as the first five years – emerging companies would be able to spend investor capital on growing their business. In the biotech industry, that means small business innovators can remain laser-focused on the search for breakthrough medicines.

If a company eclipses $50 million in average annual revenues, its full SOX 404(b) compliance obligations would kick in. The Fostering Innovation Act does not grant a carte blanche exemption – it is targeted specifically at pre-revenue companies, because revenue is the key indicator of company size, and of the ability to pay for expensive compliance obligations like Sarbanes-Oxley. Maintaining the JOBS Act's public float test of $700 million while drastically lowering the revenue test from $1 billion to $50 million limits the Fostering Innovation Act to a specific universe of truly small companies – instituting a company classification regime for years 6 through 10 post-IPO that accurately reflects the nature of small businesses while also supporting their growth.

Under current law, small, pre-revenue companies are often required to file the same reports as revenue-generating, profitable multinational corporations. Under the Fostering Innovation Act, these emerging companies will save millions of dollars that can be utilized to fund groundbreaking R&D and life-saving medical research. BIO commends Reps. Sinema and Hollingsworth for their leadership on this vital legislation, which last year was approved on a bipartisan basis by the House Financial Services Committee and then passed by the House via voice vote. I am hopeful that the Subcommittee will support the Fostering Innovation Act in order to enhance capital formation and company growth at America's pre-revenue businesses.

Proxy Advisory Firms and the Corporate Governance Reform and Transparency Act

Biotech companies value shareholder input, and strive to implement corporate governance policies that place shareholder value at the forefront of our decision-making processes. At aTyr, we place an emphasis on long-term value creation for investors – a vital metric of success given the extended nature of biotech R&D. During the development process, there are frequently scientific setbacks unrelated to the quality of company management or the corporate governance policies we have in place. Indeed, good and stable management teams in our industry have, time and again, used the knowledge gained from these short-term delays to ultimately develop life-changing therapeutic innovations – delivering exceptional long-term shareholder value in the process.

The ups and downs inherent to groundbreaking scientific advancement, combined with the general volatility of stock prices in our industry, can at times create a disconnect between the creation of shareholder value and the external recognition of it. Biotech management teams put considerable energy into communicating the company's progress to shareholders, and industry investors generally understand the nature of biotech investing. Everyone involved is in it for the long haul. As such, outside actors that place an emphasis on short-term metrics, often at the expense of long-term value creation and patient impact, can be particularly disruptive. Recent industry experiences with proxy advisory firms underscore the divide between short- and long-term approaches to shareholder value creation, and highlight the need for oversight of the proxy firm industry.

Despite their significant influence on emerging companies, proxy advisory firms (the universe of which is functionally limited to just two firms) generally refuse to engage in a productive or transparent dialogue with smaller issuers, instead relying on one-size-fits-all recommendations that do not take into account a company's or its shareholders' unique circumstances. Furthermore, the conflicts of interest inherent in the business model of those firms which engage in business consulting in addition to providing proxy recommendations raise serious concerns.

Proxy advisory firms pose a particularly acute risk for growing innovative companies like aTyr. Emerging biotechs operate in a unique industry that values a strong relationship with investors, yet they often are held to standards that are not applicable to their business. These one-size-fits-all recommendations, developed with minimal input from the company, do not accurately reflect the true nature of an emerging biotech, and are often focused on quarterly metrics rather than long-term scientific advancement and shareholder value creation.

Even in instances where a proxy firm has not yet made a recommendation, their influence is felt in boardrooms across the industry as companies strive to structure their corporate policies to satisfy the firms – rather than making decisions in the best interest of the company's growth. This issue is exacerbated by the fact that the consulting arms of the firms also put pressure on smaller issuers, raising significant conflict of interest concerns. Dealing with issues created by proxy firms' beliefs about corporate governance can distract company management and divert vital resources from the ultimate mission of any biotech – delivering groundbreaking treatments to patients.

BIO believes that proxy advisory firms should be more transparent and open to input in their standard-setting processes, particularly with regard to issues unique to small businesses. We also believe that the firms with conflicted business models should be required to avoid potential conflicts of interest.

In the 114th Congress, Rep. Sean Duffy (R-WI) and then-Rep. John Carney (D-DE) introduced the Corporate Governance Reform and Transparency Act, which would provide for SEC oversight of proxy advisory firms. By ensuring that firms have processes in place to engage in a dialogue with smaller issuers, the legislation would make it more likely that a firm's recommendation is relevant to a company's business model and allow small businesses to focus on long-term growth. Further, the bill's regulation of conflicts of interest would ensure that the proxy firms are actually acting in the best interests of shareholders.

BIO strongly supports the Corporate Governance Reform and Transparency Act, which last year passed the House Financial Services Committee on a bipartisan basis. Passage of legislation to regulate proxy firms would be a welcome change from a status quo that forces companies to contort themselves to satisfy proxy advisors rather than making decisions in the best interests of the company and its shareholders. BIO applauds Rep. Duffy for his continued interest in this important bill, and we are hopeful that the Subcommittee will support it in the 115th Congress.

Short Selling Transparency

As I have discussed, long-term value creation is key to biotech capital formation – shareholders often hold their investment for more than a decade before seeing a return. While most long-term investors can hold out through short-term ups and downs, growing biotechs also face concerted efforts from manipulative short sellers that impact shareholder value far more than the day-to-day realities of scientific uncertainty. These deliberate trading strategies can make long investors skittish about providing the capital necessary to fund the decades-long, billion-dollar development pathway intrinsic to life-saving research.

The unique business model of groundbreaking innovation leaves emerging biotechs particularly vulnerable to stock manipulation via abusive short selling strategies. The high-stakes nature of their research (both the uncertainty associated with scientific advancement and their limited portfolio of product candidates), combined with thinly traded stocks and strict FDA rules about disclosing the status of ongoing clinical trials, can be exploited by short sellers who prioritize short-term profits over the long-term health of patients. Abusive short trading strategies harm growing companies and disincentivize long-term investment in innovation.

BIO acknowledges that appropriate shorting can support the stable, liquid markets that fuel the growth of emerging biotech innovators. However, we strongly believe that the current lack of transparency related to short positions is enabling trading behaviors that unfairly harm growing companies, long-term investors, and, most importantly, patients. BIO members face a consistent and significant risk of manipulation by short sellers, who are protected by the lack of disclosure required of short positions.

Company management has a fiduciary duty to protect shareholders, but the lack of transparency around short positions makes it exceedingly difficult to police short manipulation effectively. This consistent risk of manipulation, and the lack of information available that would allow companies to combat it, disincentivizes the long investment necessary to fund life-saving biotech R&D.

BIO believes that increased short transparency, designed to complement the existing long disclosure regime, would shine a light on manipulative behaviors, allow market participants to make informed trading decisions, and ensure equitable rules for all types of investments. Specifically, we would support required disclosures of investors taking significant short positions, modeled after the beneficial ownership disclosure obligations in SEC Regulations 13D and 13G.

The current disclosure regime for long positions exists to provide information regarding persons that may have potential influence over, or control of, an issuer. Investors taking short positions, on the other hand, face no public disclosure requirement, despite the significant influence they exert on issuers. Their power stems not from voting rights, but rather from the ability to engage in manipulative trading behaviors that harm growing companies and disincentivize long-term investment in 21st century innovation and job creation – yet there is not a parallel disclosure regime for the reporting of short positions.

BIO sees no public policy justification for this disparity between the disclosures required of long and short investors. Both groups are making predictions based on the risk and/or reward a given company presents, but only one group is required to disclose its holdings and transactions. We have clearly seen that this information asymmetry can be harmful to emerging issuers and their investors.

Notably, BIO supports a short disclosure regime that is *complementary*, rather than identical, to the existing long disclosure requirements. The long disclosure trigger in Regulation 13D (5% of a class of an equity security) is unlikely to capture short manipulation for the simple reason that few short sellers take a large enough short position to cross the 5% threshold – yet still find it easy to manipulate a company's stock even if they are short far less than 5%. BIO would support either a lower disclosure trigger or a standard based on a different metric than outstanding shares (for example, trading volume could be a more appropriate measure given that the depressive effect of short sales on a stock price is largely a function of the volume and frequency of short transactions relative to the overall securities transaction volume).

Issuers, investors, and patients are all impacted by the current lack of short transparency. A commonsense disclosure regime for short positions would shine a light on manipulative practices while giving investors and companies the information they need to make informed market decisions.

Conclusion

The bipartisan JOBS Act showed that targeted policymaking designed to support job creation and capital formation at small businesses can have a dramatic real world impact. The many JOBS Act success stories in the biotech industry, including aTyr, are attributable to the one-two punch at the core of the law: First, it allows small companies enhanced access to investors, increasing the capital raising potential of an offering. It then provides them with targeted relief from costly regulatory burdens, decreasing the amount of capital diverted from research. This combination is critical for biotech innovators, and provides a useful model for the Subcommittee to follow as it considers further ways to support the growth of small public companies.

Unlike in many other industries, emerging biotechs are almost always looking to go public given the capital-intensive nature of our research. But that does not mean that conducting an IPO or staying a public company is an easy choice. Growing public biotechs face a constant array of costly regulatory burdens and short-term-oriented external actors – both of which distract company resources from the mission of delivering cures and treatments to patients in need. Congress can support these small business innovators by enacting legislation that enhances the capital formation ecosystem, reduces regulatory burdens, and incentivizes long-term funding for the next generation of breakthrough medicines.

I appreciate your dedication to these vital issues, and I look forward to supporting your work in any way I can.

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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

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 10th 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[1] and 423-3 in the House of Representatives.[2] 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.[3]

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.[4] Limited to independent directors, committees were encouraged to promote the financial sophistication of the members.[5] 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

[1] https://www.govtrack.us/congress/votes/107-2002/s192
[2] https://www.govtrack.us/congress/votes/107-2002/h348
[3] *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).
[4] Section 303 also required the adoption of rules prohibiting interference with an audit.
[5] 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.[6] Evidence indicates that the use of financial experts has become widespread.[7]

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"[8] and receiving a guarantee of "appropriate funding."[9]

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.[10] Auditors were required to inform the committee of all critical accounting policies and practices.[11] Listed companies had to put in place a system for allowing employees to provide anonymous complaints about "concerns regarding questionable accounting or auditing matters."[12] 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.[13] For those that were permitted, they were conditioned upon audit committee approval and disclosure to shareholders.[14]

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.[15]

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

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[6] *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).
[7] *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").
[8] *See* Section 301 of SOX, codified as 15 USC §78f(m). The requirements were to be implemented as mandatory listing standards by the exchanges.
[9] *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).
[10] *See* Section 204 of SOX, codified as 15 USC §78m(k).
[11] The requirement was added to Regulation S-X. *See* 17 CFR §210.2-07.
[12] *See* Rule 10A-3(b)(3), 17 CFR §240.10A-3(b)(3).
[13] *See* 17 CFR §210.2-01 (auditors are not deemed "independent" to the extent providing specified non-auditing services).
[14] *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.").
[15] Rule 13a-15(f), 17 CFR §240.13a-15(f).

shareholders in the annual report.[16] 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.[17]

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.[18] Most significantly, SOX ended self-regulation and created the PCAOB.[19]

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.[20]

C. Management

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

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[16] *See* Item 308 of Regulation S-K.
[17] 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.").
[18] 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).
[19] *See* Section 101 of SOX.
[20] *See* Section 107 of SOX.

Section 302 required the CFO and CEO to certify the financial statements included in the annual and quarterly reports.[21] 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 . . ."[22] 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."[23]

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. . ."[24] 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.[25] In addition, Section 402 of SOX imposed an almost absolute ban on extensions of credit to executive officers and directors.[26] Loans during the Enron era had been made on highly favorable terms[27] and in some cases involved an assumption of risk "that no financial institution was willing to assume."[28] SOX prevented future reoccurrences by barring the transactions.

[21] Rule 13a-14, 17 CFR §240.13a-14.
[22] *See* Section 302 of SOX, codified in Rule 13a-14, 17 CFR §240.13a-14.
[23] *See* Rule 13b2-2(b), 17 CFR §240.13b2-2(b).
[24] *See* Item 406 of Regulation S-K, 17 CFR §229.406.
[25] *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.").
[26] 15 USC §78m(k).
[27] *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.* ("Ebbers 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 Ebbers 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 Ebbers' other outside loans. Moreover, this rate was lower than the average rate WorldCom paid on its other debt.").
[28] *Report of Investigation*, *supra* note 27.

D. Enforcement

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

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.[35]

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.[36] 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.[37] 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.[38]

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[29] *See* Section 807 (amending 18 USC § 1348).
[30] *See* Section 906 (adding 18 USC § 1350).
[31] *See* Section 802 (adding 18 USC § 1520).
[32] *See* Section 802 (amending 18 USC § 1519, the anti-shredding provision).
[33] Section 806 (adding 18 USC §1514A)
[34] Section 1105 (amending Section 21C of the Exchange Act, 15 USC §78u-3).
[35] 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.").
[36] 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.
[37] 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.
[38] 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[39] and retain their allure.[40] 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.[41] Snap was able to go public in 2017 despite an apparent lack of profitability.[42]

Private markets also have their drawbacks. Valuations are subjective.[43] Nor do they have in place the same protections that are designed to ensure the accuracy of financial statements.[44] These investments can, therefore, pose substantial risk,[45] 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.[46] 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.[47] 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.[48] 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.").

[39] *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.").

[40] *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.").

[41] Shares are trading at about $1000. Amazon has 477,170,618 shares outstanding. *See* Amazon, Form 10-K, Feb. 2, 2017.

[42] 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.").

[43] *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.").

[44] *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.").

[45] 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.

[46] Stein, *supra* note 40 ("Investors also use the price discovery available in the public markets to determine the value of private companies.").

[47] 17 CFR §229.10, et seq.

effectiveness.[49] 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.[50]

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.[51] 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.[52]

2. Disclosure Effectiveness

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[48] Exchange Act Release No. 78310 (July 13, 2006).
[49] 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.").
[50] *See* Section 13(i), 15 USC §78m(i).
[51] 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.").
[52] *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,[53] evolving labor practices and consumer tastes, and the effects of climate change, can threaten a business model.[54] Investors would benefit from a disclosure regime that required more insightful discussion into the sustainability of the company's business model.[55] To be effective, sustainability disclosure would need to include analysis of long term changes and would need to address efforts to reduce these risks.[56]

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."[57] This includes future trends based upon current facts.[58] MD&A has been described as "[o]ne of the most important elements necessary to an understanding of a company's performance. . . "[59]

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."[60] Concerns include boilerplate,[61] repetition,[62] and rote calculations.[63] Academics have

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[53] 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.").
[54] 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.").
[55] Sustainability has been defined as the "capacity to endure." *See* Nancy S. Cleveland, *Sustainability, Share Value, and Reporting*, Sustrana LLP, Sept. 12, 2014.
[56] 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
[57] Exchange Act Release No. 26831 (May 18, 1989).
[58] 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.").
[59] 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.").
[60] *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.").
[61] 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.[64] 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.[65] 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.[66] 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.[67]

[62] *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.").

[63] *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.").

[64] 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.").

[65] Twitter, Snap and Facebook refer to "user growth."

[66] *See* Howard Schilit, *Financial Metrics Shenanigans*, AAII 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.").

[67] *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.[68] 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.[69] Moreover, a recent study indicates that the benefits of attestation outweigh the costs.[70] 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.[71] 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.[72] Moreover, the Board has taken steps to integrate empirical data into the regulatory function[73] and has instituted post-implementation review designed to

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[68] *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").

[69] *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.").

[70] *See Benefits and costs of Sarbanes-Oxley Section 404(b) exemption, supra* note 68.

[71] *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").

[72] *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.").

[73] 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."[74] 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.[75]

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.[76]

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.[77] 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.[78] 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.[79] Few shareholders would meet these revised eligibility requirements.

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

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

[75] The search engine is here: https://pcaobus.org/Pages/AuditorSearch.aspx

[76] PCAOB Enforcement Transparency Act of 2017, S. 610, 115th Cong., 1st Sess., 2017 & PCAOB Enforcement Transparency Act of 2016, HR 6251, 114th Cong., 2nd Sess., Sept. 28, 2016 (amending 15 USC 7215(c)(2) to provided 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

[77] Shareholder proposals are governed by Rule 14a-8. 17 CFR §240.14a-8.

[78] 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.").

[79] 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").

[80] *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.[81] 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[82] and down from earlier periods.[83]

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.[84] Moreover, these expenses have probably been reduced through the advent of electronic dissemination of proxy materials.[85]

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.[86]

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.[87] Similarly, environmental and social proposals have

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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.").

[81] *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.").

[82] Elizabeth Ising, Ronald O. Mueller, & Lori Zyskowski, *Shareholder Proposal Developments During the 2016 Proxy Season*, GIBSON DUNN, June 298, 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.").

[83] 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.

[84] 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.

[85] *See* Rule 14a-16, 17 CFR §240.14a-16.

[86] 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/

[87] 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.[88] 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.[89]

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.[90] 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.[91] Companies can address concerns about these investors by improving engagement with long term shareholders.[92] Yet restrictions on the use of shareholder

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[88] *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.").

[89] 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.").

[90] James McRitichie 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%.").

[91] *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.")

[92] *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.[93] 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.").

[93] *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.").

NYSE

TESTIMONY OF
NEW YORK STOCK EXCHANGE PRESIDENT THOMAS W. FARLEY
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES CAPITAL MARKETS, SECURITIES, AND INVESTMENT SUBCOMMITTEE
JULY 18, 2017

Chairman Huizenga, Ranking Member Maloney and members of the Subcommittee, we appreciate your interest in the issues public companies face, including the Sarbanes-Oxley Act of 2002 (SOX), federal corporate governance mandates, as well as other factors that may impact a company's decision to go or remain public. My name is Tom Farley and I am President of the New York Stock Exchange (NYSE). I am here today on behalf of the 2300 companies that list on the NYSE. Our listed companies are responsible for many of the most impactful innovations in American business over the last 225 years. These innovations have improved the lives of Americans and global citizens and embody the U.S. entrepreneurial spirit.

Robust U.S. Capital Markets Benefit the Entire U.S. Economy

Today, the New York Stock Exchange is the world's largest with total listed company market capitalization of more than $25 trillion representing nearly one-third of the world's total market value. The U.S. capital markets are the destination of choice for investors and companies as they provide unparalleled access to capital, liquidity, and trusted regulation. Robust U.S. capital markets benefit the entire U.S. economy.

We cannot, however, take for granted the fact that the U.S. will always be the world's premier destination for capital-raising, job growth, and innovation. The regulatory environment for public companies over the past 15 years has grown increasingly difficult to navigate -- threatening the tradition of public shareholders fostering innovation. The number of public companies in this country is down by half over the past 15 years. By choosing to remain private and not access the public markets for capital and liquidity, a company may severely limit its opportunity for economic growth, hiring, and wealth creation, and the American public is deprived of investment choice.

Despite the many benefits of being a public company, the cumulative effect of layers upon layers of regulation is lessening the attractiveness of the public markets. Public companies must meet significantly more complex regulatory requirements than their private counterparts, both during the IPO process and after a company goes public. While NYSE applauds smart regulation to ensure the protection of issuers and their investors, we also believe in a regulatory environment that supports a healthy, robust pipeline of companies that seek to become and remain public, which in turn will benefit job growth all across the nation, on Main Street, in pension funds, 401ks, savings vehicles of all kinds, and will contribute to the U.S. economy as a whole.

NYSE supports the stated goal of SOX to foster the accuracy of financial reporting. We also believe that it is important -- as this Subcommittee is doing -- to take a detailed look at the regulatory systems in place -- and SOX specifically -- and how they affect a company's decision to enter or not enter the public U.S. capital markets system. We believe it is possible to both protect public confidence in the integrity of U.S. capital markets, and to make those markets more accessible to an innovator, a CEO, or any of our sons and daughters -- the next great generation of business leaders -- to grow a business and create jobs.

Key Impacts of SOX

NYSE is proud to be the home of the world's greatest public companies, and we take our responsibilities to the marketplace and to our issuers and their investors very seriously. NYSE supports efforts to ensure that investors have the utmost confidence when investing in public companies. That is why NYSE values transparency above all else, and that is why NYSE's markets have the most stringent regulatory listing requirements that exist in the capital markets space.

SOX was adopted and signed into law by the Bush Administration in July 2002 on an overwhelmingly bipartisan basis. Though it has significant costs and shortcomings, SOX institutionalized transparency in financial reporting and, at the time of its adoption, boosted investor confidence in the public markets. SOX also provided a blueprint for the NYSE to revise and augment our listing requirements, further enhancing our ability to regulate the markets we operate.

While costs associated with becoming a public company have always been significant, compliance with certain provisions of SOX today sets considerably higher barriers -- not just financially for public companies -- but also for entry into public markets for private companies, particularly for small and midsize private companies. For public companies, compliance with SOX requires dedicated personnel, significant financial resources, outside consultants, auditing and law firms. Compliance with SOX Section 404 specifically has proven to be a significant hurdle: designing, implementing, and maintaining complex systems required to satisfy SOX's internal controls over financial reporting requirements can command millions of dollars in outside consultant, legal, and auditing fees, in addition to other internal costs. Public companies are devoting more time and resources than ever to grapple with administrative procedures and controls mandated by SOX Section 404, which disproportionately affect small and midsize companies.

Improving the Environment for Public Companies and Private Companies Considering an IPO

The burdens of SOX are but one aspect of being a public company today. In recent years, as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,[1] through the SEC's rulemaking agenda, and in response to calls from the investor community, public companies are engaged more than ever before in evaluating corporate disclosures and demonstrating compliance with a myriad of new and enhanced regulatory requirements. The increasingly difficult class-action litigation environment for public companies today amplifies these concerns across the board.

Disclosure Effectiveness

The SEC disclosure regime requires that publicly held companies disclose exposure to material risks regarding known trends, events and uncertainties that are reasonably likely to have material effects on the company's business, financial position or results of operations. The length and complexity of these disclosures continue to increase, while the readability of these documents is at an all-time low. These disclosures cover situations that relate to material corporate governance matters, including those known colloquially as "environmental, social, governance" or "ESG" matters. Investing based on environmental, social and governance ideas is rapidly gaining momentum, fueled by concern about policy issues and focusing on

[1] Pub.L. 111–203, H.R. 4173

corporations both as a source of irritation (e.g., CEO pay) and a source of hope (e.g., reduction of greenhouse gas emissions). NYSE supports the SEC's 2016 "Disclosure Effectiveness Review" Concept Release[2] and the Commission's report on ways to modernize and simplify Regulation S-K[3] as an appropriate starting point for considering refinements to existing disclosure mandates and addressing the materiality of ESG matters. The SEC should continue to revisit ways to streamline existing disclosure requirements by completing its "Disclosure Effectiveness Review."

At the NYSE, we interact with the best companies in the world and serve as a meeting place for the exchange of ideas. In that role, as a hub for best practices and innovation, we have a strong appreciation for the importance of corporate responsibility including efforts across the environmental, social and governance space. Many of our listed companies have implemented innovative and impactful initiatives that exemplify what it means to be a good corporate citizen, including those devoted to ESG.

Enhancing the JOBS Act

The Jumpstart Our Business Startups (JOBS) Act of 2012[4] was an excellent starting point in bringing innovation to the public markets, but there is more to be done. At the NYSE, we recently completed the *first* Regulation A+ IPO on a major exchange, something that would have been impossible prior to the JOBS Act, bringing to market an incredible company -- Myomo, Inc. -- that is changing the world for Americans with neurological disorders so that they can work and live independently.[5] These and other innovations born out of the JOBS Act need further support and enhancement from Congress and the SEC.

For example, NYSE supports raising the annual gross revenue threshold ceiling for companies to remain an Emerging Growth Company ("EGC") to above $1 billion (thereby permitting more companies to benefit from the protections afforded under the JOBS Act). We also support providing additional protections for "low revenue issuers" to qualify as EGCs because their business involves a significant amount of research and development (for example, those

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[2] Concept Release Available at: https://www.sec.gov/news/pressrelease/2016-70.html
[3] SEC Division of Corporation Finance, "Report on Modernization and Simplification of Regulation S-K" (November 23, 2016), available at https://sec.gov/files/sec-fast-act-report-2016.pdf. This report was required by Section 72003 of the Fixing America's Surface Transportation Act, Pub. L. No. 114-94, 129 Stat. 1312 (2015).
[4] The Jumpstart Our Business Startups Act, Pub. L. 112-106, H.R. 3606.
[5] http://myomo.com/myomo-inc-trades-new-york-stock-exchange-mkt/

companies in the biotech sector of the market). And we believe EGCs and companies with less than $250 million in gross revenue should be exempted from the SEC's costly financial statement format requirements -- known as XBRL format. All newly public companies, especially EGCs, should also have the opportunity to choose to have their stock only trade on a single nationally-registered stock exchange until their stock liquidity meets a minimum threshold level.

NYSE applauds the recent action by the SEC's Division of Corporate Finance to extend the process for confidential submission of draft registration statements, currently available only for IPOs of EGCs, to IPOs of companies that are not EGCs, as well as for most follow-on offerings made in the first year after going public. This sensible change will make the public offering process more time-and cost-efficient, without adversely impacting the quality of public disclosure available to investors.

Regulating Gatekeepers

With the adoption of SOX in July 2002, so came the founding of the Public Company Accounting Oversight Board (PCAOB). Born out of a desire to restore investor confidence in the independence and integrity of public companies' auditors, Congress gave the PCAOB broad authority to establish rules to the extent it determines may be necessary or appropriate in the public interest or for the protection of investors.[6] In carrying out Congress' mandate, the PCAOB regulates gatekeepers for public company internal controls and disclosures (i.e., public accounting and auditor firms).

Our listed companies are deeply committed to setting high standards for management and the audit profession for financial reporting and corporate audit functions. Over the past several years, however, our listed companies are increasingly concerned that the PCAOB's regulatory agenda is expanding the organization's footprint beyond the originally intended scope by virtue of the PCAOB inspection process and corresponding changes to issuer internal control systems. In many cases, the cost of *demonstrating* compliance for purposes of supporting an audit review or PCAOB inspection, in addition to actual costs of compliance with the underlying regulatory requirement, is rising steeply. This is an unforeseen consequence of PCAOB

[6] H. Rep. No. 107-414, at 16-17 (2002).

regulation that is unnecessarily increasing costs and burdens for public companies, and the Commission should address it promptly. NYSE wholeheartedly supports the recent remarks of SEC Chairman Clayton that, when creating or approving rules the Commission should consider compliance costs and should "have a realistic vision for how rules will be implemented as well as how the Commission' and others intend to examine for compliance."[7]

Conclusion

In the last 15 years, compliance and administrative costs for public companies have adversely affected the U.S. IPO market. Analysis shows that smaller private firms' are increasingly incentivized to seek acquisition instead of listing their shares on public markets. No one wins when companies of all sizes -- both public and private -- are forced to shoulder regulatory and administrative burdens that impose steep costs without clear benefits, thereby hindering economic growth, expansion, hiring, and capital-raising.

As regulators, as businesspeople, and as Americans, we must prioritize a regulatory environment that incentivizes companies at home and abroad to grow, to hire, and to enhance our economy. Regulation that skews decision-making away from growth, away from hiring and expansion, and that limits the public's ability to access capital and to invest in their futures must be evaluated very carefully and critically.

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[7] SEC Chairman Jay Clayton remarks available at https://www.sec.gov/news/speech/remarks-economic-club-new-york

Statement of the U.S. Chamber of Commerce

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

TO: House Committee on Financial Services, Subcommittee on Capital Markets, Securities and Investment

BY: Thomas Quaadman, Executive Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce

DATE: July 18, 2017

1615 H Street NW | Washington, DC | 20062

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Chairman Huizenga, Ranking Member Maloney and members of the Subcommittee on Capital Markets, Securities, and Investment. My name is Tom Quaadman, executive vice president of the Center for Capital Markets Competitiveness ("CCMC") at the U.S. Chamber of Commerce ("Chamber").

This hearing, "The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance" is an important hearing that is needed to examine the reasons behind the steady decline in the number of public companies over the past twenty years. In short, we need new policies that will make it more attractive for businesses to go public and to remain public.

The public company model has been a key source of strength and growth which has made the United States economy the strongest and most prosperous in world history. When businesses go public, jobs are created and new centers of wealth are formed. During the 1980's and 1990's, stories of the Microsoft executive assistant or the UPS driver becoming a millionaire were not uncommon after a company went through the initial public offering ("IPO") process. A 2012 study done by the Kaufmann Foundation found that for the 2,766 companies that went through the IPO process between 1996 and 2010, employment cumulatively increased by 2.2 million jobs.[1] Other benefits also accrue to companies when they go public, such as revenue growth.

The public capital markets are also not static and help to support innovation. Only about 12% of the Fortune 500 companies in 1955 were still on the list in 2014, while the other 88% have either gone bankrupt, merged, or fallen out of the Fortune 500.[2] This system of creative destruction has forced businesses to change with the times, or be replaced by new entrants with innovative ideas and products meeting the needs of consumers and an ever changing marketplace.

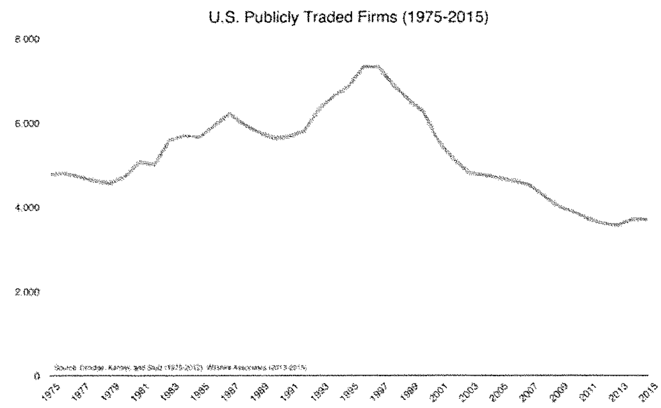
In the 20 years from 1996-2016 the number of public companies dropped in 19 of those years. The one year where there was an increase is attributable to the passage of the Jumpstart out Business Startups Act ("JOBS Act") that was spearheaded by this Subcommittee. To put it in even starker measures, a recent article by the Wall Street Journal pointed out that we have roughly the same number of public companies today as we did in 1982.[3] Since 1982, the United States population has grown by 40% and

[1] Post-IPO Employment and Revenue Growth for U.S. IPOs June 1996-2010 http://innovation.ucdavis.edu/people/publications/kenney-m.-patton-d.-ritter-j.-2012.-post-ipo-employment-and-revenue-growth

[2] Mark Perry, AEIdeas, August 18, 2014.

[3] America's Roster of Public Companies is Shrinking Before our Eyes." Wall Street Journal January 6, 2017 https://www.wsj.com/articles/americas-roster-of-public-companies-is-shrinking-before-our-eyes-1483545879

the real GDP has increased by 160%, yet the number of public companies has remained stagnant. The gains made during the Reagan and Clinton Administrations have been wiped out.



These metrics alone demonstrate that the Securities and Exchange Commission ("SEC") needs to step up its game when it comes to their statutory missions of competition and capital formation. Fortunately, new SEC Chairman Jay Clayton has made the public company crisis a top priority and we and we hope other stakeholders will work with him and the SEC to correct this problem. Last month, the Division of Corporation Finance–under the leadership of Director Bill Hinman–announced that the SEC would allow all companies to submit draft registration statements for IPOs on a confidential basis, thus extending a popular provision of the JOBS Act to all businesses, regardless of size. This was an extremely positive development and shows that the SEC is getting serious about carrying out its statutory mandate to facilitate capital formation.

No one single event or regulation lies at the heart of the public company crisis. Like straw upon a camel's back, the burdens and reporting requirements associated with being a public company have steadily accumulated over the years, to the point where many businesses today are saying "no thanks" to a model that was once the ultimate dream of American entrepreneurs. The JOBS Act was a good first step towards arresting this worrisome trend, but there is more that can and should be done.

The Sarbanes-Oxley Act

Sarbanes-Oxley was passed in response to a series of corporate scandals that in some ways undermined the confidence investors had in the American capital markets. Sarbanes-Oxley represented the first major step in "federalizing" corporate governance. Traditionally, corporate governance has been structured under the state laws where a business is incorporated, as well as the by-laws of the corporation. This system has allowed directors and shareholders to create a governance structure that fits the needs of the business and its investors. From the time of the New Deal up until the passage of Sarbanes-Oxley, with some exceptions in the area of compensation, the role of securities laws was a disclosure-based regime intended for investors to have the material information needed to make informed investment decisions.

Sarbanes-Oxley started to place the Federal government in a more predominate role in corporate governance, intruding on the long standing precedents of state corporate law and corporate by-laws. For example, Sarbanes-Oxley created specific requirements for the composition of the Audit Committee and its operation. It also created a quasi-regulatory body in the Public Company Accounting Oversight Board ("PCAOB"), an entity with expansive authority and tremendous influence over the manner in which public companies are operated.

The Dodd-Frank Act

This trend towards greater federal mandates has been accelerated by the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Dodd-Frank mandated new rules on compensation committee independence, pay versus performance, compensation disclosures, claw-back policies, incentive compensation rules for financial firms, "say on pay" votes, new disclosures regarding the Chairman and CEO structures, conflict minerals disclosures, resource extraction disclosures, and mine safety report disclosures. If that's not enough, the Investor Advisory Committee at the SEC—created by Dodd-Frank—has produced recommendations that would further expand the SEC's reach into corporate governance, such as the mandated use of universal proxy ballots in contested director elections.

More troublingly, it seems that in a post-Dodd-Frank world it has become trendy to try and use the federal securities laws in order to advance some type of social or political objective. Since the passage of Dodd-Frank, bills have been introduced—though not passed—which would require human trafficking disclosures, political and lobbying spending disclosures, and mandates for cyber-security expertise on corporate boards, to name just a few. The federal securities laws should never be used as a vehicle to solve a problem or crisis that is better left addressed by other mechanisms of government.

Section 1502 of Dodd-Frank (the "conflict minerals rule") is an instructive–and heartbreaking–example of how such disclosure mandates can have the opposite of their intended effect. The conflict minerals rule was sold to the public as a way to reduce violence in the Democratic Republic of the Congo (DRC), by requiring companies to "shame" themselves if their products contained minerals sourced from that region. In reality, the rule has caused conditions on the ground in the DRC and surrounding areas to further deteriorate as legitimate mines have been shut down, and millions of miners and their families have been driven deeper into poverty. To add insult to injury, public company shareholders are forced to pay billions of dollars in order to comply with a regulation that is so obviously harming a vulnerable region of the world.

The courts have also taken notice and held in the conflict minerals case that a disclosure solely designed to shame a company violates the First Amendment. And in the case of Section 953(b) of Dodd-Frank (the "pay ratio rule"), several pieces of legislation at the state and local level have cropped up around the country to implement a pay ratio "tax" in certain jurisdictions. In fact, the city of Portland, Oregon passed such a measure last year. These taxes are a development that was never considered by Congress or the SEC when Dodd-Frank was passed, and justify the Chamber's longstanding position that the pay ratio rule was never about providing material information to investors.

The Challenges of Being Public Today

These legislative mandates have been coupled with the exponential growth of the proxy statement and corporate disclosures. Furthermore, the SEC has largely failed or been unable to provide oversight over proxy advisory firms, modernize corporate disclosures, and update information delivery systems or reform proxy plumbing systems. The SEC has also gradually receded from its duty as a gate keeper on what shareholder proposals are allowed under Rule 14a-8, increasingly permitting agenda-driven items to work their way into the board room and shareholder meetings. This has allowed a small group of gadfly investors to dominate the shareholder process and frustrate the views of a majority of shareholders. All of this has occurred while businesses are facing increasing pressure to disclose and engage shareholders on environmental, social and governance issues, many of which investors have deemed immaterial.

In 2014, the Chamber released a report that included a number of recommendations which would modernize SEC disclosures for the benefit of both issuers and investors.[4] In addition to the average of $2.5 million in regulatory costs for undergoing an IPO, the SEC has estimated that annual compliance costs for public companies averages $1.5 million[5]–again, a not-insignificant amount of money for a small public company that is focused primarily on growth. Much of this cost stems from the SEC's overly complex and confusing disclosure regime, which even institutional investors have a difficult time understanding.[6]

These have all combined to drive up costs, increase the number of lawsuits and corporate liability, and distract management from growing the company. To put this into perspective, the final report from the 2011 IPO Task Force found that 92% of CEO's found that the administrative burden of SEC reporting requirements was a significant challenge to going public.[7]

This federalization of corporate governance has also made a fundamental change to the way corporations are governed. Traditionally, under the state law system, governance systems were diverse and nimble. The oldest U.S. corporations have tended to use different leadership structures to meet the needs of the business and their investors at that point in time. This diversity has allowed for new and innovative governance changes to occur organically and through a process amongst the stewards of a company.

Take for example the recent "controversy" over companies that choose to go public under a dual-class share structure that limits voting rights to only certain investors. Many of these companies have completed successful IPOs with heavy investor interest, and some deals have been significantly oversubscribed. Instead of requiring businesses to submit to a myopic, Washington-centered view of how a corporation should be structured, companies should be free to choose their own structure, and investors should be free to choose where they want to place their money. If you don't like the corporate structure, don't buy the stock. The markets would help determine if the business got it right or not.

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[4] Corporate Disclosure Effectiveness: Ensuring a Balanced System that Informs and Protects Investors and Facilitates Capital Formation https://www.uschamber.com/sites/default/files/021053_ccmc_disclosure.pdf
[5] SEC 2013 proposed rules on crowdfunding https://www.sec.gov/rules/proposed/2013/33-9470.pdf
[6] A 2014 study by the Rock Center for Corporate Governance at Stanford University found that only 38% of institutional investors believe disclosures related to executive compensation are "clear and easy to understand" https://www.gsb.stanford.edu/faculty-research/publications/2015-investor-survey-deconstructing-proxy-statements-what-matters
[7] Rebuilding the IPO On-Ramp https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf

Under a more federalized system, there is a standard way of thinking and changes increasingly occur through legislative or regulatory mandate. Rather than the board determining the long-term strategy of success, they are increasingly bogged down with mandated regulatory compliance issues. Corporations are being forced into a "one size fits all" model that is more expensive, provides less opportunity to grow, and makes it more difficult to run a business.

There have been beneficial developments that have occurred over the past several decades. Shareholders are more empowered and communications between businesses and investors have increased. Businesses are understanding that they must increase board diversity on their own rather than have a mandate imposed upon them.

Nevertheless, the U.S. public company system—which is still the global gold standard by far, has been increasingly turning into a net negative. As a result, businesses and investors are walking away from an ever shrinking public company pie. America's entrepreneurs are just as comfortable staying private, or being acquired as they are going through the IPO process. That is not good for the long-term growth of the American economy.

How to Fix a System that Needs Fixing

We must strike a new balance between our Federal and state systems. To highlight just one example, since 2010, the SEC has had an outstanding concept release to reform proxy plumbing—the backbone of voting on shares and transparency, yet the SEC has not made any proposals in this area or taken any action. Contrast this with a recent development in the state of Delaware, where—under the leadership of Governor John Carney, a former member of this Subcommittee—the state is on the verge of allowing corporations to use blockchain technology for proxy voting.

The Chamber has tried to offer constructive proposals to address other issues. In 2013, the Chamber proposed substantive financial reporting reforms and in 2015 proposed reforms with the PCAOB to address incongruities related to the lack of public company input into audit policies. The SEC Chief Accountant and PCAOB have established a dialogue with the business community on these issues but more needs to be done. Similarly, the SEC, PCAOB and Financial Accounting Standards Board ("FASB") should agree to a common definition of materiality in financial reporting. Unfortunately, the recent letter by the SEC's Investor Advocate regarding FASB's efforts in this area is off the mark for two reasons: 1) the letter indicates that the SEC, the agency tasked with overseeing financial reporting, isn't speaking with one voice, and 2) the investor advocate fails to understand the import of this issue for both businesses and their investors.[8] Additionally, if the PCAOB's standard on critical audit matters is approved in its current form, liability for businesses and audit firms will increase, and financial reporting may become a less effective tool for investors.

The Need to Prioritize Reform

Earlier this year, the Chamber released a report that emphasized the importance of the Supreme Court-articulated materiality standard that has effectively governed corporate disclosure for decades. We believe that the materiality standard should continue to serve as the touchstone to determine what companies are required to disclose, and that any efforts to require disclosures beyond what is material should be rejected by Congress and the SEC.

Over the next few months, the Chamber will come out with new reports and proposals on how to address these issues. Next week, the Chamber will release a set of proposals to reform SEC Rule 14a-8. These rules were originally intended to facilitate communication and collaboration between management and shareholders to help solve matters of importance related to the company. Instead, the outdated rules under Rule 14a-8 have allowed the mechanism to become a sounding board for activists to push pet issues which are often wholly unrelated to enhancing the underlying value of a company's stock. This has been a tremendously detrimental development for corporate governance in the United States, and only serves as another deterrent for companies to go public.

At a minimum, we believe that the resubmission thresholds under Rule 14a-8 for proposals that receive low levels of shareholder report should be raised so that investors are not forced to register their opposition and bear the costs on multiple occasions to unpopular proposals. We also believe that proponents should be required to provide greater disclosure as to their ownership of shares as well as their motives, and that the SEC should reassert many of the exemptions that currently exist for exclusion from a company's proxy under Rule 14a-8.

Later this year we will issue recommendations to help expand upon many of the "on-ramp" provisions of the JOBS Act, as well as some longer term suggestions for how to make "being" public more attractive for companies. For example, further simplifying disclosures (and providing further exemptions for disclosures such as

[8] Letter from SEC Investor Advocate Rick Fleming to FASB July 11, 2017
https://www.sec.gov/about/offices/investorad/letter-from-sec-investor-advocate-fasb-materiality.pdf

conflict minerals) for emerging growth companies (EGCs) would be a good place to start. Expanding eligibility for use of the Form S-3, and permitting more companies to be classified as well-known seasoned issuers (WKSIs) would also help make being public incrementally more attractive. Put simply, we believe that it is important for the SEC and Congress to continue to build on the JOBS Act and help make it easier for businesses to start, and be given the opportunity to grow into larger ones.

Another pressing issue is the outsized influence that proxy advisory firms have on corporate governance in the United States. The proxy advisory industry has been dominated by two companies–Institutional Shareholder Services ("ISS") and Glass Lewis & Co. ("Glass Lewis"), which collectively control 97% of the proxy advice market.[9] It has been estimated that ISS and Glass Lewis effectively "control" 38% of the shareholder vote because if the two firms make the same proxy voting recommendation, it moves that percentage of the vote absent a vocal campaign against their position.[10]

ISS and Glass Lewis also continue to operate with an alarming lack of transparency and accountability, which has the effect of undermining confidence in the system of proxy voting in the United States. These two firms have yet to take steps to ensure that their voting recommendations are developed on clear, objective, and empirically-based corporate governance standards to help management and investors evaluate and improve governance as a means of increasing shareholder value. They are also riddled with conflicts of interest, and internal processes that have not kept with other changes in the proxy system.

For these reasons, the Chamber strongly supports the "Corporate Governance Reform and Transparency Act". This legislation would require proxy advisory firms to register with the SEC, and become subject to a robust and entirely appropriate oversight regime. We commend Congressman Duffy for his work on this issue, and look forward to working with him on the legislation during this Congress. We will also continue to work with the SEC on its 2014 Proxy Advisory Firm Guidance as well.

The Chamber views the continued efforts of this subcommittee as an important factor for the dynamic changes that make our economy and our capital markets the envy of the world. We believe that the next few years present Congress,

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[9] There are other firms such as Egan Jones which provides a full array of proxy advisory services and Manifest which provides only research. However, these firms are negligible in their market impact.

[10] ISS 24.7% Glass Lewis 12.9% Source: Ertimur, Yonca, Ferri, Fabrizio and Oesch, David, Shareholder Votes and Proxy Advisors: Evidence from Say on Pay (February 25, 2013). 7th Annual Conference on Empirical Legal Studies Paper.

the SEC, and the private sector with a golden opportunity to achieve great victories for American businesses and investors, and we stand ready to assist in any way we can.

DTCC

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July 18, 2017

The Honorable Bill Huizenga
Chairman
Subcommittee on Capital Markets, Securities, and Investment
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Carolyn B. Maloney
Ranking Member
Subcommittee on Capital Markets, Securities, and Investment
4340 Thomas P. O'Neill, Jr. Federal Building
Washington, DC 20515

Re: Hearing entitled "A Review of Fixed Income Market Structure"

Dear Chairman Huizenga, Ranking Member Maloney, and Members of the Subcommittee,

The Depository Trust & Clearing Corporation ("DTCC")[1] appreciates the Subcommittee on Capital Markets, Securities, and Investment's ("Subcommittee") oversight and interest in the fixed income market. The Subcommittee's hearing entitled "A Review of Fixed Income Market Structure" ("Hearing") was timely and raised important issues about the fixed-income markets. As an integral part of those markets, DTCC is submitting this letter to address some of the issues raised in the Hearing related to the U.S. Treasury market. We also understand that the Subcommittee is planning subsequent hearings on these important topics, and we look forward to continuing a constructive dialogue with the committee in order to share our views and inform the Subcommittee to help ensure changes that serve the marketplace as a whole and the public.

DTCC's wholly-owned subsidiary, the Fixed Income Clearing Corporation ("FICC"),[2] is a critical part of the U.S. Treasury market. FICC is a clearing agency registered with the

[1] DTCC provides critical infrastructure to serve all participants in the financial industry, including investors, commercial end-users, broker-dealers, banks, insurance carriers, and mutual funds. DTCC operates as a cooperative that is owned collectively by its users and governed by a diverse Board of Directors. DTCC's governance structure includes more than 300 shareholders.

[2] FICC is designated as a systemically important financial market utility ("SIFMU") pursuant to Section 805 of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") in recognition of its critical role in the national financial infrastructure.

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Securities Exchange Commission ("SEC"). It provides central counterparty ("CCP") services to its customers in the U.S. government securities market, which includes facilitating the submission, comparison, risk management, netting and settlement of Treasury securities transactions.

As the primary CCP for Treasury securities, FICC is committed to maintaining the safety, soundness and resiliency of this critical market. We agree with the Subcommittee that requires having and adjusting to market changes in a responsible manner for the benefit of the entire system. Likewise, the rules promulgated by the SEC for Covered Clearing Agencies – the registration category for FICC – are designed to ensure appropriate risk-management standards and safeguards are being met by all CCPs serving the U.S. cash markets.

Within this framework, DTCC is committed to responding to market-structure changes in the Treasury securities market to meet our customers' needs and serve the interests of the marketplace as a whole. Toward this end, DTCC has expended considerable effort, especially in recent years, to expand access to clearing for more and different types of market participants across asset classes. These efforts serve as evidence of DTCC's commitment to tailor clearing and settlement services that respond to market demands.

FICC has launched recently two initiatives that should expand access to clearing, and its associated benefits, while building on existing risk safeguards at FICC and among its members. First, FICC submitted – and the SEC issued an order approving – a rule change that expands the types of entities that are eligible to participate in FICC as Sponsored Members.[3] Previously, to become a Sponsored Member an entity was required to be a registered Investment Company under the Investment Company Act of 1940, be a "qualified institutional buyer" ("QIB")[4], and have at least one Sponsoring Member willing to sponsor the entity.[5] FICC eliminated the requirement that a Sponsored Member be a registered Investment Company and clarified that a firm whose entity type does not fall clearly into one of the enumerated categories in Rule 144A's QIB definition may still qualify for Sponsored Membership so long as it meets the financial requirements listed in paragraph (a)(1)(i) of Rule 144A of the Securities Act of 1933.[6]

[3] Securities and Exchange Act Release No. 34-80563 (March 1, 2017) (SR-FICC-2017-003). The FICC Rulebook defines "Sponsoring Member" and "Sponsored Member" in Rule 3A. Generally, a Sponsoring Member is permitted to submit to FICC for comparison, novation and netting certain types of eligible transactions between itself and its Sponsored Members. The Sponsoring Member is required to establish an omnibus account at FICC for all of its Sponsored Members' FICC-cleared activity, which is separate from the Sponsoring Member's regular netting account. For operational and administrative purposes, FICC interacts solely with the Sponsoring Member as agent for purposes of the day-to-day satisfaction of its Sponsored Members' obligations to FICC.

[4] QIB is defined in Rule 144A of the Securities Act of 1933.

[5] *Id.* at 2-3.

[6] *Id.*

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Critically, this expansion of Sponsored Member eligibility did not alter risk management practices applicable to Sponsoring Members.[7]

Second, FICC also sought approval to broaden the clearing of tri-party repurchase agreement ("repo") transactions.[8] The SEC recently approved a change to FICC's rulebook broadening the pool of entities that would be eligible to submit tri-party repo transactions for central clearing at FICC.[9] Specifically, FICC established the "Centrally Cleared Institutional Tri-Party Service" or the "CCIT™ Service."[10] To effectuate the proposed CCIT Service, FICC created a new limited service membership category for institutional cash lenders.[11] The SEC approved this rule change as well.[12]

These examples illustrate the progress being made to modernize the existing Treasury-security marketplace in a manner that is consistent with the SEC's and Congress' broad policy goals. But there is more to do.

The U.S. Treasury Department issued a Request for Information ("RFI") last year asking stakeholders for their views about the Treasury market structure, including the growing presence of principal trading firms ("PTFs") in the Treasury securities markets.[13] As DTCC and others shared in that context, unlike the trades of Treasury securities between bank dealers, PTFs' trading activity typically is not cleared by a CCP, such as FICC.[14] This bifurcates the Treasury market, with a growing percentage of the market being bilaterally cleared by PTFs, while much of the bank-dealer trading activity continues to clear at FICC.[15]

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7 *Id.* at 17.

8 Repo transactions involve the sale of securities along with an agreement to repurchase the securities on a later date. Bilateral repo transactions involve a cash lender (e.g., a money market mutual fund, pension fund, or other entity with funds available for lending) and a cash borrower (typically a broker-dealer, hedge fund, or other entity seeking to finance securities that can be used to collateralize the loan). In the opening leg of the repo transaction, the cash borrower receives cash in exchange for securities equal in value to the amount of cash received, plus a haircut. In the closing leg of the repo transaction, the cash borrower pays back the cash plus interest in exchange for the securities posted as collateral. In tri-party repo transactions, a clearing bank tri-party agent provides to both the cash lender and the cash borrower certain operational, custodial, collateral valuation, and other services to facilitate the repo transactions

9 Securities and Exchange Act Release No. 34-80574 (May 2, 2017) (SR-FICC-2017-005).

10 *Id.* at 3.

11 *Id.*

12 *Id.* at 15.

13 *Id.*

14 DTCC RFI Comment Letter (March 18, 2016) at 2.

15 *Id.*

DTCC

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In the response to the RFI, market participants from across the financial sector generally expressed broad support for greater clearing of Treasury securities transactions.[16] Greater clearing of Treasury securities would provide several benefits, including the reduction of aggregate counterparty and credit risk in the system; increased transparency; more efficient use of collateral; and increased balance sheet relief for CCP members.

To address these challenges, DTCC has been in active dialogue with its various stakeholders from the marketplace as well as the official sector. Among FICC's members, the legal structure and risk profile of PTFs would be relatively unique and do not fit neatly into FICC's traditional categories of Clearing Members or Sponsored Members. Nonetheless, DTCC is committed to finding a solution to expand the clearing of Treasury securities in a manner that adheres to the framework established by both Congress and the SEC, and that would help deliver the policy goals envisioned by the official sector and market participants alike.

We appreciate the opportunity to comment on these important issues. We hope we can be a resource to the Subcommittee going forward. Please let us know if you have any questions or comments.

Sincerely,

Murray Pozmanter
Managing Director
Head of Clearing Agency Services

[16] Remarks by Acting Assistant Secretary for Financial Markets Daleep Singh at the SIFMA Fixed Income Market Structure Seminar (May 24, 2017) (available at https://www.treasury.gov/press-center/press-releases/Pages/jl0465.aspx).

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Conflicts between Institutional Investors and Retail Investors in using Federal Securities Laws to regulate Campaign Finance

TESTIMONY

J.W. Verret, Assistant Professor
George Mason University School of Law

Before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

10:00 a.m. on Thursday, March 11, 2010
2128 Rayburn House Office Building

Chairman Kanjorski, Ranking Member Garrett, and distinguished members of the Committee, it is a privilege to testify in this forum today. My name is J.W. Verret. I am an Assistant Professor of Law at George Mason Law School, a Senior Scholar at the Mercatus Center at George Mason University and a member of the Mercatus Center Financial Markets Working Group. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of state and federal authority in corporate governance.

The one group with the most to gain from H.R. 4537, "The Shareholders Protection Act of 2010," are large institutional shareholders that have unique conflicts of interest. The group that stands to suffer the most from the legislation under consideration today are ordinary main street shareholders who hold shares through their 401(k)s.

There are two types of shareholders in American publicly traded companies. The first are retail investors, or ordinary Americans holding shares through retirement funds and 401(k)s. Half of all American households own stocks in this way. The other type of investor is the institutional investor, including union pension funds as well as state pension funds run by elected officials. H.R. 4537 seeks to give those institutional investors leverage over companies for political purposes at the expense of retail investors. We have seen numerous instances where institutional shareholders use their leverage to achieve political goals, like Capler's insistence on environmental or health policy changes paid for by ordinary shareholders.

H.R. 4537 attempts to contort the securities laws to regulate campaign finance risking and limiting the ability of companies to communicate with legislators by giving special interest institutional shareholders, such as unions, power to stop those communications. This bill does not limit union political spending in any way and has nothing to do with the investor protection goals of the Securities Exchange Act.

Shareholders have two available remedies if they become dissatisfied with the performance of their companies. Shareholders can sell their shares, or they can vote for an alternative nominee in the next annual election of the Board. They do both with some frequency. In the rare event that political advocacy actually results in corruption, there is a third line of defense in place. If the Audit Committee of the Board of Directors, which is independent of company management, determines that any political donations are inappropriate they are required under the Foreign Corrupt Practices Act to stop them immediately.

The structure of American corporate law rests the authority to manage the day-to-day affairs of the company, including decisions of how to invest the company's funds, with the Board of Directors. Putting corporate expenditures to a shareholder vote, as H.R. 4537 requires, is the first step toward turning shareholder votes into town hall meetings.

Some shareholders may want the company to locate a new factory in their town or give away free health benefits for employees without regard to whether the expenses risk bankrupting the company. Shareholders choose the board of directors and delegate authority to make these decisions to the board in order to avoid that very problem.

Political risk poses a danger to the 401(k)s of ordinary Americans more now than ever before. Political leaders responsible for policies that subsidized dangerous mortgage practices through Fannie Mae and Freddie Mac now seek to expand financial regulations to generate the appearance of responsive action.

The Supreme Court recently affirmed that corporations have a constitutional right to advocate on behalf of their shareholders. Corporations do so particularly to protect the property rights of those shareholders from expenses associated with regulations whose benefits may exceed their cost. Many reputable companies spend money for this purpose. Berkshire Hathaway, one of the most highly regarded companies in America, spent $3 million dollars last year advocating for the interests of the company and its shareholders.

This bill purports to re-define state corporate law to make un-voted expenditures a violation of the corporation's fiduciary duty to its shareholders. This represents a serious misunderstanding of how corporate law is structured. As Justice Powell wrote: "No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."

The Shareholder Protection Act of 2010 has absolutely nothing to do with reforming financial regulation in response to the financial crisis, and is indeed a distraction from that vital work. It risks giving powerful institutional investors, such as pension funds and state elected treasurers' dangerous leverage over the retirement savings of ordinary Americans. To call H.R. 4537 a "Shareholder Protection Act" is fundamentally misleading.

Federal vs. State Law: The SEC's New Ability to Certify Questions to the Delaware Supreme Court

By J.W. Verret

In the summer of 2007, the Delaware legislature amended the Delaware Constitution to permit the Securities and Exchange Commission to certify questions of law directly to the Delaware Supreme Court.[1] This ability to provide advisory opinions, if utilized by the SEC, is poised to enhance Delaware's dominance as the state of incorporation for publicly traded corporations. The SEC has not announced it has initiated any rule specifying an official procedure to certify questions of law to the Delaware Supreme Court. Thus, in the event of an internal controversy, one wonders whether a letter from the SEC General Counsel or Director of the Division of Corporation Finance would be sufficient, or whether it must be signed by a majority of the Commissioners. Nevertheless, barring such internal dissent, this development adds a fascinating chapter to the symbiotic, though at times rival, relationship between the SEC and Delaware as the primary sources of American Corporate Law.[2]

The primary mode through which Delaware corporation law interacts directly with the securities laws arises when shareholders attempt to place bylaws onto the corporate ballot. Under the DGCL, the bylaws of a corporation may contain any provision not in conflict with the DGCL, and may be adopted by the shareholders, or, if given the power to do so in the corporate charter, the board of directors.[3] Rule 14a-8(i)(2) permits the exclusion of a stockholder proposal if it would, "if implemented, cause the company to violate any state, federal, or foreign law to which it is subject."[4] Delaware law on the legality of proposed bylaws is, however, somewhat unclear when it comes to whether proposed bylaws are in conflict with the DGCL.[5]

It is uncertain, for instance, whether a bylaw proposal purporting to remove board authority to alter or amend that bylaw would be legal under Delaware law. Though unclear, directors may have the authority to unilaterally eliminate bylaws not otherwise protected by the DGCL.[6] Some commentators have argued that 109(a) requires at least some shareholder bylaws be protected from board amendment[7], some argue that such a provision would be highly suspect.[8] One recommendation is to simply require unanimous board approval of amendments to shareholder bylaws, in the hopes that at least one independent director might holdout.[9]

In any case involving the legitimacy of a bylaw, boards are also likely to make a more general argument in reliance on DGCL 141, which specifies that "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."[10] Thus, they will argue that a bylaw at issue is in conflict with this general grant of authority to the board. One useful analysis is that the types of bylaws which would withstand such a challenge would be bolstered by four key characteristics: (i) a bylaw relates to fundamental changes in the structure of the corporation rather than day to day business decisions (ii) it constrains board action rather than requiring affirmative action (iii) it relates to procedural rather than substantive decisions and (iv) it relates to a re-allocation of corporate governance relationships rather than business strategy[11]

The standard method to support an assertion of illegality for the purposes of 14a-8 was traditionally to secure an opinion from a Delaware corporate lawyer reasoning that a particular bylaw was not permitted and then seek exclusion by way of no-action relief from the SEC[12], but there was no facility for the SEC to communicate directly with the Delaware courts. In 2006, Professor Lucian Bebchuk, director of the Harvard Law School Center on Corporate Governance, submitted a bylaw proposal for inclusion on the proxy solicitation materials of Computer Associates, Inc (CA) which sought to limit the board's ability to adopt a poison pill and required a unanimous vote of the board to amend the proposed bylaw. CA filed for no-action relief on the grounds that the proposed bylaw was illegal under state law, but Bebchuk challenged the assertion of illegality in the Delaware Court of Chancery[13] and the SEC

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refused to comment on the no-action request due to the pending litigation.[14] Bebchuk's suit sought a declaratory judgment that his proposed bylaw was legal in addition to an injunction prohibiting CA from excluding the proposed bylaw from its ballot. The Court ruled that the issue was unripe for adjudication, reasoning that only a bylaw passed by the shareholders reached the stage at which it became a justiciable controversy. This holding would make placing bylaws on the ballot nearly impossible, however, as the target could exclude it claiming a state law violation under 14a-8 (despite the DGCL's murky jurisprudence on that matter) and the shareholders would be left with only the remedy of ex-post challenge in federal courts. In the risk-averse institutional investor community, such a remedy would be insufficient to permit bylaw challenges to succeed.

With this new ability to certify questions directly to the Delaware Supreme Court, the SEC would be hard pressed to claim an inability to rule on the legality of a 14a-8 exclusion. The SEC could certainly rule in favor of a challenging company and grant no-action relief without choosing to certify to Delaware. Nevertheless, a shareholder could then utilize his implied power under 14a-8[15] to challenge the SEC ignoring its power to clear up the issue. That failure, combined with the fact that even the Court of Chancery in *Bebchuk v. CA* recognizes the uncertainty in the state law governing this area,[16] would offer significant evidence for a federal court to rule against such an SEC no-action decision, especially since no-action findings are not considered agency rulemaking and thus not subject to *Chevron* deference.[17]

The types of bylaws that will be proposed are limited only by the creativity of the shareholders offering the proposal. The first, and likely most popular, type will relate to the process whereby the board of directors is elected. A recent addition to Section 216 of the DGCL, adopted in August of 2006, specifies that "A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors." Thus, the DGCL has blessed the legality of bylaws relating to elections, but that does not mean that all questions surrounding election bylaws have been resolved. For instance, what about a bylaw that, instead of specifying the number of votes necessary for success, instead specifies a method for counting (or excluding) supervoting shares from certain decisions, or a method for excluding broker street votes, or changes to the record notice period?

Complicating this issue is another provision of 14a-8 permitting exclusion of bylaws that relate to an election.[18] Governance gurus will be familiar with the SEC's most recent attempt at proxy access. The SEC considered two proposals: one which would specifically permit election bylaws being placed on the corporate proxy and another which would interpret 14a-8 to disallow placing such bylaws. Chairman Cox, the deciding vote on a four person panel, opted to support exclusion of election bylaws despite his initial support[19] of proxy access (by election bylaw). Chairman Cox offered his decision as a temporary one, claiming that the prospect of litigation facing companies in light of uncertainty in interpretations of 14a-8 spoke in favor of a temporary resolution, but promises to look at the issue again in 2008.[20] The legitimacy of Cox's uncertainty objection is called into question, though, by his failure to certify a question concerning bylaw legality to the Delaware Supreme court to resolve that aspect of the uncertainty.

Bylaws may also relate to the issue of poison pills, as in *Bebchuk v. CA*. Though the court in that case never actually ruled whether the proposed bylaw was legal, under Section 157 of the General Corporation Law, the power to create and issue rights and to determine the duration for which rights may be issued and maintained is explicitly vested in the directors, not in stockholders or others.[21] Thus it seems that poison pill bylaws are least likely to survive Delaware review. De-staggering of the board is another popular issue and a more open question when it comes to bylaws. As the form and subject matter of bylaw proposals veer off the beaten path of previous derivations, their legality becomes more uncertain.

The most interesting implication of the new Delaware certification is that it can permit the SEC to resolve pressure from Congress or interest groups by leaving open ended aspects to its rule-making in areas that may overlap with state law. For that matter, future rules proposals could make more use of state law carve-outs. For instance, the new independence definitions added to the NYSE listing standards in the wake of the Sarbanes-Oxley reforms have been much criticized, but imagine if the SEC had defined an opt-put cross referencing independence as defined under Delaware law. The SEC could then, in the event that Delaware case law was unclear, consult the Delaware Supreme Court in advance of an enforcement preceding it may later consider.

Going forward, the likelihood that the Delaware certification capability will have a significant effect on corporate law will depend on the SEC's willingness to certify questions, and the Delaware Supreme Court's willingness to accept the appeal. In that event, and especially if the SEC revisits a bylaw oriented version of proxy access for elections, one should expect that election bylaws will be the first order on the agenda.

Notes

1. Del. Const. §11(8) (2007).

2. Edward Rock and Marcel Kahan, Symbiotic Federalism and the Structure of Corporate Law, 58 Vand. L. Rev. 1573, *1616 (2005).

3. DEL. CODE tit. 8, § 109(b) (2007).

4. 17 C.F.R. § 240.14a-8.

5. Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett, 19 Cardozo L. Rev. 511, 546 (1997).

6. *See* Gen. DataComm Indus. Inc. v. State of Wis. Invest. Board, 731 A.2d 818, 821 (Del. Ch. 1999) (noting, in the context of a motion for expedited proceedings, that "the question of whether a stockholder-approved bylaw can be repealed by a board of directors with such authority has not clearly been answered by a Delaware Court. However, the Supreme Court's decision in Centaur Partners and the views of a learned commentator (Professor Lawrence Hamermesh) suggest that the affirmative answer may be the correct one."). See Am. Int'l Rent a Car, Inc. v. Cross, No. 7583, 1984 WL 8294, at *3 (Del. Ch. May 9, 1984) (Berger, V.C.) ("If a majority of American International's stockholders in fact disapproved of the Board's amendment of the bylaw, several recourses were, and continue to be, available to them. They could vote the incumbent directors out of office. Alternatively, they could cause a special meeting of the stockholders to be held for the purpose of amending the bylaws and, as part of the amendment, they could remove from the Board the power to further amend the provision in question.") (emphasis added).

7. Professors Coates and Faris consider the issue in some depth. John Coates & Bradley C. Faris, Second-Generation Shareholder Bylaws: Post Quickturn Alternatives 56 Bus. Law. 1323 (2001). In their view, the "best argument in response is that Section 109(a) of DGCL reserves to the shareholders the residual authority to adopt, amend, and repeal bylaws. If the shareholders' residual authority under Section 109(a) is to mean anything, the argument would go, it must mean that the shareholders may adopt a bylaw that is beyond board repeal." *Id.* at 1368. They also note possible ways to uphold a no-repeal provision, either by arguing that the repeal of the bylaw is a violation of fiduciary duty, or that it is a Blasius like disenfranchisement of the shareholders. *Id.* at 1369.

8. *See* Larry Hamermesh, Corporate Democracy and Stockholder-Adopted By-laws: Taking Back the Street?, 73 Tul. L. Rev. 409. at 469-470 (1998) (Arguing that a bylaw which purports to limit a director's ability to amend the bylaw is highly suspect under Delaware corporate law).

9. Coates and Faris, supra, at 1356.

10. Del. Code tit. 8, § 141 (2007).

11. Professor Coffee also explores these four dimensions that seem to indicate whether a bylaw restricting the power of the board might be upheld. *See* John C. Coffee, Jr., The Bylaw Battlefield: Can Institutions Change the outcome of Corporate Control Contests?, 51 U. Miami L. Rev. 605 (1997).

12. *See* Bebchuk v. CA, Inc., 902 A.2d 737, *739 (Del.Ch., 2006).

13. *See* Bebchuk v. CA, Inc. 902 A.2d 737, *739 (Del.Ch., 2006).

14. *See* CA, Inc., SEC No-Action Letter, 2006 WL 1547985, at *1 (June 5, 2006).

15. *See* Roosevelt v. E.I. Du Pont de Nemours & Co., 958 F.2d 416 (D.C. Cir. 1992).

16. *See* Bebchuk v. CA, Inc., 902 A.2d 737, *742-744 (Del.Ch. 2006).

17. *See* Roosevelt v. E.I. Du Pont de Nemours & Co., 958 F.2d 416, *427, (DC Cir. 1992).

18. *See* Exchange Act Rule 14a-8, 17 C.F.R. § 240.14a-8 (2007).

19. Christopher Cox, Chairman, SEC, Opening Remarks at the SEC Open Meeting (July 25, 2007), available at: *http://www.sec.gov/news/speech/2007/spch072507cc.htm.*

20. Christopher Cox, Chairman, SEC, Opening Remarks at the SEC Open Meeting (November 28, 2007) available at: *http://www.sec.gov/news/speech/2007/spch112807cc.htm*

21. 8 Del. C. § 157.

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The Misdirection of Current Corporate Governance Proposals

TESTIMONY

J.W. Verret, Assistant Professor
George Mason University School of Law

Before the Senate Committee on Banking
Subcommittee on Securities, Insurance and Investment Hearing entitled
"Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance"

2:30 p.m. on Wednesday July 29, 2009
538 Dirksen Senate Office Building

Chairman Reed, Ranking Member Bunning, and distinguished members of the Subcommittee, it is a privilege to testify in this forum today.

My name is J.W. Verret, and I am an Assistant Professor of Law at George Mason Law School, a Senior Scholar at the Mercatus Center at George Mason University and a member of the Mercatus Center Financial Markets Working Group. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of state and federal authority in corporate governance.

I will begin by addressing proxy access and executive compensation rules under consideration and close with a list of contributing causes for the present crisis.

I am concerned that some of the corporate governance proposals recently advanced impede shareholder voice in corporate elections. This is because they leave no room for investors to design corporate governance structures appropriate for their particular circumstances.

Rather than expanding shareholder choice, these reforms actually stand in the way of shareholder choice. Most importantly, they do not permit a majority of shareholders to reject the federal approach.

The Director of the United Brotherhood of Carpenters said it best, "we think less is more, fewer votes and less often would allow us to put more resources toward intelligent analysis." The Brotherhood of Carpenters opposes the current proposal out of concern about compliance costs. The proposals at issue today ignore their concerns, as well as concerns of many other investors.

Consider why one might limit shareholders from choosing an alternative means of shareholder access. It can only be because a majority of the shareholders at many companies might reject the federal approach if given the opportunity.

Not all shareholders share similar goals. Public Pension Funds run by state elected officials and Union Pension Funds are among the most vocal proponents of shareholder power. Main street investors deserve the right to determine whether they want the politics of Unions and State Pension funds to take place in their 401ks.

The current proposals also envision more disclosure about compensation consultants. Such a discussion would be incomplete without mentioning conflicts faced by proxy advisory firms. Proxy advisory firms advise institutional investors on how to vote. Current proposals have failed to address this issue. The political clout enjoyed by these firms is evidenced by the fact that the CAO of Riskmetrics, the dominant firm in the industry, was recently hired as special advisor to the SEC Chairman.

To close the executive compensation issue, I will note that if executive compensation were to blame for the present crisis, we would see significant difference between compensation policies at those financial companies that recently returned their TARP money and those needing additional capital. We do not.

Many of the current proposals also seek to undermine, and take legislative credit for, efforts currently underway at the state level and in negotiations between investors and boards. This is true for proxy access, the subject of recent rulemaking at the state level, and it is true for federal proposals on staggered boards, majority voting, and independent Chairmen.

The Sarbanes-Oxley Act passed in 2002 and was an unprecedented shift in corporate governance designed to prevent poor management practices. Between 2002 and 2008, the managerial decisions that led to the current crisis were in full swing. I won't argue that Sarbanes-Oxley caused the crisis, but this suggests that corporate governance reform does a poor job of preventing crisis.

And yet, the financial crisis of 2008 must have a cause. I salute this Committee's determination to uncover it, but challenge whether corporate governance is the culprit. Let me suggest six alternative contributing factors for this Committee to investigate:

i) The moral hazard problems created by the prospect of government bailout;

ii) The market distortions caused by subsidization of the housing market through Fannie Mae, Freddie Mac, and federal tax policy;

iii) Regulatory failure by the banking regulators and the SEC in setting appropriate risk-based capital reserve requirements for investment and commercial banks;

iv) Short-term thinking on Wall Street fed by institutional investor fixation on firms making, and meeting, quarterly earnings predictions;

v) A failure of credit rating agencies to provide meaningful analysis, caused by an oligopoly in that market supported by regulation;

vi) Excessive write downs in asset values under mark-to-market accounting, demanded by accounting firms who refused to sign off on balance sheets out of concern about exposure to excessive securities litigation risk.

Corporate governance is the foundation of American capital markets. If this Committee tinkers with the American corporate governance system merely for the appearance of change, it risks irreparable damage to that foundation.

I thank you for the opportunity to testify, and I look forward to answering your questions.

GEORGE MASON UNIVERSITY | School of Law

UBER-IZED CORPORATE LAW: TOWARD A 21ST CENTURY CORPORATE GOVERNANCE FOR CROWDFUNDING AND APP-BASED INVESTOR COMMUNICATIONS

J.W. Verret,
George Mason University School of Law

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16-14

Uber-ized Corporate Law: Toward A 21st Century Corporate Governance for Crowdfunding and App-Based Investor Communications

J.W. Verret*

This Article begins with a thought experiment about how corporate governance of small public companies trading on new platforms—like crowdfunding portals (or alternatively, "crowdfunding exchanges")—might be expected to evolve to make corporate governance easier and more flexible for users. New opportunities could involve increased use of default rules whereby shareholders or owners defer direct participation in governance (in line with the Bainbridge director primacy argument), subject to default participation rules developed on crowdfunding platform apps (in a multitude of ways, including through open source methods).[1] They could also include more shareholder empowering regimes. In examining the heterogeneous corporate governance needs that crowdfunded firms are likely to have, this Article will link contributions from the New Institutional Economics, or "Theory of the Firm" Literature, to corporate entity formation to provide a flavor for the range of "outside the box" innovations that may be possible in a new and more competitive corporate chartering race free from the federal overlay.

Of all the claims made in this Article, the strongest is that increased use of arbitration—rather than litigation—to resolve shareholder claims against company defendants will be a necessary element to reinvigorated charter competition for crowdfunded firms. The SEC currently prohibits full use of arbitration of shareholder claims against companies. This Article argues that since antifraud actions under the Securities Exchange Act of 1934 and state corporate governance claims are now largely interchangeable, the SEC's intransigence on arbitration, in spite of federal case law favoring arbitration generally, must be addressed to make state law arbitration a viable alternative means of adjudication for states that compete with Delaware as sources of business entity law.

* The Author thanks the George Mason University School of Law and the George Mason Law School Law and Economics Center for Research support. I appreciate helpful comments from Stephen Bainbridge, Roberta Romano, Bruce Kobayashi and participants at the George Mason Law and Economics Center's Henry Manne Scholar Forum. Before they passed away, I received unparalleled mentorship from Henry Manne and Larry Ribstein that encouraged my development of the ideas in this article.

1. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 583 (2003).

I. PRELUDE: A WINDOW INTO THE 21ST CENTURY WORLD OF CORPORATE GOVERNANCE

Imagine downloading a "crowdfund app"[2] and selecting a few dozen companies for purchase of shares costing roughly $100 each. When you set up your crowdfund app, you are prompted with a series of questions with choices. One might read: "Do you wish to (1) receive updates about company elections and participate in shareholder votes for the board; (2) select a default of voting for the management recommended slate of nominees in all elections; or (3) vote for management nominees unless a list of material negative events recommended by Crowdfund Inc. has occurred?" You may be notified with other messages: "You may change your voting defaults under the settings tab at any time," and possibly, "Do you want to be reprompted with this question any time you purchase new shares through Crowdfund App?"

Periodically, you may receive updates on your app. You check the app a few months later and find an update which states: "A bidder has made an offer of $120 for your share in Techmarket Inc., and will cease purchases when he has acquired 90% of the shares. If the bidder is successful in acquiring 90% of the outstanding shares, your interest may be frozen out and you may be required to accept an offer that may be lower than the tender offer. If so, you may also submit a request for appraisal at that time (see here for more about the appraisal process). The most recent closing price for one share is $110. Do you wish to accept?"

You select "no." A few days later, you receive another update: "The bidder has acquired a 90% stake in Techmarket Inc. and has invoked the freezeout statute. You may either accept the freezeout price of $110, or choose to join an arbitrated appraisal process. Pursuant to arbitrated appraisal, over a 24-hour period an independent accountant will determine whether to award you the freezeout price, or to award you an amount either higher or lower than the freezeout price. If you select arbitrated appraisal, and you wish to register your preference for the arbitrator (which includes an algorithmic weighting incorporating preferences submitted by both the controlling shareholder and frozen-out shareholders), a list of eligible arbitrators can be found at the link below accompanied by user ratings of those arbitrator candidates." Periodically, you check your crowdfund app to track the status of your investments; you examine updates about other pending litigation and elections in companies in which you are invested, selecting from menus if you choose to participate.

You may later open the crowdfund app to find an update stating: "Techmarket Inc.'s annual election is taking place in 30 days. You may access the proxy statement filed with the SEC at the following link. Your default settings are to vote with management unless the company has issued a restatement of its finances because of a significant prior fraud or error discovered in its quarterly reporting. The company has issued such a restatement in the last year. Please vote for a maximum of 12 candidates from the nominees provided by the Board of Directors or those nominated by shareholders with a greater than 5% stake in the company, who are allowed to nominate candidates pursuant to the company's corporate charter, included in the list below."

The app might also prompt: "You have subscribed to voting recommendations from Corporate Governance Analytics Inc. That crowdfunding portal analysis provider

2. Apps have become shorthand for computer operating applications utilized on smartphones.

recommends you vote for eight candidates from management and four candidates recommended by shareholders listed below. To follow that recommendation, click this button." Or, alternatively, if you do not have time or inclination to participate in that way, those decisions could all be made for you according to default actions you select per stock, or for all stocks, in your settings tab. These defaults provided to aid your decision-making on the app-based platform could be developed via an open source method, in which corporate governance professionals—like corporate lawyers—design the defaults and thereby attempt to augment their professional reputations.

II. CROWDFUNDING: AN EVENT WINDOW TO RENEW CORPORATE FEDERALISM

Investors and entrepreneurs will soon face corporate governance challenges as crowdfunded companies—traded on small crowdfunding portal exchanges—soon go online pursuant to a recent SEC rule.[3] Corporate governance entity forms created for large public firms may not be best for this novel, ultra small scale public firm. Similarly, existing off-the-rack LLC options intended primarily for private firms may not exactly fit (particularly Delaware's model). Moreover, powerful interest groups controlling corporate innovation in the leading state of entity formation may have conflicts that limit innovation sufficient to meet required needs. In any event, a federal overlay that selectively preempts corporate governance, and could preempt it further in unexpected ways, further limits incentives of states active in chartering competition to further innovate.

This Article argues that unless a complete rethinking of the federal overlay in corporate governance is undertaken, investors and entrepreneurs may miss their "Uber moment" in business entity formation competition as crowdfunding portals go online in coming years. Imagine if the Romans were prohibited from recognizing the separate entity formation that facilitated the creation of the aqueducts, or if the 19th century incorporation model (where state legislatures were required to pass a new bill to create every new business entity) was still in effect as the nation's economy entered the 20th century. That is the precipice on which business entity law currently sits.

In part, the new crowdfunding platforms are interesting for the simple fact that they open up the possibility for a new experiment in corporate governance. It may be the case that crowdfunding firms have unique dynamics very different from the type of firms currently traded on public platforms, and this Article will explore why that may be the case. But even if they are similar, crowdfunding nevertheless opens up an opportunity to apply corporate governance innovation to a totally new public exchange platform free from pre-existing path dependencies. O'Hara and Ribstein note that "amending a public corporation's charter is costly and cumbersome" and therefore incumbent public firms may find it costly to change their individual corporate charters to reflect economic need and must rely on new provisions in codes developed by other jurisdictions for innovative changes.[4] This does not entirely limit innovation; for example, Grundfest notes that many firms adopted new forum selection bylaws prior to Delaware specifically recognizing that

3. Crowdfunding, 17 C.F.R. pts. 200, 227, 232, 239, 240, 269, 274 (2015), https://www.sec.gov/rules/final/2015/33-9974.pdf.

4. Larry E. Ribstein & Erin Ann O'Hara, *Corporations and the Market for Law*, 2008 U. ILL. L. REV. 661, 700 (2008).

option. It does suggest, however, that particularly paradigm-shifting corporate governance innovation will require new initiative.[5] Thus, the advent of crowdfunding in itself may open a window for some of the ideas presented in this Article. The difficulty of changing paradigms for large publicly-traded firms suggests that innovation is more likely to begin with new firms entering the market. This is particularly true with respect to smaller firms funded by entirely new methods that are not subject to the path dependent pathologies[6] that currently drive choice of forum and choice of law for large public companies.

This Part of the Article below will explain what crowdfunding means and explore the unique economic attributes for small public firms to argue that crowdfunded firms will require innovative and heterogeneous options not presently permitted by the federal overlay in corporate governance. This Part will also explore two smaller firm, lightly regulated exchanges in the United States and Great Britain to develop useful insights for the crowdfunding platform world. This Part will also consider how crowdfunding's interaction with app-based user interaction will lower the costs of shareholder interaction with firms. Finally, this Part will explore how the unique attributes of crowdfunding are likely to help make federalism reforms that are likely to endure, based on a public choice analysis.

A. What is Crowdfunding?

Ethan Mollick defines crowdfunding as:

> [A]n open call, essentially through the Internet, for the provision of financial resources either in form of donation or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes . . . [including] internet-based peer-to-peer lending . . . and fundraising drives initiated by fans of a music group . . . . Crowdfunding refers to the efforts by entrepreneurial individuals and groups—cultural, social, and for-profit—to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries.[7]

In a sense, crowdfunding in the United States has not really happened yet. Thus far, the SEC has prohibited sales of ownership in firms through this technology without registration as a securities exchange and without each individual project or firm on the platform registering as a public company. This results in ensuring that a multi-million dollar proposition remains outside the range of possibility for small scale projects and most firms contemplated on crowdfunding platforms.

5. *See generally* Joseph Grundfest, *The History and Evolution of Intra-Corporate Forum Selection Clauses: An Empirical Analysis* (Stan. L. Rev., Working Paper No. 427, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2042758 (observing that forum selection bylaws were adapting to allow intra-corporate litigation to occur in jurisdictions that specialize in that state's corporate law).

6. *See generally* Lucian Arye Bebchuck & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999) (analyzing structure-driven and rule-driven pathologies of prior corporate structures and their effects on new corporate structures).

7. Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 1, 2 (2013).

In the USA JOBS Act, signed into law in 2012, Congress recognized the growth possibilities of crowdfunding and ordered the SEC to approve a light-touch regulation regime for crowdfunding platforms. Once the SEC's rule implementing crowdfunding exchanges is fully implemented by crowdfunding portals, then some version of what has previously evolved in stunted quasi-crowdfunding platforms will be expected to thrive. But in advance of the rule's implementation, crowdfunding has been limited in that funders are prohibited by law from obtaining a direct monetary interest in the firms they fund.

Prior to crowdfunding going online with adoption of a final SEC rule, most crowdfunded projects do not include an equity ownership component, but instead consist of contributions in exchange for in-kind benefits. Kickstarter is the largest operator of such a pre-crowdfunding platform in the United States. One open question will be whether attributes seen on the crowdfunding pre-cursor Kickstarter will continue to hold as Kickstarter firms transition to crowdfunding platforms able to sell ownership equity. Agrawal posits that, though crowdfunding platform Kickstarter does not permit the issuance of equity shares, and indeed crowdfunding will not involve the sales of equity until the SEC's rules for crowdfunding pursuant to the JOBS Act are finalized, the dynamics of crowdfunding on the pre-cursors Kickstarter, and a European analogue Sellaband, can inform how some of the economics of equity crowdfunding are likely to play out.[8]

Kickstarter is the most popular of the pre-crowdfunding sites. Crowdfunding on Kickstarter has resulted in funds as small as $1000 to fund an event, clearly not what one would classically define as a firm, but for the top 50 largest projects funded by Kickstarter, 45 of them have become surviving business entities.[9] Mollick describes projects funded on Kickstarter as encompassing a wide variety of heterogeneous objectives. He generally divides those objectives into those encompassing a "patronage model" whereby funders act as philanthropists and do not expect a financial return, "reward-based" model where funders expect some in-kind benefit such as preferential access to a funded product, and an "investment model" through which funders seek to obtain profit.[10] The profit model on Kickstarter is somewhat limited, in that federal securities laws prohibit the sale of equity securities with registration absent some exemption (and the exemption for crowdfunded equity securities required by the JOBS Act which was just recently finalized).[11]

8. Ajay K. Agrawal et al., *Some Simple Economics of Crowdfunding* 5 (NBER, Working Paper No. 19133, 2013), http://www.nber.org/papers/w19133.pdf.

9. Mollick, *supra* note 7, at 2. The "Veronica Mars Movie" Project is one of the largest funded projects on Kickstarter. It was a fan-funded movie, continuing a story line from a canceled series, and raised $5.7 million by offering funders in-kind benefits ranging from regular movie productions updates (for $1 dollar contributors) to a role in the movie (for a single $10,000 funder) and a range of other benefits for funders in between. *The Veronica Mars Movie Project*, KICKSTARTER, https://www.kickstarter.com/projects/559914737/the-veronica-mars-movie-project/description (last visited Mar. 28, 2016).

10. Mollick, *supra* note 7, at 3.

11. The third model thus can only offer funders preferential access to purchase securities at a later date, some form of royalty sharing, or other close approximation of a future stream of revenue, while carefully avoiding the SEC's test for an equity security which is largely dependent on the presence of direct revenue sharing.

Mollick's study of crowdfunded firms suggests they often combine these objectives. Mollick notes one odd example of a Kickstarter project in which a user posted, as a joke, a proposal to fund a statue of Robocop to install in Detroit, which subsequently went on to raise $67,000 in six days.[12] This suggests a somewhat organic quality to crowdfunded projects, with initiators at times unsure of the ultimate evolution of their project (and indeed, whether their proposal will be a one time discrete project or will evolve into a full fledged firm). Mollick posits that a number of features unique to Kickstarter help police fraud, "including threshold funding, active participation by large communities, frequent interaction between founders and potential funders, and the ability of founders to broadcast signals of quality through rich descriptions and biographic information."[13]

Mollick conducted a study of 48,500 crowdfunded projects with combined funding of $237 million on the Kickstarter website, and found that number of Facebook friends, geography, and underlying project quality are the key drivers of success in crowdfunded firms.[14] Mollick describes the geographic component as "founders proposing projects that reflect the underlying cultural products of their geographic area (such as country music in Nashville, Tennessee)."[15]

Mollick notes that in crowdfunded ventures "the money is raised up front, and, in the case of reward-based crowdfunding, without any clear legal obligation from the project initiator to deliver their promised rewards. For the dishonest, this creates an opportunity for fraud."[16] This Article will consider the potential corporate governance innovations which may serve to reduce agency costs that flow from this problem. And yet Mollick does not find a significant rate of fraud with respect to Kickstarter projects.[17] He does however find a significant delay rate, which could be merely a result of the unique risks and challenges of crowdfunded firms or which could result from opportunities for shirking created by the crowdfunding environment.

This suggests that a corporate governance modification or innovation which would be quite useful in this context would be a rule of review which focused on the initial intent of the entrepreneur as intended toward a legitimate business venture, albeit fraught with risk, as opposed to a purely fraudulent project. By contrast, the focus of fiduciary duties in traditional corporate law is on the day-to-day business decisions of the executives. It also suggests a role for arbitrators in engaging in the fact-based inquiry of whether a project's goals have indeed been met, and perhaps a default option then triggered to give the original funders a statutory referendum on whether to continue the firm's existence or liquidate it.

Agrawal examine a precursor to Kickstarter based in Amsterdam called Sellaband, which funded new music bands. Sellaband operated free from U.S. federal securities laws and was therefore able to share profits with funders.[18] The Sellaband platform took a role in the governance of funded projects, and after posting a profile of the band and a demo,

12. Mollick, *supra* note 7, at 3; *see also* Bryan Hood, *Detroit's Robocop Statue Almost a Reality*, N.Y. POST (Jan. 22, 2014, 6:13 PM), http://nypost.com/2014/01/22/detroits-robocop-statue-almost-a-reality/.

13. Mollick, *supra* note 7, at 14 (describing the Robocop statute funding prank).

14. *Id.*

15. *Id.* at 2.

16. *Id.* at 11.

17. *Id.*

18. Agrawal et al., *supra* note 8, at 7.

would collect $10 futures investments in the band.[19] If the band failed to raise $50,000, funding was returned to investors. If it did, the money was used to fund production of an album recording, pursuant to a budget approved by the Sellaband platform. Kickstarter's role in reviewing projects on its platform was more limited—public disclosure indicates its diligence is limited to rooting out fraud, not to meter investment quality.[20] To the extent that crowdfunding platforms themselves could potentially invest in some of their projects, it could serve to minimize agency costs along the Sellaband model, but they are unfortunately prohibited from doing so by the JOBS Act.

Agrawal describes how crowd-based diligence can also be effective in rooting out fraud, given that a large community of users can pool resources.[21] As crowdfunding platforms go online, crowdfunding investors or analysts could seek to build reputations as star pickers and thereby serve as repeat players, or informational intermediaries could evolve. Agrawal notes that another solution to reputational constraints and adverse selection problems on crowdfunding platforms is to break up the project financing into a series of milestones.[22]

Information problems not resolved by intermediaries could be resolved by the signal of an initial anchor investor. For example, seed funding from a venture capital (VC) could be a vitally important initial signal for crowdfunded entities. This way crowdfunders could free ride on the initial investment of diligence by the VC. On the other hand, the VC has a chance to observe what the firm does with the crowdfunded money to determine whether additional funding is worthwhile. They would also have a valuable signal in the publicly traded price of the crowdfunded firm which they might use to gauge the value of their investment through a market process. All of which will suggest a need for adaptive funding mechanisms that allow for the possibility of applying contingencies to shareholder rights that may not be permitted under existing federal corporate governance rules or state law regimes.

Focusing on Sellaband again for a moment, invoices were sent to Sellaband for payment of band expenses, and any profits were split equally between funders (who also get a free CD), artists and Sellaband. During the three-year period of the Agrawal study 34 albums obtained $50,000 in funding. Agrawal observed that crowdfunded investments under the Sellaband model are highly path dependent, and as amount previously invested grows, the propensity of investors to invest tends to accelerate quickly.[23] This suggests crowdfunding platforms may find value in more variability in the disbursement and control rights of different groups of shareholders, and may value a structure that facilitates giving different stages of preference to multiple classes of shares to attract large blocks of shares initially, as well as maintaining variable voting and cash distribution rights to facilitate subsequent rounds of funding. Delaware's corporate law code is far too rigid to accommodate such a level of flexibility in shareholder control rights, and the residual obligation of contractual good faith and fair dealing in Delaware's interpretation of its LLC code would similarly threaten full utilization of an entity form

19. *Id.*
20. *Id.* at 25.
21. *Id.* at 28.
22. *Id.* at 25.
23. Agrawal et al., *supra* note 8, at 16.

with necessarily fluid and variable control rights. Agrawal also notes how an initial tranche of "friends and family" investment tends to be local and signals to other, more distant investors, the entrepreneur's commitment to the project.[24]

If investments by large block investors can serve the same signaling function for crowdfunded firms (as if, for example, a VC fund offers a small slice of funding to a startup, but awaits further funding on a crowdfunded platform contingent on the firms ability to raise a block of funding via the crowdfunding portal), then that same signaling effect could facilitate crowdfunding. VC's are typically thought of as pre-IPO funders, but small tranches of crowdfunded capital could be contemplated betwixt rounds of funding from a VC firm. This may call for variability in share class rights, and indeed for an element of contingency in share class rights which could change upon subsequent rounds of funding. This suggests a need for more variability than can initially be expected from the Delaware corporate code or is permitted by the residual obligation of good faith and fair dealing in Delaware's LLC code. It may also demonstrate the folly of the NYSE's prohibition on dual class share issues for post-IPO firms—as a rule which crowdfunded exchanges should certainly not emulate (though, since the exchange's limits on dual class shares was a result of pressure from the SEC, there is reason to suggest they will similarly be pressured to do so). This sort of variability could be evidenced in several ways. For instance, there could be a right to issue shares with voting or outright control rights that trump the rights of existing shareholders. Relatedly, there is also the right to issue shares that have dividend rights that trump the rights of existing shareholders. These rights could potentially water down other rights of existing shareholders, upon a subsequent opportunity to obtain VC financing. All of which would be prohibited by nearly all national exchanges, including the Nasdaq's new venture exchange.

Agrawal, Catalini, and Goldfarb describe what is currently by far the greatest success story on Kickstarter, which was the development of the Pebble watch.[25] An entrepreneur had secured $375,000 from an angel investor to produce a watch which could synch with Blackberry and iPhone devices, but needed another $100,000 to finish production and was unable to obtain it. He turned to Kickstarter, where he promised funders a watch in exchange for every $120 contributed. He raised $100,000 within two hours, and an additional $10 million within 37 days.[26] He promised delivery by September 2012, but production fell behind and he was unable to deliver until May 2013 (though he did eventually fill all orders).[27] The competition of the Pebble watch eventually led Apple to respond by offering a smartwatch of its own. This example suggests the value of linking tranches of venture capital investments with crowdfunding tranches in an early stage startup.[28]

Some of the benefits of crowdfunding to issuers include an ability to bundle funding

24. *Id.* at 19–20.

25. *Id.* at 3–4.

26. *Id.* at 2.

27. *Id.* at 3.

28. Agrawal posits that some firms may actually prefer non-equity based crowdfunding to equity crowdfunding, as it could limit the dilution of subsequent rounds of financing to venture capital firms, and they note that after Pebble's successful crowdfunding venture it chose to obtain additional capital through a more traditional Reg. A offering. Additional flexibility and heterogeneity in share class differentiation could help to bridge that gap. Agrawal et al., *supra* note 8, at 6.

in-kind benefits, including participation in the underlying project itself and recognition for funders, as well as obtaining information such as the strength of a consumer preference for future production by their participation in equity funding.[29] Agrawal notes, for example, how funders were highly involved in the initial design of the Pebble watch, and suggested numerous modifications that were subsequently included in the watch.[30] This suggests that investors may need new means of communicating with entrepreneurs other than the classic modes of shareholder voting and shareholder proposals. It also suggests that potential for misapplication of controlling shareholder, equitable subordination, or veil piercing doctrine in this context to inhibit shareholder participation in idea development at crowdfunded firms.

B. The Economics of Crowdfunding Demonstrate that Crowdfunding Will Require a Level of Flexibility that Current Federal Preemption Would Not Facilitate

The last Section made some initial suggestions about corporate governance innovation which would be useful at crowdfunded firms, but this section will explore the range of corporate governance flexibility which will likely be required by crowdfunded firms in more depth based on application of the New Institutional Economic or firm theory economic literature. It will particularly explore innovation which would not be easily accommodated by the federal overlay present in the current corporate governance system. Some of these suggestions are speculative and may not ultimately prove in high demand for crowdfunded firms, while other unexpected innovations may develop in a corporate governance system freed from the federal overlay. Nevertheless speculation about useful corporate governance innovations in this space may help to convince readers of the range of potential innovations that will be precluded in the crowdfunding space as a result of the federal overlay.

1. Expected Demand for Arbitration

The fractionalization of ownership on crowdfunded platforms may be such that arbitration of claims could be a more useful means to determine the fact question of whether the crowdfunded entity operated within the boundaries of its stated objective. Fractionalized shares may be so small that shareholders in a class may be unable to monitor conflicts between attorneys and the represented class for example, and thus this Article will argue that they may require means of adjudicating their rights which represent a low cost to firms. Thus, traditional class actions may be expected to destroy the fledgling firm with long delays and expensive litigation, and thereby prevent accomplishment of some objective which the initial investors value highly. This may generate interest in an entity form that combines features of default corporations with features of LLCs, and may be more usefully enforced through an arbitration method of business code enforcement.[31] Schramm notes that particular emphasis on defining donor

29. *Id.* at 11.

30. *Id.*

31. Some may argue that a new quasi non-profit business organization form which limits the profit maximization objective may be applicable for firms in this space, such as the LC3 organization form developed in Oregon and Washington state. The LC3 business entity form will not likely fit this model well, as that code form takes an already nebulous concept like the duty of good faith, loyalty, and care, which is currently

intent in the non-profit context can facilitate separation of ownership from control to such an extent that something resembling more of a classic firm becomes possible.[32] Therefore, in lieu of nebulous fiduciary duty type standards, non-profit crowdfunding firms may find it helpful to more clearly explain the parameters of their mission, or the contours of a specific project or groups of projects. They may find it so helpful that agency costs can be policed through arbitration fact-finding to determine whether the contractual specification has been met. Alchian and Demsetz and Fama and Jensen[33] explore the role of residual claimant owners in monitoring firm employees.[34] In some sense one type of project funded on Kickstarter, mixed motive firms, may be seen as blending the presence of residual owner monitors with partially non-profit firms. If the defining objective of the firm can be completed to achieve a fixed goal but will take place over an uncertain timeframe, then owners of mixed-motive crowdfunded firms can be thought of as residual claimants with a contingent claim. Once the firm's initial objective has been met, any subsequent profits are subject to an ownership claim pursuant to contractual rights provided in the charter. Before that time the firm's obligation can be thought of as unconstrained by a requirement to maximize profits. If the initial project has been met, and along the way it becomes clear that the one time project has generated spillover value that can become an enduring firm, shareholders may find value in a code that has a default means for the shareholders to reassess whether they want to firms separate existence to continue.

For example, consider the investor in a biotech development for a drug to cure an ailment affecting a very small number of victims, one of whom happens to be a distant relation or contact (e.g. Facebook "friend") of the investor. This model of financing is expected to grow in the future, which may well include crowdfunded financing.[35] For an investor/donor at the margin the lack of potential profit may have otherwise limited their interest. Investors may then buy in with a preference for some hope of profit, but which hope is seconded to a primary purpose of spending the maximum amount toward R&D required to cure the disease, even if it maxes out their investment.

A business entity charter for such an institution will likely not be well-served by a broad, indeterminate fiduciary duty obligation of managers to owners with all its attendant doctrinal baggage. It may also be ill-served by a pure fiduciary opt-out in an LLC form, as some intermediate third-party review could reduce agency costs and

interpreted within a loose profit maximization norm, and makes it even more nebulous. Bainbridge describes how stakeholder based duties for corporate directors would only make accountability problems worse, as directors would be able to "play off one constituency against another." Bainbridge, *supra* note 1, at 583. Thus, a contractually-based obligation drafted more specifically to the goal of the project is likely to prove far more useful in this context, particularly if it also utilizes an arbitration based framework for interpretation.

32. *See generally* Carl J. Schramm, *Law Outside the Market: The Social Utility of the Private Foundation*, 30 HARV. J.L. & PUB. POL'Y 355 (2005) (emphasizing donor intent in a non-profit setting).

33. *See generally* Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972) (showing the role of residual claimant owners); *see also* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership from Control*, 26 J.L. & ECON. 301 (1983) (demonstrating the same).

34. *See generally* Alchian & Demsetz, *supra* note 33 (showing the role of residual claimant owners).

35. Lia Steakley, *New Crowdfunding Sites Apply Kickstarter Model to Health and Medicine*, STANFORD MEDICINE (July 12, 2012), http://scopeblog.stanford.edu/2012/07/12/new-crowdfunding-sites-apply-Kickstarter-model-to-health-and-medicine/.

thereby prove helpful to both managers and investors, particularly with respect to the question of when it is necessary to continue a project's separate existence or require dissolution. In any event, this Article in a later Part will demonstrate that the dominant Delaware LLC entity form does not actually permit full fiduciary opt-outs for those firms that would seek a full opt-out.

These firms may be better served by a fact-based inquiry into whether the initial objective has been met should a shareholder challenge a firm that is seemingly dragging its heels to maintain discretion over the firm by delaying accomplishment of its objective. The firms may also be better served with a mode of arbitration that is not administered by judges, but instead is administered by professionals in that particular business, such as our example medical industry researchers.

Some have argued that the broad fiduciary duty obligations imposed by Delaware corporation law are gap fillers for contractual arrangements between shareholders and boards that cannot anticipate every contingency. Bainbridge describes the role of fiduciary duties as gap fillers for corporate contracts.[36] This may be true, but Delaware's fiduciary jurisprudence is not the only form of useful gap filler. The more specific goal-based review explored in this article could prove a more effective alternative in many crowdfunded firms, particularly mixed-motive firms. There may also be some expected demand for conflicts policies for board members serving in multiple business endeavors or methods of defining whether a non-profit "objective" has been met both would appear useful in this context and await legal innovation and interpretation.

Note also that this analysis does not suggest utilizing the Delaware corporate code or LLC code, or some variant, and merely arbitrating it with reference to Delaware precedent. Instead it suggests an entirely new form of code, with duties and obligations of corporate officers designed to be optimally determined via an arbitration model.

Williamson describes arbitration as a frequently superior means of enforcing contracts as, when it employs specialized arbitrators, can make use of superior information to slower and less efficient court based systems (particularly when a court will subsequently enforce the arbitrated award).[37] Williamson also notes that arbitrators have means of learning information during a controversy that are not as constricted as those in litigation.[38] Crowdfunding may well prove Williams right, if the federal overlay in corporate governance can be rescinded to allow arbitration-based alternatives to blossom.

2. Expected Demand for Non-Traditional Governance Structures

Another characteristic typical of projects operating on Kickstarter is that a small number of entrepreneurs work for the organization, which would serve to minimize the incidence of internal rent seeking within organizations between division directors in a large public firm.[39] So while crowdfunded firms will not obtain the same scale

36. Bainbridge, *supra* note 1, at 586.

37. Oliver E. Williamson, *The Economics of Governance*, 95 AM. ECON. REV. 1, 14 (2005).

38. Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. R. 519, 527 (1983).

39. DANIEL F. SPULBER, THE THEORY OF THE FIRM: MICROECONOMICS WITH ENDOGENOUS ENTREPRENEURS, FIRMS, MARKETS, AND ORGANIZATIONS 49 (Cambridge Univ. Press 2009).

efficiencies as larger public firms, they will minimize some of the internal organizational monitoring costs typical of larger firms.

A case study of the largest profit-based crowdfunded project in the Pebble watch suggests that funders provided funding to the only verifiable aspect of the firm, meaning the biography of the inventor and the signal that he had been provided funding for his idea by a VC, but the production itself was almost exclusively outsourced.

If that dynamic holds true for crowdfunding as ownership in the new model, crowdfunded firms may stay especially tight and small, merely internalizing the discovery of an idea and an individual's ability to utilize their networks in obtaining subsequent VC financing, and otherwise rely in large part on outsourced production. While this Article explores below that non-profit crowdfunded firms are likely to demand significant participatory rights, in cases as these the identity of the entrepreneur may be a substantial portion of the value of the organization, and so the entity may require strict limitations on shareholder participation rights.

If that is true, however, then contractual counterparties like suppliers may face significant hold up problems. Klein, Crawford and Alchian note that contractual counterparties in the development of firm-specific assets can have incentives to engage in opportunistic behavior once production has begun to appropriate quasi-rents.[40]

Klein and Leffler suggest that sunk investments like advertising to obtain brand name capital, combined with premium revenue streams, can serve as a signal that firms will not engage in such opportunistic behavior, but for a brand new startup like those anticipated on crowdfunding exchanges this may prove difficult. For those crowdfunded firms for which potential appropriable quasi rents are high, such as a new startup that has a totally new product which requires a unique production process and which outsources all of its production, Klein Leffler solutions will prove difficult for as long as the firm is unable to generate significant brand name capital.

Klein, Crawford and Alchian suggest that vertical integration is a solution to this problem. Thinking along a continuum of solutions it may be the case that partial integration, through partial sharing of control rights, could also serve to either minimize opportunistic behavior or, in the case of board seats, provide a low cost means of monitoring opportunistic behavior.

Williamson argues against the utility of suppliers placing monitors on corporate boards, in part because they can themselves use their positions to appropriate quasi-rents. Williamson describes providing seats on the Board of Directors as a cumbersome instrument to provide contractual enforcement to stakeholders, in that it "such protective powers as it possesses are compromised by inviting broad participation on the board."[41]

While this may be true in some cases for much larger firms, crowdfunded firms with a small number of large firm specific production contracts may find board placement of large suppliers a valuable tool of contractual bonding. Williamson warns that once a partisan constituent of the firm has obtained a board seat, they can use that position act

40. *See* Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978), *excerpted in* LOUIS PUTTERMAN & RANDALL KROSZNER, THE ECONOMIC NATURE OF THE FIRM 107 (2nd ed. 1996).

41. Oliver E. Williamson, *Strategizing, Economizing and Economic Organization*, 12 STRAT. MGMT. J. 75, 86 (1991).

opportunistically or log roll their votes with other members of the board.[42] If two firms have members on each other's boards, however, it could serve a hostage taking function that could facilitate contractual enforcement for each side.

In the general case if a single long-term supplier is the only constituent serving on the board the log rolling problem is limited, and in any event Williamson's critical analysis of constituent board members responds to a suggestion that constituent board membership should be mandated to serve some social democracy objective, not to board memberships contracted for by counterparties of startups. A member joining a board to serve a monitoring role would notably have an interest in significantly limiting their exposure to liability for disruptive action under whatever corporate governance duties they owe to the firm and its shareholders (which is as yet up for debate). Also note that Williamson assumes the standard board of directors, not one in which innovative changes in board structure and powers have been implemented.

This may provide some value to the provision of board seats that have some permanency, as joint monitoring mechanisms to limit hold up on firm specific contracts. If a contractual counterparty has a seat on the board, the firm's ability to engage in opportunistic behavior would be quite limited. For that to work, however, the ability of owners to select board members would need to be significantly limited. It also suggests that director independence requirements mandated by federal law would be counterproductive for these firms. Even if it isn't a question of board seats, but some other contractual control right, perhaps one that only kicks in upon a firm's inability to make good on a contractual commitment to a significant supplier, it is nevertheless another reason for potential demand for governance flexibility.

This Section has thus demonstrated that early stage crowdfunded firms will require significant flexibility in their ability to choose the makeup of the boards of directors that run the firm, or indeed will require flexibility for some alternative novel mechanism to oversee the firm.

3. Expected Demand for Novel Shareholder Participation for Some Crowdfunded Firms, Particularly Public Hybrid Firms with Constraints (Enduring or Limited) on the Profit Maximization Objective

Spulber notes that non-profit firms are defined as firms in which objectives cannot be separated from those of owners, and thus free transferability of ownership is not a function of non-profit structure.[43] Crowdfunded non-profit firms are likely to challenge this conventional wisdom, as the information efficiencies created by crowdfunding platforms economize on the costs of search and can better match funders with similar objectives. Thus, part of what makes crowdfunding unique is that reductions in the cost of search can actually make publicly traded non-profit firms a possibility.

A unique feature of crowdfunded firms, that otherwise share some characteristics of non-profit firm objectives, is that the group of owners may be so large (and search costs of owners finding each other who share the same objective are reduced by the crowdfunding platform innovation) that transferability of interests among that group may

42. Oliver E. Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1206 (1984).
43. SPULBER, *supra* note 39.

be possible. This could allow for both market-based valuation of the firm and provide liquidity benefits to the individual funders. In order to enforce objectives, those firms may be designed to provide unique control rights to those owners. In the purely non-profit publicly traded firm, the market value of the share would be the right to control the non-profit. In a mixed-motive crowdfunded firm, the value would include a profit distribution contingency.

For example, with respect to the Kickstarter financed fan film the "Veronica Mars Film Project" explored above, the entrepreneur financing the project was the director of the original TV series.[44] If, after crowdfunding goes online, such a project were organized as a for-profit firm operating over a crowdfunding platform, it is unlikely shareholder participation in governance would fit. The relationships and creative capital are all unique to the project's originator.

For other publicly traded, non-profit projects operating on crowdfunding platforms, the identity of the initial entrepreneur may not be as firm specific, and funders may highly value the ability to participate in the selection of managers or board members to maintain the character of the firm. Kuaan models non-profit firms as an example of consumers integrating into the production process of the firm.[45] This appears to characterize many projects funded on Kickstarter. Thus, a part of what is being traded is the right to proportionate shareholder control of the non-profit firm (and also, for some firms, the right to profits for value created by the non-profit if it subsequently "converts" to a for-profit firm).

This suggests a departure from the board-centric model of Bainbridge,[46] which would otherwise typically be associated with the contractarian analysis utilized in this Article. The Bainbridge model is one centered in the neoclassical firm with a wealth maximization objective.[47] This as we have seen is likely to be modified should the type of projects seen on Kickstarter also transition over to crowdfunded platforms.

Bainbridge's director primacy model provides tremendous descriptive power for large publicly traded firms.[48] He notes one of the primary reasons why his board centric model describes many public firms is that it "provides a hierarchical decision-making structure well suited to the problem of operating a large business enterprise."[49] This function of the director primacy model may have limited application to crowdfunded firms as they may simply be too small and operate by horizontal consensus. Then again, some firms seeking to grow and move to large securities exchanges may adopt governance models based on the Bainbridge director primacy model out of recognition that path dependencies could develop making transition to another governance structure costly down the line.

Bainbridge also focuses on conflicts of interest among groups of shareholders like union pension funds,[50] which may justify limits on shareholder control rights for some firms. While some of the shareholders he observes in the large public company context

44. *The Veronica Mars Movie Project*, *supra* note 9.
45. SPULBER, *supra* note 39.
46. Bainbridge, *supra* note 1, at 583.
47. *Id.* at 558.
48. *Id.*
49. *Id.* at 572.
50. *Id.* 583.

may be restricted from investing in crowdfunding ventures, there are still other conflicts we might expect that would cause the same problem. For example, if there is asymmetry of information between shareholders and competitors about the value of a new innovation, then competing firms may obtain control of crowdfunded startups in order to vote to replace the managing entrepreneur and stifle the competitive innovation that might threaten their competitive advantage in the market.

Bainbridge's argument is at heart a contractarian one, and therefore, the general arguments in favor of director primacy for large public companies does not preclude the utility of alternative arrangements for firms with different unique needs who contract for alternative arrangements. In particular, those smaller and early stage firms likely to trade on crowdfunded exchanges may have unique requirements such that shareholders and boards will demand more shareholder empowering methodologies. Fama describes reasons why security holders may want to abdicate their control rights to managers, including their ability to diversify risk, and that manager's opportunity wages may depend on the success of the firm—suggesting there may be many situations in which managerial control and the separation of shareholder ownership from control could be optimal.[51] Some crowdfunded firms may reflect this description. Others in which shareholder interests are firm specific and less diversifiable like fan-financed entertainment projects may be better paired with voting control depending on whether there are substantial firm specific quality to the entrepreneur.

In sum, we can expect some instances in which the Bainbridge director primacy model will continue to have force in the crowdfunding context. But even in those instances, the types of shareholder conflicts necessitating limits on shareholder control rights is likely to be unique, and innovation inhibited by the federal overlay will prove a challenge. For other firms more shareholder participation will likely be demanded, but rigid shareholder participation approaches favored by the federal overlay—like voting for directors and voting for shareholder proposals—may also prove to be a poor fit. Either way, flexibility in corporate governance will be essential in the crowdfunding world.

4. Expected Demand to Facilitate Adaptive Funding Methods

Delaware corporate law and Delaware alternative entity law both stand for the proposition that, even though a board or manager may be permitted to take an action by the state's code, they may be found to have violated either their fiduciary duties (or in the case of an LLC that has opted out of fiduciary duties, their still enduring "duty of good faith and fair dealing")[52] in so doing. Further, the SEC has pressured the large national exchanges to limit the ability of listed firms to issue dual class shares with unique control rights once a firm has gone public. This Section will show how those constraints contained in the federal overlay, and within the Delaware dominant business entity model, will ill serve crowdfunding firms.

Prior literature on the economics of entrepreneurship considers the agency costs that

51. KROSZNER & PUTTERMAN, *supra* note 40, at 305; Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

52. Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131, 158 (2009).

arise when performance is unobservable.[53] Some have observed venture capital firms have developed mechanisms to address these costs, as in the allocation of control rights or in the form of unique combinations of convertible securities.[54] In addition to specialized monitoring, venture capital firms can also provide human capital to new entrepreneurs in the form of un-conflicted consulting advice.[55]

Fama and Jensen, in "Separation of Ownership from Control," argue one mitigating factor in larger organizations, in which decision management and decision control are disaggregated, is agency costs are lower because of monitoring among and between employees—creating internal systems of checks and balances.[56] For a crowdfunded entity mirrored on the Pebble model, that would not be the case, suggesting another reason why the joint VC funding and crowdfunding model is likely to be replicated on many crowdfunded firms, particularly those like Pebble which rely on a small number of employees for large scale and outsourced production. Utilizing a firm structure for venture capital investments in projects allows use of the signal provided by a venture capital investment to provide information to much smaller investors who can minimize their risk through diversification but also are a result of their greater diversification not interested in expending much monitoring costs. Crowdfunding investors also minimize their risk through fractionalized investments. The crowdfunding participants may have different risk preferences and/or different budget constraints from the VC firms, but the signal of an initial VC investment provides value to them. The VC can minimize its up-front investment to a little less than the amount required by the firm.

One of the benefits of publicly traded securities identified by Fama as a means to minimizing agency costs is the signal that publicly traded equity serves in evaluation of managerial performance.[57] For a venture funded enterprise, adding a layer of crowdfunded equity provides venture capital firms with such a signal to evaluate their investment, determine whether to exercise any contractual control rights they possess or exercise conversion rights in their securities, and allows them to assess the viability of future investments. This dynamic was exactly how the most successful venture on Kickstarter operated in the story of the Pebble watch previously described in this article. This suggests that corporate governance needs unique options for crowdfunding firms that make use of this dynamic which may include dealing with transition problems as firms obtain small initial investments from VC firms with high specialized monitoring: then firms obtain rounds of capital from crowdfunded finance and then perhaps obtain additional rounds of funding from a VC. Negotiations expected to take place with VC firms during these transitions should be expected to include changes in control rights that may be restricted by Delaware's residual obligation of good faith and fair dealing and by the federal overlay.

As one example, the ability to issue multi-class shares after initial shareholders are issued with specified rights, without fear of fiduciary duty litigation or "duty of good faith and fair dealing" litigation—which are risks inherent in Delaware corps and LLCs—

53. SPULBER, *supra* note 39, at 172.

54. *Id.* at 173.

55. *Id.*

56. *See generally* Fama & Jensen, *supra* note 33, at 11 (discussing how management decisions are impacted by ownership and control).

57. *See generally* Fama, *supra* note 51.

could present a problem. And the listing requirements of exchanges that limit your ability to do so should not be replicated as an SEC-mandated element of crowdfunding platforms, though it is unclear whether that will be the case. Preferred stock has been one way to traditionally limit conflicts between different classes of investors.[58] But in this instance, multiple rounds of financing that move between VC block investors and public funding may require highly contingent residual control rights for crowd investors, which is not favored by the equitable principles in the Delaware code.

Fama and Jensen describe capital market financing in publicly traded companies as uniquely designed for "activities optimally carried out with large quantities of long-term assets that are difficult to value and that are more efficiently purchased by residual claimants rather than rented."[59] They contrast that description of publicly financed projects against those financed through proprietorships or partnerships with restrictions on withdrawal rights for residual claimants as "when the important asset in an activity is the human capital of existing decision agents."[60] They also note:

> [A]t various stages in the life of a venture it may be best carried out under different organizational forms. For example, it may be first organized as a proprietorship and then, with increasing demands for financing risk investments, converted to a partnership or a closed corporation, and then to an open corporation.[61]

The transition they describe is not costless, however, and there may be path dependencies that limit the freedom to convert entity form. Members of the partnership, which potentially have what Fama and Jensen describe as widely different consumption preferences, may not be predisposed to support the conversion, for instance as a form of holdout problem. Therefore, it is possible that what crowdfunding will do is create a transition space for firms that may be otherwise constituted as partnerships, but which are facing increasingly intense capital financing needs. This change may also characterize some of the smaller firms trading on pink sheets.

This further suggests a need for contractual flexibility in crowdfunded firm governance, as there may be a wide heterogeneity in the relative mix of capital intensive versus human capital elements of the firm's investments, and therefore a wide range of optimal levels of restrictions on the rights of residual owners. Some theorize that firms can create managerial tournaments to incentivize managers within firms.[62] Fama describes this function as a means of limiting agency costs that flow from the separation of ownership and control.[63] To the extent that crowdfunded enterprises will be relatively small startups with a relatively flat management structure, this is not likely to have as much significance as it does for large publicly traded firms.

However, if the crowdfunded startup's best alternative is instead a proprietary owner fully funded with debt, the possibility of obtaining future equity interest in the firm may serve to provide a cost-effective means of financing, despite the presence of residual

58. SPULBER, *supra* note 39, at 173.

59. KROSZNER & PUTTERMAN, *supra* note 40, at 342.

60. *Id.*

61. *Id.* at 344.

62. SPULBER, *supra* note 39, at 273.

63. Fama, *supra* note 51, at 295.

agency losses. Jensen and Meckling note that a market for managerial talent and a market in the company's stock both serve as constraints on agency costs.[64] Crowdfunding for many smaller startups will be characterized by a relatively higher level of firm-specific executive talent and by a relatively illiquid secondary market for the firm's securities relative to larger firms on public markets. This suggests that the traditional importance that Delaware law and the federal overlay place on shareholder voting rights as agency cost-monitoring mechanisms is misplaced for many firms in the crowdfunding context.

5. Expected Demand to Facilitate Their Organic Growth

Agrawal describes the shift from non-equity crowdfunding to equity crowdfunding as associated with the question of whether investors want to merely pre-order a single, specific product, or instead want to invest in future projects due to "the creator's ability to generate equity value by building a company rather than just delivering a product."[65] For some entrepreneurial projects, crowdfunding could be thought of as a form of purely pre-order contracting through which a group of entrepreneurial consumers could seek financing for production of an item they wish to see invented and which they hope to purchase in the future. That partial bundle could grow on a crowdfunding platform into the type of bundle of contracts that characterize a firm. In this instance, as well, the firm may need to substantially limit the control rights of residual claimants. Otherwise, the pre-order customers could strategically vote to vitiate their contracts through voting to dissolve the firm once production has begun, and then later renegotiate the price once the product-specific investments have been made.

To limit that sort of strategic behavior, the control rights of owners would need to be limited by the firm's organizational structure. However, if production is never achieved, such a firm may require some means of dissolution, which may then require arbitration of whether dissolution is appropriate. Or it may involve set time limits on the life of the firm, subject to production quotas. We should expect corporate governance innovations demanded for this subset of crowdfunded firms to reflect the fact that what is being traded initially on crowdfunding platforms is not ownership in a firm, but ownership in a set of multilateral contracts, which could eventually become a firm.

The nexus of contracts that firms represent have historically been a bundle of contracts that have an entrepreneur as its center establishing, relationships with employees, suppliers, customers, and capital. But crowdfunded projects can begin as a collection of promises by consumers to pay for a particular good and agglomerate, such that they can catch the attention of entrepreneurs and providers of additional capital, and then grow from a bundle of customer pre-orders to an entrepreneurial project, and then finally to a full fledged firm. Just as Coase talks about the boundaries of the firm being grounded in the utility of the price system,[66] we can think of some crowdfunding entities and projects as a more organic method of growth around the boundaries of the effectiveness of the price system. This type of growth can be viewed as a means of

64. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 338 (1976).

65. Agrawal et al., *supra* note 8, at 68.

66. R. H. Coase, *The Nature of the Firm*, RASMUSEN, http://www.rasmusen.org/g751/06b-readings/3-coase1937.pdf (last visited Mar. 28, 2016).

delineating firm boundaries more efficiently than large initial investments to entrepreneurs, who are making educated guesses about whether the scope of their production represents the efficient frontier of their firm based on educated guesses about the operation of the price system. For example, a crowdfunding project could also be structured as a form of research tournament,[67] with control of the firm acceding to whomever fulfills the contractual requirements as defined in the contract and interpreted by a designated arbitrator.

The "Penrose Effect" explains that managers learn through the strategic deployment of resources and can redeploy their attention as they master the strategic needs of existing projects, but the boundaries of multi-project firms are a function of diminishing returns to the rate of redeployment of additional managers.[68] Crowdfunding might be viewed as a more organic means of growth for Penrose Effect problems in young firms whose only alternative means of financing is solely VC investment. Consider a fan-based *Star Trek* film being developed on Kickstarter. The development of such a project may create a firm that is good at doing those types of projects, and the initial funders of the project may want to capture some of the subsequent agglomeration benefits of the project as a full fledged, multi-project firm develops out of it.

As the crowdfunding industry integrates a for-profit character to some projects on crowdfunding platforms, it may be that the collective input of the firm, and the governance of the individual project, develop spillover value that crowdfunding entities want to capture. Blair noted that a distinct attribute of firms facilitated by corporate organizational law is a firm's ability to facilitate firm-specific investments of capital by firm contractual counterparties.[69] The independent life of the firm allows free entry and exit of investors and managers without threatening the independent existence of the firm, and thereby facilitates longer-term contracts between the firm and contractual counterparties. As a current project-based model of funding projects on Kickstarter morphs into ownership, unique corporate governance innovations geared toward crowd-funded firms will likely take this into account.

Demsetz saw economization of specialized information in the production of goods as defining the contours of firms, and described how:

> continuing association of the same persons makes it easier for firm-specific and person-specific information to be accumulated . . . . Knowledge about the objectives and organization of the firm is learned 'cheaply' through continuing association, and so is knowledge about the capabilities and limitations of the persons involved in this association.[70]

But for small novel projects at the earliest stage, it is unclear whether this is the case, and therefore whether a firm will arise from the specialized knowledge acquired via the initial project. Crowdfunding ownership for such projects can help a crowdfunded projected obtain a premium for the possibility that this will be the case by proving funders of the project an equity claim on a potential future firm. Thus, crowdfunding has the potential to allow large scale, diversified equity funding of innovation at a stage so

67. SPULBER, *supra* note 39, at 184.
68. KROSZNER & PUTTERMAN, *supra* note 40, at 180.
69. SPULBER, *supra* note 39, at 69.
70. Harold Demsetz, *The Theory of the Firm Revisited*, 4 J.L. ECON. & ORG. 141, 157 (1988).

early that it is not yet clear whether a fully fledged firm will develop from a single team project. There may be an in between where equity crowdfunding projects could include purchase of rights to a succession of projects, with some mechanism for return of the investment in the event of failure and/or a contingent claim on the firm that results from the individual project. In the spectrum between the crowdfunded project as merely a form of "pre-order" and a fully functioning crowdfunded firm as a "nexus of contracts"[71] in the traditional sense, some crowdfunded equity could be thought of as a "bundle of projects" in succession. The rights of shareholders could be variable based on how the succession of projects proceeds, and could be highly contingent based on subsequent rounds of equity financing.

Equity claims could be contingent and become debt upon failure to meet a delivery date, for example. If funding is that tightly tied to rounds of projects, then shareholder duty litigation in state and federal court could risk destroying the ability of the firm to finish the bundle of projects. This suggests a heightened need for limited and predictable arbitration based remedies. This comports with how Williamson elaborates on the boundaries of firms as alternatives to private exchange and to account for evolving bilateral exchange conditions as "the degree to which the transaction in question is supported by durable investments transaction-specific assets—by which I mean assets that can only be redeployed to alternative uses and users only at a loss of productive value."[72]

The initial investors in projects funded on Kickstarter or on new crowdfunding exchanges may eventually evolve into firms with these transaction specific assets, or not, at the initial startup stage for a small firm with a speculative plan for growth it may be unclear, and investors may simply want an ownership structure that allows them to capitalize on value in the eventuality that the one-time project evolves into a firm with indefinite life. Cookie-cutter application of governance structures applied to larger, established firms, or mandated by the federal overlay, could risk destroying these projects through bureaucratic management or abusive litigation. In essence, the transition from individual projects funded on Kickstarter as a form of consumption expenditure to crowdfunded projects can allow packaging of consumption of an individual project with speculative investment in the potential that a firm will arise out of the project. Thus, we see that the organic growth character to crowdfunded firms ties into all of the particular needs recognized for crowdfunded entities explored in this Section.

6. Expected Demand for Unique Dissolution Procedures

Coase describes the organization of activities within firms as a function of the cost of using the pricing mechanism to allocate goods and services in production.[73] The managers of individual projects on a crowdfunded platform will be uniquely situated to determine the value of whether project specific contracts and assets can be utilized repeatedly in additional projects. As crowdfunded firms are able to provide ownership interest to dispersed owners, they will be better able to agglomerate projects that share a similar objective into the same firm and economize on the costs of production through

71. Fama, *supra* note 51, at 290.
72. Williamson, *supra* note 37, at 8.
73. SPULBER, *supra* note 39, at 92.

centralized management of activities for which managerial coordination is more efficient than market allocation. If the evolution of the Kickstarter platform is any guide, the boundaries of these firms will likely develop through a fairly fluid evolutionary process that managers may be tempted to abuse. As such, particularized innovations in methods for dissolution of projects that have lost their ongoing value are likely to be needed in the crowdfunding context. This unique means of dissolution may also require an off-the-rack option for third party appraisal of the value of the firm or project. In a later Part, this Article explores how the mandatory appraisal process utilized in Delaware is flawed.

The goal of this Section is not to accurately predict all of the unique corporate governance attributes that investors and entrepreneurs will require in the crowdfunding space. It is merely to demonstrate that a simple economic analysis of crowdfunding suggests it will require a highly heterogeneous set of options, some of which will need to be newly designed. When combined with the next Section of this Article, analyzing the current state of competitive corporate federalism, the analysis will demonstrate that without significant limitation on the federal overlay in corporate governance, it is unlikely the corporate governance will evolve and innovate sufficiently to make the most of crowdfunding's potential.

C. One Perspective on Uberization: An Interest Group Story Suggesting Crowdfunding Can Make Corporate Federalism Stick

There is reason to believe that, should competitive, state-based incorporation receive a new jolt of energy from the reforms suggested in this Article, they may just have staying power to survive any future attempts toward federalization. Rauch and Schleicher describe how a key determinant of "sharing economy" firms is that they have been able to rally local citizens to their support because of highly popular services.[74] The characteristics of crowdfunding seem to share some of these attributes that have helped Uber and AirBnB become successful despite the powerful interest groups interested in maintaining the current system. The fact that there is a federalism aspect to the reforms offered here also offers hope; Greve argues that the American citizenry is uniquely comfortable with the key attributes of federalism, particularly as compared to Europe, and so he expresses hope for the future of competitive federalism in the United States.[75]

Weingast notes that in order for a federalist system to survive it must be self-enforcing, meaning that the architecture of the underlying interest group coalitions must ultimately support maintaining a federalist structure.[76] In light of the Weingast thesis, there is reason to doubt that Delaware, the dominant domicile of incorporation for half of all public firms, alone will sufficiently discourage an inefficient federal overlay. It is instead more likely that a balance incorporating challengers to Delaware will more effectively preserve a federal system. If a federal overlay serves to inhibit other states from challenging Delaware's dominance, Delaware would not have an incentive to

74. Daniel E. Rauch & David Schleicher, *Like Uber, but for Local Government Policy: The Future of Local Regulation of the "Shared Economy"* 3 (Geo. Mason L. & Econ., Working Paper No. 15-01, 2015), http://ssrn.com/abstract=2549919.

75. Michael S. Greve, *Against Cooperative Federalism*, 70 MISS. L.J. 557, 604 (2000).

76. Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J.L. ECON. & ORG. 1, 3 (1995).

reduce federal preemption but would instead appreciate how federal preemption preserves its dominant position in the market. But if instead federalism reforms actually make the system more competitive, then it may be more likely to stick. Parts II and III of this Article make precisely that argument.

One mechanism Weingast describes to preserve federalism is citizen consensus; he presents a historical anecdote in the use of citizen consensus to maintain local power during England's Glorious Revolution.[77] If crowdfunding manages to obtain a critical mass of retail popularity, then that retail popularity might be expected to serve the market-preserving mechanism similar to the context that Weingast describes (as retail popularity has helped Uber at all levels of government). Weingast also suggests a balance between coalitions can serve as a mechanism of market-preserving federalism as well.[78] He notes that during conflicts between the North and South during an era of Jacksonian democracy, the conflict resulted in a balanced respect for federalism, as "each worried that the other might come to dominate the national government, allowing it to use national power for its own regional purposes. Because the problem was symmetric, both sides agreed to limits on national authority as a means of limiting the ability of the other to dominate."[79]

Weingast credits federalism and decentralized government authority in China as a key institutional condition for its unprecedented growth in recent times.[80] Weingast notes, consistent with Macey's public choice analysis of federalism, that as China's regional governments became increasingly successful, and as the rents provided to federal officials were maximized by merely restraining their urge to federalize, the regional governments were increasingly able to maintain their autonomy.[81] Weingast notes that major economic upheaval can upend the institutional dynamics that support federalism.[82]

One example of such a broad delegation of power to the states, which endured for a long time and has only come under fire relatively recently, was the McCarran-Ferguson Act delegating the regulation of insurance companies to states.[83] As evidence that codification protecting state corporate law is possible at the federal level, consider the Securities Litigation Uniform Standards Act, which preempted state litigation of shareholder claims under the Securities Exchange Act. It explicitly carved out state litigation of shareholder claims under state corporate law and preserved those actions from federal pre-emption in order "to preserve the expertise and efficiency of Delaware courts and case law."[84] This suggests that federal laws preserving aspects of state business entity law can at times endure if the interest group calculus is just right.

Macey theorizes federalism can endure because the federal government can obtain rents solely by virtue of "permitting independent or concomitant state regulation at little

77. *Id.* at 18.

78. *Id.* at 21.

79. *Id.*

80. *Id.* at 22.

81. Weingast, *supra* note 76, at 23.

82. *Id.* at 27.

83. *See* Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265, 280 (1990).

84. Ribstein, *supra* note 52, at 158.

or no political cost to itself," and he predicts that "Congress will delegate to local regulators only when the political support it obtains from deferring to the states is greater than the political support it obtains from regulating itself."[85] According to Macey's theory, any federalism legislation will endure only so long as it is able to create a sufficient number of interest groups before the next major impetus for federal regulation, such as a future financial crisis or scandal.[86] Interest group pressure from delegated state and local formation entities can limit the impetus to develop a federal response.

This inquiry is analogous to Uber's challenge to the established rent-seeking networks created and supported by Uber's competitors. Uber is essentially a self-regulator of the relationship between drivers and riders, and in most jurisdictions it has been able to endure only because the outpouring of support from dedicated users is more significant than the rents obtained by taxi regulators. Macey describes this support as either coming from regulated entities directly, or indirectly by way of the regulators themselves.[87]

One can imagine that if banks, entertainers, and non-profit charities, all of whom have a right to residual interests in their future revenue, traded as part of crowdfunded firms, organizing a "save crowdfunding" campaign similar to the Uber campaigns at the grassroots level would be more likely than a "save Delaware corporate law" campaign targeted to all shareholders of Delaware companies. Perhaps the Olsonian interest group dynamics of crowdfunding will allow for a more cogent defense against future federal overreach. An illustrative hypothetical is the repeal of an explicit federal law protecting the internal affairs doctrine advocated by this Article. Such a repeal may be more difficult to get past interest groups than piecemeal, creeping, or implicit preemption of individual slices of the doctrine and state corporate codes by indirect agency action.

Macey notes that the fact that the federal government has not already created federal corporation law and fully preempted the states is evidence that there are already interest group pressures that insulate state corporate law from complete federal preemption.[88] And yet, the analysis in the next Section of this Article demonstrates that those interest group pressures are not always successful, and have allowed federal law to inhibit some of the available field of innovation. This future partial preemption presents a risk that the return to any new innovation may be subsequently dissipated by federal intervention.

D. A Second Perspective on Uberization: App-Based Interaction Changes the Information Cost. Conventional Wisdom of the Collective Action Story of Corporate Law

Rauch and Schleicher attribute to "sharing economy" firms the general attribute of "a stark reduction in transaction costs that allows for radically disaggregated consumption" with that reduction in costs often resulting from a combination of new

85. Macey, *supra* note 83, at 267.

86. *Id.*

87. *Id.* at 268. Macey's explanation may demonstrate the differences between the initial "Schumer bill of rights" introduced prior to Dodd–Frank and the subsequent legislation that was adopted, in which some provisions were shifted from mandatory to permissive opt-in approaches (such as an independent chairman for public company boards). The changes explored in this Article may enhance these existing interest group pressures and add new interest groups, such that the reforms may stick.

88. *Id.* at 279.

digital means of information transmission and app-based interaction.[89] Bainbridge notes that one of the principal attributes of a corporation is a collective action problem because shareholders are rationally apathetic.[90] Indeed, much of corporate law scholarship in some way references the Berle-Means vision of corporations as characterized by overwhelming collective action problems that many corporate commenters either requires a strong federal hand in governance, deference to manager-centric governance models like the Bainbridge director-primacy model, shareholder empowering regimes, or particular mandatory provisions in state corporate laws. Scholars on all sides of these debates tend to reference the Berle-Means hypothesis as a starting point. And yet, the Berle-Means collective action hypothesis is likely to lose much of its explanatory power in the crowdfunding world.

Although this Article observes that crowdfunding will decrease the costs of shareholder participation, it is nevertheless neutral on the question of shareholder primacy versus board primacy. If Bainbridge's observation about boards as necessary intermediaries between shareholder participation and executive action endures in this technology, then we would expect those firms in which shareholders have chosen defaults to delegate authority to be more successful, and crowdfund portals to strongly recommend board-centric defaults via their app.

Agrawal points to three elements of internet-based interaction that explain the rise in crowdfunding. As search costs for projects and communications costs decrease, greater funding in much smaller increments is possible. That has a follow on effect of allowing for greater funding in much smaller increments.[91] That has a further follow on effect, which reduces risk exposure through diversification.

We might expect that crowdfunding could link well with app-based user experiences. Indeed, the crowdfunding pre-cursor Kickstarter utilizes app-based interaction that is popular among its users. Konsynski and Bush explore the platform-based development model that has evolved in software development in the last decade for new web browsers and iPhone applications.[92]

Mollick notes that:

> The innovative ability of online communities has been of increasing interest to scholars (Baldwin et al., 2006; David and Shapiro, 2008; Von Hippel, 2005), and crowdfunding represents a concrete way in which online communities can influence the creation of new ventures. Crowdfunding also suggests a path by which user innovators, who are often the sources of radical innovations, might transition to entrepreneurship (Franke and Shah, 2003; Shah and Tripsas, 2007).[93]

This suggests that for a subset of firms in which donors tend to get highly involved in projects via some crowdsourced method, as was the case with development of the

89. Rauch & Schleicher, *supra* note 74, at 11.

90. Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1745 (2006).

91. Agrawal et al., *supra* note 8, at 7.

92. Amrit Tiwani et al., *Platform Evolution: Coevolution of Platform Architecture, Governance, and Environmental Dynamics*, 21 INFO. SYS. RES. 675 (2010).

93. Mollick, *supra* note 7, at 14

Pebble watch on Kickstarter, investors will want a high level of interaction with entrepreneurs. This may be best achieved through traditional corporate governance like shareholder voting or shareholder referendums, but for many firms those traditional methods may likely be outdated for this purpose, which again suggests that the more flexible and adaptive means of corporate governance innovation will be required than the federal overlay in corporate governance presently permit.

Kobayashi and Ribstein note how limits on intellectual property protection for corporate governance innovations can inhibit private production of law.[94] Open source production can serve as a solution to the problem of insufficient intellectual property protection, explored under certain conditions.[95] In this instance we might expect, for example, corporate attorneys to participate in the creation of new governance arrangements via an open source platform in order to establish or maintain their reputation with potential advisory clients. Or crowdfunding exchanges and their participants may collaborate to solve problems in crowdfund governance. Rauch and Schleicher note the benefits of digital ratings systems as a substitute for reputation, and we should also expect that technology will have important implications for minimizing agency costs in the crowdfunding environment, including by facilitating the development of informational intermediaries.[96]

E. Analogue to Crowdfunding?: The U.S. Over-the-Counter Pink Sheets Market

An examination of the American Over the Counter (OTC) Market shows that, for the most part, the persistence of various elements of the federal overlay ultimately makes study of this market of limited value for understanding crowdfunding. One exception is that, in the absence of some of the federal overlay in this space, exchanges are observed to take an interest in limiting agency costs for investors on their exchange consistent with Mahoney's argument in "Exchange as Regulator." [97] Otherwise there appears at present, in the absence of additional empirical work, little to suggest that corporate governance attributes present on OTC exchanges can inform expectations for crowdfunding.

Mahoney argues that private exchanges can have incentives to develop governance arrangements suitable for the firms that trade over its platform, and thereby internalize the benefits of increased comparability between products by shareholders.[98] This stands in contrast to the Easterbrook/Fischel argument that national securities regulation is required to facilitate optimal disclosure rules because of comparability externalities. In the same way, we could expect exchanges to also share an incentive to develop corporate governance rules for firms listed on the exchange, and indeed exchanges have a history of doing so.[99] Thus, under the right circumstances crowdfunding exchanges may end up playing a role in the creation of corporate governance arrangements.[100]

94. Bruce Kobayashi & Larry Ribstein, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79 (2001).

95. Eric von Hippel & Georg von Krogh, *Open Source Software and the "Private-Collective" Innovation Model: Issues for Organization Science*, 14 ORG. SCI. 208, 209 (2003).

96. Rauch & Schleicher, *supra* note 74, at 9.

97. Paul G. Mahoney, *The Exchange As Regulator*, 83 VA. L. REV. 1453, 1455 (1997).

98. *Id.*

99. *Id.* at 1461–62.

100. A majority of OTC firms are incorporated in Delaware and Nevada. Ulf Bruggemann et al., *The*

Mahoney notes that exchanges face a challenge in capturing the return to their innovations insofar as information like public price discovery over the exchange is non-excludable, but he argues that exchanges have restrictive rules that substitute for intellectual property rights to accommodate that challenge.[101]

However, since the dual class share litigation and since Sarbanes–Oxley, it has become clear that, at least with respect to large national exchanges regulated by the SEC, it may be the case that the SEC views the exchanges as a tool through which to expand the reach of its regulatory authority into state corporate law. Trading regulations like the "trade through" rule adopted by the SEC further limit the incentives of national exchanges to compete on quality of productions of services like listing standards; thus, for large national exchanges like the NYSE, listing standards are developed by regulatory fiat from the SEC and the Congress rather than as a quality signaling mechanism for exchange customers.

The OTC facilitates quotes for shares on a "Bulletin Board" that are registered and regularly file with the SEC, and though the OTC doesn't have its own corporate governance requirements,[102] Bulletin Board firms are nevertheless subject to the constraints of Sarbanes–Oxley, Dodd–Frank and the Williams Act.[103] Thus, the traditional bulletin boards are more like national exchanges like the NYSE than how we expected crowdfunding platforms to operate.

"Pink Sheet" shares traded over-the-counter, however, operate with some of the same freedoms from the federal overlay that we might expect to occur on a crowdfunding

Twilight Zone: OTC Regulatory Regimes and Market Quality 9 (ECGI, Working Paper No. 224/2013, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2290492. To date there has been no comprehensive study in the literature examining corporate governance attributes among pink sheet firms, suggesting an important avenue for further empirical study. If Pink Sheet and grey market firms make use of heterogeneity, how do they do it? If not, why? Could it be because of path dependencies for those firms that were previously listed on NYSE or NASDAQ and were delisted, that have trouble subsequently reorganizing their firms into an LLC structure with more freedom? Could it be because you hope to get back onto NYSE or NASDAQ, and you expect that changing your corporate governance choices to non-compliant would be a bad signal to investors or to those exchanges? Bruggemann's Table 2, Panel D suggests an avenue for possible future empirical work, as it suggests Nevada might be challenging Delaware as a domicile for some publicly traded OTC firms. Notably, the Bruggemann study finds that a majority of new firms operating on OTC exchanges, who remain on the exchange over the sample period, are formed in Nevada. *Id.* at 23. Future data collection should further break down their chart into out-of-state vs. in-state, corporate vs. LLC, and further breakdown into choices for LLC charter, presence of a control shareholder, industry, size, etc. Those breakdowns should occur by exchange. You have one exchange with no exchange listing requirements, another with no exchange listing requirements but with SEC registration, and a third with both corporate governance listing requirements and SEC regulation. If there are differences in out-of-state formation or entity choice that are solely attributable to which platform you use, then you may have (1) evidence of federal overlay inhibiting entity formation competition, or (2) attorney or underwriter bias, if they markedly differ for platforms, or you may have evidence of situations in which Delaware's network effects are not insurmountable for smaller publicly traded firms.

101. Mahoney, *supra* note 97, at 1456.

102. Bruggemann et al., *supra* note 100, at 15.

103. A new NASDAQ exchange, called BX Venture Market, would seem to be another useful analogue, but that exchange will be subject to the full panoply of the federal overlay (with the one exception from NASDAQ's corporate governance listing standards being firms will not be required to have a majority independent board). *See* Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 532, 532 (2012) (proposing a lifecycle model in which regulations would adapt to firms as they age).

platform.[104] In 2010 the OTC markets traded 8000 securities, of which 4500 were not registered with the SEC.[105] Those not registered with the SEC are nevertheless subject to state blue sky regulation.[106] The Bulletin Board firms are all required to register with the SEC, but Pink Sheet firms are only required to register in certain circumstances.[107] For those Pink Sheet firms which are not required to register with the SEC, and therefore required to comply with state Blue Sky laws, Bruggemann describes blue sky regulation in this context as fairly light touch.[108]

Consistent with the Mahoney hypothesis of exchange regulation, the OTC exchanges provide transparency rules for even Pink Sheet and grey market firms, including through a rough classification system that rates them as "current information available, limited information available, no information available" and a fourth warning signal for firms labeled "caveat emptor" which have both failed to provide information to investors and which engage in unusually high levels of unsolicited communication to potential investors.[109] The Jiang study found that the introduction of the OTC categories resulted in a shift of liquidity away from firms in the lower tiers and toward firms in the higher tiers, and they argue that indicates exchanges can provide useful governance innovations despite cost constraints. Schwartz argues that the Pink Sheets are dogged by their reputation as a haven for firms that have been delisted from other exchanges for poor performance.[110] Even if Pink Sheet firm governance were more readily available, it may be that the exchange's reputation as a haven for troubled, delisted stocks drives potential emerging firms to other forms of financing, such as private placements, and therefore the Pink Sheets do not serve as an informative model for crowdfunding.

But a majority of firms on the Pink Sheets are not delisted. The Bruggemann study found that over a ten year sample, only 17% of them were previously delisted from an exchange requiring SEC registration, and roughly 10% eventually rise to the traditional exchanges.[111] OTC exchanges can include firms incorporated outside of the United

104. Bruggemann et al., *supra* note 100, at 6.

105. *Id.*

106. *Id.*

107. *Id.* at 7. Bollen and Christie describe four distinct types of firms trading exclusively on the Pink Sheets, including highly distressed firms or firm equity recently issued after a bankruptcy proceeding, microcap stocks too small for larger exchanges and trading in very small increments (or "penny stocks"), large foreign issuers who want to access U.S. liquidity but want to bypass more heavily regulated exchanges (Nestlé or Nintendo) and companies that are closely held and trade infrequently. Nicolas P.B. Bollen & William G. Christie, *Market Microstructure of the Pink Sheets*, 33 J. BANKING & FIN. 1326, 1327 (2009).

108. "In 42 states, issuers are exempt from registration and 'blue-sky compliant' if they are published in 'a nationally recognized securities manual' such as Mergent's (formerly Moody's) Manuals, Standard & Poor's Corporation Records, and others. The providers of manuals perform a (basic) review of documents supplied by the issuer, e.g., examine business description, corporate history and financial statements." Bruggemann et al., *supra* note 100, at 8.

109. *Id.* at 8–9.

110. Schwartz, *supra* note 103, at 47.

111. Most OTC firms are below $20 million market cap, a quarter of them are below $5 million, they tend to be much more volatile and have much lower liquidity relative to other exchanges, average annual returns of -27%, and individuals firms have outsized annual returns ranging from +100% to -95%. Bruggemann et al. find that OTC firms filing disclosures with the SEC have higher liquidity and more efficient price discovery than firms that do not, and they find the same with respect to non-listed firms that publish in Moody's or Standard & Poor's, which they suggest indicates that shareholders in OTC firms are efficiently taking into account

States, as they find that roughly 10% of new firms incorporate outside of the United States or Canada.[112] Schwartz's argument also does not explain why large firms disclosing a wealth of information choose to list their American Depository Receipts on the Pink Sheets.

Pink Sheet issuers are still subject to the general prohibition against fraud.[113] Thus the Securities Exchange Act overlay described in the next Section may still be present on these markets in part to the extent they provide voluntary disclosures that open up potential corporate governance litigation, though certainly not to the same degree given how little they end up disclosing merely to achieve compliance by being listed in the S&P or Moody's book. Also the fact that the Securities Exchange Act prohibition against fraud applies to the Pink Sheets, and therefore the SEC's reluctance to permit shareholder arbitration for corporate governance claims still applies, suggests that the OTC markets provide at best a very limited window into the possibilities available for small publicly traded firms free from the federal overlay.

F. Analogue to Crowdfunding: The London AIM Market

The London AIM Market provides evidence that a new era of chartering competition on crowdfunding platforms freed from the federal overlay might then also evolve symbiotically with new crowdfunding platforms that serve a gatekeeper rule to crowdfunded firms and which may play a role in entity formation as well, and possibly thereby involve private entities more directly in the business entity formation and code production process in some way. The London AIM market was created in 1995 and was designed to attract listings from smaller companies in the U.K. and overseas by offering less stringent listing requirements for particular corporate governance arrangements than those required for larger companies on U.K. exchanges.[114] 3610 companies have listed on AIM since its inception and have raised 92.6 billion euro in the process.[115]

On London's AIM Market, corporate governance is a much more flexible and firm-specific affair. It includes a significant role for a company's nominated advisor (or "Nomad") in determining which provisions otherwise required for larger companies should be adopted by the AIM listing.[116] Notably, the London AIM market has very few

information provision by OTC firms in their pricing. Bruggemann et al., *supra* note 100, at 9.

112. *Id.* at 23.

113. *See* Joseph I. Goldstein et al., *An Investment Masquerade: A Descriptive Overview of Penny Stock Fraud and the Federal Securities Laws*, 47 BUS. L.J. 773, 810 n.184 (1992) (citing cases where Pink Sheet issuers were still subject to the general antifraud provisions of federal securities laws).

114. *AIM Factsheet*, LONDON STOCK EXCHANGE (2015), http://www.londonstockexchange.com/statistics/historic/aim/aim-statistics-archive-2015/june-15.pdf.

115. *Id.* at 3.

116. The London Stock Exchange describes the process for becoming a "Nomad." Approval as a Nomad demonstrates that a firm has fulfilled the strict eligibility requirements set by the London Stock Exchange. A Nomad is the primary regulator of an AIM company, making the role demanding yet rewarding. An applicant seeking approval as a Nomad must: be a firm or company, not an individual; have practiced corporate finance for at least the last two years; have acted on at least three relevant transactions during that two year period; and employ at least four "qualified executives." The AIM Rules for Nominated Advisers also detail the ongoing responsibilities of a Nomad and set out the review and disciplinary procedures. *Becoming a Nomad*, LONDON STOCK EXCHANGE (2015), http://www.londonstockexchange.com/companiesandadvisors/aim/advisers/becoming/nomad.htm.

mandatory corporate governance requirements, but each listing on the AIM market has a Nomad, most of whom also serve as a broker in the issuer's securities, which advise the new issuer about its corporate governance choices. That dynamic suggests the possibility for useful vertical integration in the provision of unique corporate governance arrangements for operators of exchanges or brokers on lightly regulated exchanges if freed from a strong federal overlay.

A firm serving as a Nomad for an AIM-listed company may also serve as a broker for the company's securities.[117] Most Nomads serve both roles on the AIM exchange.[118] Most of the companies listed on the AIM exchange are less than $25 million market cap, and only a handful have a market cap of greater than $100 million.[119] Thus, the AIM market is roughly characterized as hosting firms somewhat larger than expected crowdfunding firms, but somewhat smaller than the expected size of the Regulation A market under the newly enhanced JOBS Act.

This indicates that, generally speaking, the benefits that Mahoney ascribes to exchanges may also apply to active brokers on crowdfunding exchanges. They may thereby afford a role to private parties in the corporate governance innovation process. The limited availability of data about the corporate governance choices that AIM firms actually make otherwise does not currently help with understanding the expected needs of crowdfunding firms, but nevertheless it might afford a ripe area for future empirical inquiry.

III. THE STATE OF CORPORATE FEDERALISM

Business entity law has been around for some time and has been an important contributing factor to the economic systems that develop and utilize them. Corporate law was key to building the Roman aqueducts, and critical to the industrial revolution; now a newly competitive and innovative model for the production of corporate law will be critical to make the most of technological advances that are reducing the cost of individual interaction seen in crowdfunding platforms that will soon go online after the SEC's final rule on federal crowdfunding is finalized.

The mere fact that the economics of crowdfunded firms—explored in Part II—suggests a demand for more flexible innovation in corporate governance does not mean the states will be in a position to make that innovation available to firms and investors. For example, Bainbridge and Henderson recently designed a novel approach to the structure of boards of directors in which other business entities can themselves serve as members of the board. This would allow board member companies to economize on scale and scope, have more directed compensation and liability incentives than the current model, better expose the market for board membership to market forces, and provide reputational constraints for repeat player board member firms.[120] Bainbridge and Henderson note that federal rules which would prevent their idea were not necessarily even designed to prevent entity membership on the board, but the effective consequence

117. *AIM Factsheet*, *supra* note 114, at 11.
118. *Id.* at 18.
119. *Id.* at 18–32.
120. Stephen M. Bainbridge & M. Todd Henderson, *Boards-R-Us: Reconceptualizing Corporate Boards*, 66 STAN. L. REV. 1051, 1077 (2014).

to references to natural persons in the federal rules effectively precludes their innovation from being implemented.[121]

This Part considers a natural experiment. The federal overlay for public firms was peeled back just a little, in the case of a few marginal exemptions from NYSE listing requirements regarding board structure for publicly traded, master limited partnerships. The findings were a wealth of innovation and heterogeneity.

A. When The Federal Overlay Is Rolled Back, Innovation Sprouts: The Case of Publicly Traded Master Limited Partnerships

Though the overwhelming majority of publicly traded firms utilize the corporate form, with its mandatory fiduciary duty regime, a small minority of public firms operate as either LLCs or LLPs.[122] Most of those are operated as some variation of a type of public firm that was provided some limited relief from exchange listing requirements by the NYSE and NASDAQ.[123] There is a substantial amount of heterogeneity in the organization choices made by the firms. All of those LLCs opted out of appraisal rights entirely.[124] Some of them held annual meetings, some did not, and some members (shareholders) held voting rights without making financial contributions.[125] Some opted out of fiduciary duties completely, some did not, and most had some hybrid formulation of obligations owed by members of the LLC to each other.[126]

The governance of publicly traded, master limited partnerships (MLPs) provide a small-scale case study in the adaptability and heterogeneity of business organizational form. Master limited partnerships form a small subset of publicly traded companies in which the federal overlay has been moderately lifted by the exchanges. They were created pursuant to a tax exemption for energy companies that allows them to avoid entity level taxation if they make regular distributions of earnings to investors. Under exchange listing rules, MLPs are not required to have a majority of independent directors, a nominating committee, or a compensation committee.[127] MLPs and other public companies are otherwise subject to the same set of federal securities laws.[128] Thus, with

121. *Id.* at 1100.

122. Looking more broadly to the master limited partnerships that continue to operate using a limited partnership form, Goodgame notes that, as of 2012, there were 87 energy-related MLPs traded on public markets. John Goodgame, *New Developments in Master Limited Partnership Governance*, 68 BUS. LAW. 81, 83 (2012). While they have traditionally been organized as limited partnerships, more recently some of them have organized as LLCs. *See id.* at 88–91 (discussing the "public LLC model"). These energy firm MLPs make up the vast majority of publicly traded alternative entities on United States exchanges. *Id.* at 83.

123. Gomtsian notes that there were 20 publicly traded LLCs, all of which were formed in Delaware, as of September 2013. Suren Gomtsian, *The Governance of Publicly Traded Limited Liability Companies*, 40 DEL. J. CORP. L. 207, 222 (2015). Most of those were energy companies that had previously been energy master limited partnerships, and a handful of others were private equity funds and hedge funds that obtained most of their capital through private offerings under Regulation D but created entities to supplement their capital by raising money in the public markets. *Id.* The number of members in these 20 LLCs ranged from 2000 to 98,000. *Id.* at 224.

124. *Id.* at 231.

125. *Id.* at 234.

126. Gomtsian, *supra* note 123, at 234.

127. *Id.* at 264.

128. *Id.* at 271.

this relatively minor exception from the federal overlay, a wide diversity of governance arrangement has evolved.

Goodgame considers one of the dominant organizational features of the master limited partnership its contractual provisions providing for the regular allocation of distribution payments to equity holders acts as an effective substitute for equity participation in governance.[129] Goodgame notes that some MLPs have equity holder participation in governance as features, but those MLPs generally do not provide for the same regular distribution mechanisms as MLPs that do not provide for direct participation in the selection of directors.[130]

Goodgame generally describes a great deal of heterogeneity in organizational form, as some MLPs provide for annual elections; some have staggered boards. Some MLPs have poison pills; others do not. Some choose default fiduciary duties; some opt out of fiduciary duties. But, they generally choose to opt out of rules favored in the public context, as they have stronger contractual requirements to distribute all their earnings on a quarterly basis.[131]

Structural heterogeneity in governance tends to adapt to the particular needs of individual firms. Those firms with more dependable and steady streams of cash flow tend to substitute earnings distribution and regular fundraising from capital markets with agency monitoring measures for traditional governance arrangements.[132] One can readily think of other governance arrangements which could be useful, such as a different appraisal process tailored to handle the unique needs of biotech firms—which lack cash flow for long periods.

This limited innovation leads one to wonder what level of innovation may have been possible in the absence of the full federal overlay. As these public firms were all formed in Delaware, note that even in the publicly traded alternative entity context, there is one clear item that you cannot contract out of, namely "the implied covenant of good faith and fair dealing."[133] One then further wonders that if that binding constraint in the Delaware alternative entity code had not been present, and if another state were operating an alternative arbitration based mode of corporate law, what additional adaptive governance modes would have been developed for the MLP and MLP LLC space.

IV. Arbitration of Disputes Between Shareholders and Boards, and a Code Adapted for that Purpose to Compete With Delaware

A. Arbitration is Key to Challenging Delaware

Bainbridge notes that North Dakota's recent attempt to compete with Delaware was doomed to fail because it was not actually innovative. Rather, it merely adopted

129. Goodgame, *supra* note 122, at 88.

130. *Id.* at 83.

131. They also have an innovative governance style similar in many ways to the organization board member proposal advanced by Bainbridge and Henderson and referenced above. Bainbridge & Henderson, *supra* note 120, at 1097. MLPs are typically controlled by a sponsoring general partnership, which reserves contractual control of the board of directors for the sponsoring general partnership by reserving a majority of board seats for individuals selected by the general partnership.

132. John Goodgame, *Master Limited Partnership Governance*, 60 BUS. LAW. 471, 488 (2005).

133. *Id.* at 488.

provisions already allowed by the Delaware code that shareholders and managers had declined to choose for their organizational structures.[134] North Dakota also failed because it sought to compete with Delaware through a litigation-driven code despite Delaware's clear advantage in providing consistent, predictable business litigation.

Roe notes that one reason states have difficulty competing with Delaware is—in attempting to create the specialty business courts necessary to compete with the Delaware litigation model—states find that a coalition of local trial lawyers and interest groups push back for fear of lacking competitive advantage in a pro-business forum for local cases.[135] This may be a challenge unique to replication of the Delaware model, as replicating a new court of equity to compete with Delaware would entail creating a forum that not only adjudicated state corporate code cases, but that also obtained jurisdiction over contract disputes. An arbitration alternative may not bring the same baggage with it from a local interest group perspective and so may be more likely to succeed.

Kahan and Klausner argue that a lack of heterogeneity in firm organizational contracts can be traced to a combination of learning and network externalities.[136] Despite the presence of these network effects, however, they do not account for how the economics of innovation in corporate law would change if the presence of potential federal pre-emption of new innovations were reduced or if the dominance of Delaware's state-based forum were sidestepped with an arbitration alternative. Perhaps those paradigm shifts would be enough to promote more innovation in contractual terms. Indeed, the case of Master Limited Partnerships is instructive for the possibilities in innovation when the federal overhang is lifted.

Furthermore, the speed and ease with which investors can obtain information and third party assessments about governance arrangements should shift when crowdfunded shares are traded through app-based platforms, making things like attorney familiarity with corporate codes less important. Kahan and Klausner note that switching costs may prevent firms from changing their governance choices after going public.[137] Nevertheless innovation at the crowdfunded firm level may support innovation in large public firms, as it could mean that innovative governance modes developed at a smaller scale, may stick with firms as firms grow and become a part of the large publicly traded landscape.[138]

Kahan and Klausner argue that underwriters can serve to coordinate innovations in governance and resolve the challenges posed by network effects. For instance, they can commit to subsequently recommend new innovations in future offerings to create

134. *See generally* Stephen M. Bainbridge, *Why The North Dakota Publicly Traded Corporations Act Will Fail*, 84 N.D. L. REV. 1043 (2008) (predicting and explaining why North Dakota's publicly Traded Corporations Act will not be successful).

135. Mark J. Roe, *Delaware and Washington as Corporate Lawmakers*, 34 DEL. J. CORP. L. 1, 6 (2009).

136. *See generally* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or 'The Economics of Boilerplate')*, 83 VA. L. REV. 713 (1997) (presenting "a theoretical, institutional, and empirical analysis of how increasing returns—specifically, learning externalities and network externalities—influence standardization, customization, and innovation in corporate contracts").

137. *See id.* at 727–29 (explaining situations in which switching costs occur; switching costs happen "[w]hen internal learning or network benefits are present").

138. As a critical mass of smaller firms develops with more innovative governance models, and as they grow to become larger public firms, governance innovations that begin on smaller crowdfunded exchanges could develop some of the network effects of their own that lower switching costs for existing firms and for new entrants to larger exchanges.

network benefits for early adopters.[139] Exchanges and crowdfunding platforms can provide a similar form of commitment if they participate in advising new issuers and if they can operate free from pressure by the SEC.

Kobayashi and Ribstein show that the existence of network effects does not necessarily preclude innovation in corporate law.[140] They challenge Kahan and Klausner's network externality hypothesis. They define the network hypothesis in this context as that "[a]n example might be large corporations' long-term use of Delaware law in order to take advantage of judicial and legal expertise and other benefits they expect the Delaware legal 'network' to continue to produce."[141]

They show that once the federal tax law overlay changed to permit entity competition for firms, then network effects did little to impede the move to LLCs.[142] In much the same way, removal of the federal overlay will be key to overcoming the Delaware effect in the public company context. Perhaps what is going on is that network effects for large public companies only matter because the federal overlay is the source of the "lock in." Without the federal overlay, network externalities do not matter any more, as they did not with the switch to LLCs for smaller or non-public businesses once tax code constraints were lifted. Kobayashi and Ribstein describe a number of solutions to network externality limitations, including bundling the law of the new entity form with aspects of the old from during the transition.[143] The use of bundling to aid the transition may be more difficult in this context as the old and new products are much more distinct. It is difficult to say how much of the law of Delaware corps will apply in the arbitrated LLC context, for example.[144] They describe a number of other sources of lock-in, including conflicts of interest from interest lawyers who prefer standardization.[145] The large public company context may exhibit this conflict as underwriters who prefer Delaware because they get advisory opinion business later on.

Kobayashi and Ribstein find that competition for out of state LLC formation is chiefly a function of court quality. Furthermore, any competition through innovation of organizational arrangements is not a reliable predictor of firm choices of where to

139. Kahan & Klausner, *supra* note 136, at 737–39.

140. *See* Ribstein & Kobayashi, *supra* note 94, at 82 ("The data indicate that the inherent characteristics of the business forms, such as their state tax implications, are much more significant factors in choice of organizational form than network externalities.").

141. *Id.* at 110. Kobayashi and Ribstein note that one recent and unanticipated innovation in organization structure was the series LLC, which allowed great subdivision of assets and liabilities within an umbrella holding structure. Bruce H. Kobayashi & Larry E. Ribstein, *Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies*, 2011 U. ILL. L. REV. 91, 105 (2011). This is the type of unanticipated innovation in organizational structure this Article seeks to encourage through elimination of the federal overlay in corporate governance.

142. *See* Ribstein & Kobayashi, *supra* note 94, at 84–86 (describing the tax code and LLCs in relationship to the business form selected).

143. *See id.* at 113 (explaining "the move to a new standard can be facilitated by linking or bundling it with an existing standard form in order to utilize case law and other interpretive materials").

144. But in some limited senses it could work—for instance—class arbitration methods might draw on some, but not all, procedures present in common law class actions to facilitate the new litigation approaches. But generally the basic obligations and duties of directors, officers, and the corporate governance structures of new crowdfunding firms may morph so distinctly that bundling would not be particularly useful.

145. Ribstein & Kobayashi, *supra* note 94, at 115.

organize.[146] This provides powerful evidence that the Delaware effect, or the high preference firms place on Delaware as a choice of forum, out measures all other variables in chartering competition for alternative entities. This observation supports the argument of this paper that in order to enhance chartering competition, a clear route must be established for alternative dispute resolution mechanisms other than court adjudication based on the Delaware model. While the Delaware effect does not make innovation completely impossible, as for instance in the series LLC innovation which began outside of Delaware, it does suggest that if other states were able to compete on adjudication forum as well as code flexibility the level of innovation in corporate codes might be substantially increased.

B. Does Ribstein's Uncorporation Thesis Fill the Gap in Demand?

Ribstein describes how "uncorporations" or LLCs, LLPs, and other alternative entity forms allow for more flexible private contracting to develop contractual devices that can substitute for what firms might see as flaws in Delaware's code and adjudication model for the standard corporation.[147] Ribstein ascribes some general features to uncorporate firms and others to corporate firms, including a different approach to lock-in of capital and to the free transferability of shares, and argues different approaches to corporate governance needs in the more adaptive alternative entity space can achieve some of the ends of corporation law without the indeterminate code that Carney and Shepherd ascribe to Delaware corporation law.[148]

Ribstein notes however a number of dubious cases in which Delaware courts struggle to implement the legislature's intent to promote freedom of contract in alternative entity law.[149] Ribstein notes Delaware has recognized the right of LLC's to force arbitration,[150] but any doctrine creep of the duty of good faith and fair dealing or legislative change could risk that right. In any event it is not likely to do much good for public companies until a right to arbitrate federal securities act claims is recognized.

The Delaware Court of Chancery has interpreted the covenant of good faith and fair dealing as requiring the court to examine the "spirit of the agreement" and apply to doctrine on that basis, indicating room for expansion of the doctrine in the future to substantially limit freedom of contract.[151] Thus, though Ribstein may well have been right that problems inherent to the corporation form will be resolved by migration away to alternative entities like LLCs, it is unlikely that will occur within the Delaware LLC form. This structural limit on contractual freedom within the Delaware LLC code will match with the interest group politics within Delaware explored by Macey and Miller to significantly limit innovation within the Delaware LLC code.[152] As we have further seen,

146. Kobayashi & Ribstein, *supra* note 141, at 135–36 (stating "most movement that can be explained by court quality and series provisions is movement to Delaware").

147. Ribstein, *supra* note 52, at 133.

148. *Id.* at 140–45.

149. *Id.* at 153–65.

150. *Id.* at 161.

151. Mohsen Manesh, *Express Contract Terms and The Implied Contractual Covenant of Delaware Law*, 38 DEL. J. CORP. L. 1 (2013), http://www.djcl.org/wp-content/uploads/2014/06/EXPRESS-CONTRACT-TERMS-AND-THE-IMPLIED-CONTRACTUAL-COVENANT-OF-DELAWARE-LAW.pdf.

152. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate*

the federal overlay does not support a fully adaptive model for publicly traded firms. Much like model codes, federal corporate governance provisions tend to be uniform and do not facilitate adaptive selective by organizers.

Kobayashi and Ribstein argue, for example, that fiduciary duty opt-outs are efficient for many firms because of the specter of Type I errors, in which judges inaccurately deem management decisions to violate fiduciary duties, may exceed any benefits that shareholders obtain through the possibility of fiduciary duty litigation.[153] Kobayashi and Ribstein argue that as Delaware and Nevada compete for LLC formation, Nevada's competitive advantage is that it can bond to maintain a bright line, low liability rule, while Delaware's competitive advantage is its ability to administer a regime with less clear rules but more predictable courts. Therefore, Nevada can compete in a space which Delaware may not wish to enter, as doing so would devalue the institutional investments it has made with its current system.[154]

Kobayashi and Ribstein note one advantage which allows Nevada to uniquely compete with Delaware is its small population, which generates greater assurance that Nevada will not arbitrarily change its corporate code because it is more dependent on chartering revenues than states with larger populations.[155] Kobayashi and Ribstein also note Nevada's reputation as a gaming center reduces its sensitivity to any reputational effects derived from being a lax jurisdiction state.[156] The dynamic between Delaware and Nevada which Kobayashi and Ribstein describe could play out even stronger in an arbitration regime, and it could occur over a greater number of participants in the race to charter firms.[157]

Ribstein and Kobayashi remind readers a lack of diversity in corporate governance items may not necessarily reflect lack of competition but instead may suggest demand for uniformity in rules for which uniformity is efficient—such as rules regarding the relationship with the organization and third parties such as the law of veil piercing.[158] Thus, it would be a mistake to suggest that any instance of uniformity in corporate governance is necessarily value reducing. Given the first part of this Article's consideration of likely demanded heterogeneity and the second half of this Article's

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Law, 65 TEX. L. REV. 469, 471 (1987).

153. Bruce H. Kobayashi & Larry E. Ribstein, *Nevada and the Market for Corporate Law*, 35 SEATTLE U. L. REV. 1165, 1175 (2012).

154. *Id.* at 1177.

155. *Id.* at 1178.

156. *Id.*

157. Kobayashi and Ribstein note legal system quality is a key factor in choice of entity formation for LLCs favoring Delaware. Kobayashi & Ribstein, *supra* note 94, at 127. Kobayashi and Ribstein note there may be reasons why smaller firms will be less interested in tailoring unique organizational forms because they are less likely to be involved in litigation. *Id.* at 97. However the decrease in search costs for organizational tailoring associated with app-based governance may result in renewed tailoring of organizational form for smaller firms. Furthermore, intermediaries and gatekeepers to small firm exchanges may have an interest in facilitating organizational tailoring for smaller firms particularly if they have a role in designing that organizational form in managing the arbitration forum. They note local lawyers may use their participation in drafting organizational statutes to develop reputations that can help them obtain clients to compete with other lawyers in-state. *Id.* at 98. If the mode of innovation in corporate law assumes an open-source character, in which local attorneys can take credit for particular adaptations of the corporate code, then they can establish national reputations as organizational lawyers in competition for clients on a much larger scale.

158. *Id.* at 100.

exploration of federal constraints on adaptability, there is reason to believe a substantial amount of uniformity for publicly traded firm governance is artificial and crowdfunding offers an initial opportunity to test that hypothesis.

The new era of chartering competition may elevate the public LLC to eclipse the corporate form for public firms according to the Ribstein Uncorporation thesis. Alternatively, it may substantially hybridize our existing understanding of the boundaries between corporations, LLCs, and other entity forms. In any event, no matter where the innovation happens, whether in some new type of business entity or by way of modifications of the LLC code, it is not likely to happen in Delaware and therefore will not happen until network effects inherent in the Delaware code—and magnified by the federal overlay—are alleviated through an arbitration-based business entity code framework is possible.

C. The Federal Government and Delaware Both Discourage Arbitration for Public Company Shareholders

Note that, although Delaware has innovative arbitration provisions for contracts, conducted by Delaware judges, the current Delaware statute prohibits use for corporations and effectively does so for publicly traded LLCs because it requires all parties bound by arbitration to actually sign the LLC agreement.[159] This requirement is effectively prohibitive in an environment of highly disbursed and traded securities. This Section will explore how Delaware discourages arbitration, but first it should be noted that until the SEC permits arbitration for federal securities claims by shareholders, arbitration of state corporate law claims will likely be useless. This is because of the ever increasing overlap between securities actions under the federal laws and state law corporate governance claims. Even if Delaware's code explicitly permitted arbitration of state corporate governance claims, we should expect nearly all those claims would find a new home as they morph into Securities Exchange Act claims.

Thompson and Sale describe private rights of action under the Securities Exchange Act as being interpreted by federal courts in such a way that they could "annex" corporate governance; this observation is not withstanding the internal affairs doctrine itself.[160] Thompson and Sale describe state corporate governance as essentially relegated to the contacts of corporate acquisitions and self-dealing transactions. They also observe that otherwise the fundamental regulation of company behavior has been preempted by the federal government by way of private shareholder litigation under Rule 10b-5.[161] Thompson and Sale describe that most private litigation under the Securities Exchange Act is brought after a public company corrects a prior earnings misstatement, and

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159. GREGORY V. VARALLO ET AL., PRACTITIONER'S GUIDE TO THE DELAWARE RAPID ARBITRATION ACT 17 (2015), http://www.rlf.com/Files/11206_DRAA%20Book%20Final.pdf.

160. Robert B. Thompson & Hillary Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 860 (2003).

161. *Id.* at 861. Thompson and Sale argue SEC rulemakings under Item 303 of Regulation SK functionally displace the state law duty of care and that a requirement in the Sarbanes–Oxley Act that CEOs must certify financial statements pre-empts part of the state law duty of care. They list a number of further functional items which preempt state corporation law in the Sarbanes–Oxley Act. *Id.* at 873. Thomson and Sale cite no federal restrictions under Sarbanes–Oxley limiting the ability of firms to provide loans executives effectively replace a piece of the duty of loyalty. *Id.* at 877.

combines elements of loyalty and care claims, and might have been made pursuant to state law.[162] Thompson and Sale also note that securities fraud claims often charge that misstatements are made for the purposes of benefiting insiders which clearly overlap with state duty of care claims.[163]

The mechanisms of state and federal shareholder claims are also quite similar, with typical use of class action mechanisms being largely driven by attorneys.[164] This analysis suggests that any attempt to arbitrate shareholder claims at the state level will be largely ineffectual without a concomitant recognition of the shareholder's right to arbitrate federal securities claims as well, as any arbitration of the former may simply result in the migration of shareholder claims to the latter. If, on the other hand, firms and shareholders choose to maintain shareholder litigation in a judicial forum, but select arbitration of federal securities claims, the extent of federal preemption of state internal affairs through private litigation under the '34 Act may be reduced.

Kobayashi and Ribstein note that:

> [m]ass production and sale of litigation or arbitration kits, perhaps supplemented by low-cost assistance as to how to use the kits, might allay these concerns by better enabling consumers to arbitrate individual claims. This would provide a compromise between the duplication of effort involved in thousands of individual claims and the agency costs inherent in class actions.[165]

This idea becomes even more helpful, and cheaper, in the context of app-based governance. It is unlikely however that Delaware will ever permit shareholders in public companies to fully arbitrate all claims against companies and their directors outside of the Delaware court system. The Macey/Miller interest group analysis of Delaware corporate law, which explores how the development of Delaware law reflects in part the preferences of the bar in Delaware, presents a powerful argument for why the interest groups represented in the Delaware bar would quickly press a solution in the legislature to any effort to diminish the rents they obtain in the system.[166]

Recent events provide a concrete example of the Macey/Miller Delaware interest group theory. In response to a Delaware Supreme Court opinion finding that companies had the right to adopt bylaws imposing the English fee-shifting rule on plaintiff shareholders who failed to win on any claims, the Delaware legislature quickly responded with an amendment to the DCGL prohibiting fee-shifting bylaws for any "internal corporate claim," which is to say any claim brought pursuant to Delaware corporate law.[167] This result was clearly motivated by a fear that plaintiffs would migrate out of Delaware and bring claims in other jurisdictions that are less likely to enforce the fee-shifting bylaw, or otherwise bring fewer claims. In recent work, Bainbridge, who has

162. *Id.* at 889.

163. Thompson & Sale, *supra* note 160, at 901.

164. *Id.* at 904.

165. Bruce H. Kobayashi & Larry E. Ribstein, *Law's Information Revolution*, 53 ARIZ. L. REV. 1169, 1199 (2011).

166. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 471 (1987).

167. ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554 (Del. 2014).

often defended the Delaware courts and code, cites this incident as Delaware's "self-inflicted wound."[168]

Allen argues that from a purely doctrinal standpoint, there is no reason Delaware law should not be willing to accommodate mandatory arbitration for corporate claims.[169] She cites *American Express Co. v. Italian Colors Restaurant*, finding that the Federal Arbitration Act (FAA) authorizes mandatory arbitration provisions in commercial contracts that prevent class actions, and *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, in which the Delaware Court of Chancery upheld a board bylaw requiring that Delaware corporate claims be litigated exclusively in Delaware courts, as demonstrating sufficient doctrinal basis for Delaware courts to uphold mandatory arbitration provisions for corporate claims arising under Delaware law.[170] After that litigation, the Delaware Supreme Court upheld the validity of a board bylaw imposing the English fee-shifting, loser pays rule on shareholder plaintiffs bringing corporate litigation.[171]

As previously mentioned, the Delaware legislature quickly responded by invalidating board action imposing fee-shifting, but accepting the validity of forum selection bylaws. The Delaware legislature's rapid overturning of a holding which threatened the litigation bar's rents suggests one should not rely on Delaware doctrine alone in this analysis, but instead should keep a keen eye on the interest group calculus of the Delaware bar.[172]

Even if Delaware law were to expressly recognize a company's right to adopt arbitration, Delaware courts may still review the decision to adopt an arbitration provision or the decision to exercise it. The unique equity jurisdiction of Delaware courts has a shared trait with the "Hotel California" in that one can "check out any time you like, but you can never leave."[173] For instance, in *Schnell v. Chris-Craft Industries* the Delaware Supreme Court held that "inequitable action does not become permissible simply because it is legally possible."[174]

Allen notes the general assumption that arbitration must necessarily obviate class

168. Stephen M. Bainbridge, *Fee Shifting: Deleware's Self-Inflicted Wound* (UCLA Sch. L., Law-Econ Res. Paper No. 15-10, June 29, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2624750.

169. *See generally* Claudia H. Allen, *Bylaws Mandating Arbitration of Stockholder Disputes?*, 39 DEL. J. CORP. L. 751 (2015).

170. *Id.* at 753.

171. *Id.* at 765; ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554 (Del. 2014).

172. Allen argues that if Delaware law found that firms were not permitted under Delaware law to adopt mandatory arbitration, the FAA would preempt Delaware law. Allen, *supra* note 169, at 770–71. That presumes, however, that a court wouldn't find that the internal affairs doctrine requires a reading of the FAA that, since Congress did not directly express an intent to preempt state law, the matter should be left to the states. And in any event, this Article argues in another part that arbitration is not likely to take off until roadblocks to mandatory arbitration at the SEC are lifted, and until the legislative recommendations described in this Article are passed into law (which includes a strong codification of the internal affairs doctrine.)

173. Eagles, Hotel California (Asylum Records 1977).

174. Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971). While Delaware's alternative entity statutes permit arbitration, Delaware law still maintains the contractual duty of good faith and fair dealing requirement that presents a risk you cannot fully contract away. Allen, *supra* note 169, at 772. And in any event, it is unlikely the interest groups in Delaware would ever permit a full arbitration regime to replace fiduciary litigation for large public companies in Delaware courts.

action procedures.[175] This would represent a substantial change to the process of corporate adjudication, as a significant percentage of both direct and derivative claims are brought as class actions. If that is what shareholders and firms value, it may be utilized. If, however, many particularly large institutional shareholders were reluctant to give up a class based approach, then some hybrid form of class arbitration could be developed. But a new hybrid class arbitration procedure could be designed to accommodate some of the procedures used to certify and prosecute class actions, but in a much faster, more predictable way than that seen in the Delaware courts in a less indeterminate manner. The first bylaw proposed for a company listed with the SEC, which sought arbitration in 1990 and was denied, provided for a form of class arbitration.[176] Allen notes how Delaware courts attempted to provide for arbitration by Delaware judges in that spirit for private contracts (an arbitration procedure that would expressly not apply to disputes in corporations or for publicly held alternative entities).[177]

Though that innovation was subsequently challenged as violating open government rules, it may be the case that Delaware would respond to a renewed federalism race in which it was losing substantial market share with some kind of arbitration forum, likely composed of Delaware judges. While such an innovation may present useful choices for new firms, it would likely always be constrained by the gravitational forces of Delaware's interest group politics and would therefore likely lose a renewed entity formation race. The SEC staff strongly disfavors arbitration for private claims under the securities laws, despite the fact that they should be perfectly legal.[178] When previous large corporate IPOs have included in their organizational documents a provision requiring mandatory arbitration of all shareholder claims, the SEC staff have refused to accelerate the registration statements of those companies on the grounds that a provision in the Securities Exchange Act of 1934, which forbids waivers of provisions contained in the Securities Exchange Act, forbids mandatory arbitration.[179] SEC Staff has similarly disallowed shareholder proposals for mandatory arbitration on the same basis.[180] Therefore, we see that in order for arbitration to work, it must be expressly permitted at both the state and federal level simultaneously. In this area federal preemption actually supports Delaware's dominance of the state entity formation race and inhibits state

175. Allen, *supra* note 169, at 754.

176. *Id.* at 802–03.

177. *Id.* at 771–72.

178. This is a rather incredible position, since private rights of action were never actually intended by the drafters of the Securities Exchange Act, but were instead created by courts decades later. Chief Justice Rehnquist described the private right of action under the Act as a "judicial oak" grown from a "legislative acorn." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975). Thus, one reason why arbitration will be vital to reinvigorating charter competition is that private Act litigation will continue to creep into issues covered by the internal affairs doctrine, and indeed if state law claims become subject to an arbitration process, and are coupled with codes that reduce the range of litigation permitted, migration of otherwise state law claims to federal claims would rapidly increase. Note that for crowdfunded firms on a federal platform, an express right to sue is statutorily defined and linked to 12(a)(2) damages for securities offerings. *See* Securities Act of 1933, §12(a)(2). Thus, a crowdfund issuer could still opt-out of Act liability, and state crowdfunding platforms should be able to opt-out of Act liability if the SEC were properly applying the law, and possibly also completely opt-out of securities liability.

179. Allen, *supra* note 169, at 776.

180. *Id.* at 779.

challengers who might develop an entirely new mode of corporate governance with a host of possible governance innovations.

D. Arbitration Will Require a Novel Code Design, and (Initially) an Advisory Opinion Mechanism

Kobayashi and Ribstein note a tradeoff in that lawmaking by arbitration reduces incentives to produce law, and thereby inhibits positive externalities to non-litigants.[181] If the arbitration body and the producer of the corporate code are the same entity, then it may internalize that effect and thereby have incentives itself to create law through opinions that deal with unanticipated situations—as for example in the form of advisory opinions.[182] Innovations in the use of concrete advisory opinions will likely also form a part of a new code. Delaware judges dance with this approach through use of dicta and extensive speeches and articles to telegraph expected changes in the law. Indeed, they permit other federal courts and the SEC to request what is effectively an advisory opinion from the Delaware Supreme Court. A more direct advisory opinion mechanism could offer a clearer picture for business entity formers by way of advisory opinions—as perhaps a collective vote of arbitrators on annual interpretations of the corporate code that have precedential value or otherwise respond to requests for clarification. In order to compete with Delaware's initial advantage in its extensive precedential authority, providing determinate corporate codes might require an advisory based means of interpretation to supplement case law precedent, particular in the early years of a new competitor jurisdiction with a new non-judicial forum just getting off the ground. Indeed, Kamar discusses no-action letters by the SEC, issued in response to requests for guidance from private parties, at the federal level that minimize indeterminacy in the securities laws.[183]

Allen notes arbitration provisions can include substantial flexibility in design by contract, incorporating modified versions of nearly any concept seen in common law

181. Kobayashi & Ribstein, *supra* note 165, at 1207. Another way in which a more streamlined arbitration process is likely to be helpful is in the process whereby the value of minority shareholders' interest is appraised. This could take place when an entity is dissolved or when a freezeout merger is accomplished and a controlling shareholder with a minimum percentage of ownership "freezes out" by statutory right the remaining holdout shareholders. Delaware's own Chief Justice Strine bemoans the state of Delaware's appraisal process: "The concept of fair value under Delaware law is not equivalent to the economic concept of fair market value." William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, U. ILL. L. REV., at *28, http://www.illinoislawreview.org/wp-content/ilr-content/articles/2009/1/Carney.
pdf. Carney and Shepherd identify four Delaware merger fairness and appraisal actions that took an average of 8.7 years to resolve. *Id.* at 45. Carney and Shepherd note that what could otherwise be a simple process of appraising company value has been made unnecessarily difficult by Delaware's indeterminate approach to company evaluation, which utilizes, rather than a market based measure, a judicial fairness opinion which is guided by a nebulous concept of a fair pro-rata apportionment of the pre-merger value for the shareholders. *Id.* at 25.

182. One other way in which a different corporate code could be uniquely different from Delaware would be a different means to sift through derivative cases (assuming derivative actions are a concept used in the new code) such that some outside panel of experts in the field, like VC or techies, determine whether a funded business was a good faith venture or in fact a fraudulent sham enterprise, in much the same way that med mal cases in many states use a panel of MDs to sift through cases before they go to trial.

183. Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1922 n.56 (1998).

litigation, including a process for the creation of case law.[184] Black notes among the benefits of arbitration over litigation are "faster and less expensive proceedings," "decreased risk of aberrational jury verdicts," "more accurate outcomes because of arbitrator expertise or the application of trade rules, and "better protection of confidential information."[185] She also notes one typically referenced drawback is limitations on appeals,[186] though the Financial Industry Regulatory Authority's (FINRA) process for arbitration appeals to an appeals board is a notable exception.[187]

E. Blending the Economics of Crowdfunding Firms with a New Corporate Law System Free of the Federal Overlay

Some crowdfunded firms currently operating on Kickstarter mix profit motives with non-profit social objectives. Many states, including the Delaware corporate code, recognize some form of public benefit corporation that merges for-profit and non-profit goals. The federal overlay becomes quite awkward if one of these chooses to issue public shares in these types of entities.

This Article further explores how crowdfunded firms are likely to require a level of flexibility that has thus far been impossible in state charter competition under the federal overlay, particularly the overlay of private litigation pursuant to the Securities Exchange Act.[188] Until crowdfunding goes online, the prospect of non-profit business entities being "publicly traded" and the unique issues posed by publicly traded firms of this nature will not be faced. The federal overlay represented by SEC rules promulgated under the auspices of the Securities Exchange Act, with its investor profit focus, will significantly limit freedom of innovation in corporate governance for these types of entity forms, and thereby upend the typical interest group politics of federal preemption in corporate governance in the area of what this Article explores as "publicly traded non-profits" or "publicly traded charities."

Agrawal notes philanthropic entities are increasingly asking for defined benchmarks

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184. Allen, *supra* note 169, at 796, 798, 800.

185. Barbara Black, *Arbitration of Investors' Claims Against Issuers: An Idea whose Time has Come*, 75 L. & CONTEMP. PROBS. 107, 119 (2012).

186. *Id.* at 120.

187. Black cites as evidence that arbitration can work effectively even in the context of shareholder claims against large companies. One example in which it was permitted, and in which a class based arbitration mechanism was acknowledged as the appropriate mechanism, involved a dispute over dividend payments for Surgut shares traded in the U.S. but subject to Russian Federation Laws, provided for class arbitration of shareholder claims in an international forum, and was upheld. *Id.* at 117.

188. Many of the firms currently funded on a crowdfund pre-cursor called Kickstarter (which allows dispersed retail funding of projects, but does not permit distribution of profits, and instead features distribution of in-kind benefits; i.e., fans funding their favorite band via the online platform do not obtain a share of future profits, but may obtain preferential access to discounted concert tickets) operate under a norm that one would characterize as a strange mixture of profit motive and charitable donation. That strange brew is likely to explode in publicly traded entities as crowdfunding comes online, and despite well-supported firm theory evidence that such a mixed motive firm will be poorly run, nevertheless is expected to represent a strong consumer preference on these platforms going forward. Many states, including Delaware, have attempted to innovate to meet their consumer demands with some version of "public benefit" corporations. Indeed, the Cato Institute is organized through such an entity form as a non-profit corporation organized under the laws of Kansas.

of success from grantees.[189] It could be that review of activity by a board or by an external reviewing entity such as an arbitration body or the crowdfunding platform itself could simply involve verification that the entity has achieved its benchmark. It may be the case that shareholders could commit themselves to subsequent rounds of funding in advance, premised on the entity's meeting a series of benchmarks.

For some types of crowdfunded firms, the market for corporate control could prove useful, but for others in which the leadership of the entity has some firm specific attribute the market for corporate control could be unworkable. Shareholder preferences may significantly discount high residual agency losses resulting from these organizational forms. For example, an investor preference may reflect high utility in the ability to say one is a shareholder in their favorite band. A potential investor could exhibit a strong investor preference in the ability to share in any profits through the development of a drug targeting a very small population of patients but nevertheless be willing to see the investment as a donation if development costs dissipate all profits.

Part III has demonstrated arbitration will be an essential component of a reinvigorated corporate federalism. Even if many firms do not necessarily select an arbitration-based alternative, successfully challenging Delaware's dominance may require development of at least one successful arbitration based alternative regime. That will require federal recognition of arbitration rights for firms and their shareholders.

Part I of this Article demonstrated that crowdfunding opens up an event window for recharging corporate federalism and entity formation competition and also demonstrated how crowdfunded firms will have unique and heterogeneous needs outside the range of what is presently available. Part II demonstrated how and why the federal overlay restricts that available range of innovation. Part III demonstrated that an arbitration-based means of adjudication and a corporate code designed to be arbitrated will be key components to challenging Delaware's network effects. The final Part of this Article develops some predictive analysis for the various means by which these new innovations might evolve—first over the crowdfunding platform and then possibly spilling over into renewed innovation for larger public firms.

V. CONCLUSION

Even if not all of the innovations evolve in the new world I am suggesting, some of them might, and they might create things like a functioning arbitration system that could fundamentally alter the current state of corporate federalism. Even if only some of them crossover into the large public company space, it could substantially alter state chartering competition in that sphere as well—particularly as smaller sized firms grow and transition from being crowd funded to being large public firms. This Article suggests an initial incursion into the federal overlay in corporate governance that could, initially, enhance the incredible benefits of crowdfunding and ultimately may completely reshape corporation law itself.

189. Agrawal et al., *supra* note 8, at 6.

Source: Hester Peirce and Benjamin Klutsey, eds., *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers*. Arlington, VA: Mercatus Center at George Mason University, 2016.

CHAPTER 16
Ending the Specter of a Federal Corporate Law

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For most of US history, corporation law, or the law governing the interaction between investors and the companies in which they invest, was a function of state law. State corporate law governed the duties that company directors owed to their investors, established the powers of investors to select new directors and managers, and maintained authority for fundamental business decisions in the board of directors. State corporate codes have evolved in the intervening years, increasingly allowing investors and companies to design alternative arrangements to the default provisions contained in these old codes. Steady incursions by federal law into discrete pieces of state corporate law have begun to slowly erode this system, however, and threaten to inhibit innovation in corporate governance at the state level.

In 1933 and 1934, the US Congress passed laws requiring disclosure of financial information to investors in widely traded firms, but left the working parts of state corporate law largely intact. For the first thirty years after the US Securities and Exchange Commission (SEC) was established, it was clearly understood that state law governed traditionally state corporate law matters, such as the duties that boards owed to shareholders or the permitted structural makeup of a

*This chapter is based in part on J. W. Verret, "Uber-ized Corporate Law: Toward a 21st Century Corporate Governance for Crowdfunding and App-Based Investor Communications," *Journal of Corporation Law* 41 (Summer 2016): 927–69.

company and the way its directors and officers were selected. In 1945, for example, the SEC made clear that the propriety of shareholder proposals at annual company meetings would be determined pursuant to state law.[1]

The détente began to change in 1968 when the Williams Act gave the SEC authority to go beyond merely disclosure-based regulation and actually empowered the SEC to regulate the process whereby public companies were taken over by new buyers. In the 1970s, then SEC Chairman William Cary proposed an express federal corporate law that entirely preempted state corporate law when he urged that "a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy."[2]

Bill Cary's express suggestion never happened, but a slow advance of federal incursions into state corporate law continued, culminating with an explosive enlargement of the federal footprint in state corporate law in financial reform legislation in 2002 and 2010. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), for example, included a variety of corporate governance reforms that were in large part entirely unrelated to the financial crisis of 2008. For example, one of them required companies to disclose their use of minerals mined in the Democratic Republic of the Congo. Another required a nonbinding vote by shareholders, which carries no practical consequences, on CEO pay. Still another required companies to disclose the ratio of their CEO's pay to that of the average worker, a suggestion made some ten years earlier by a labor-funded group as a way to increase union leverage in negotiations.[3] Many of the suggested reforms had been proposed long before 2008, yet were included in what was perceived as must-pass financial reform legislation in order to cater to the powerful special interest groups that had long supported those proposals.

As much as the corporate governance reforms of 2008 were misguided, they were the result of many years of regulation by the federal government that has slowly eroded the role of states in creating corporate law. That process began with rules adopted in response to the Enron and WorldCom scandals in 2001 and 2002, embodied in the Sarbanes-Oxley Act that now determines the qualifications for service on company boards of directors. Oddly, the corporate governance rules regarding independence that were codified in 2002 and 2003 largely reflected attributes of the Enron board of directors.[4]

Much of existing corporate law scholarship has been divided into two competing camps. One urges that states "race to the top" and seek to balance the rights of shareholders and the obligations of directors by adopting laws that maximize shareholder value. That side of the discussion tends to argue that the market for publicly traded stock will discipline any excesses by the state that cater to corporate insiders at shareholders' expense. The opposing camp urges that corporate insiders will distort the race into a "race to the bottom" in which the state that designs corporate governance codes that allow insiders to exploit shareholders and destroy firm value will attract the most new incorporators. The latter camp typically urges as an alternative a federal incorporation regime broadly, and also urges discrete preemptions of state law by a more enlightened federal regulator.

This chapter urges that over the last five decades, the race has been distorted by the presence of federal preemption. The supposed race is not much of a race at all. Federal incursions into state law have themselves garnered significant market power to the currently dominant state for public incorporations, Delaware. Proponents of the "race to the bottom" theory have the causal link backwards. Federal preemption of discrete areas of corporate law is not the answer to market failures in the market for corporate law, federal preemption is in fact causing market failures. Federal incursions do this in part by inhibiting innovations, like an arbitration-based corporate code, which could challenge Delaware's dominance in corporate law by challenging one of the principal competitive attributes of Delaware in its predictable court system. As such, a rollback of the federal footprint is the best way to reinvigorate the chartering race in corporate law.

This chapter argues that first and foremost, this federal overlay in corporate governance must be stripped away. Alternately, at a minimum the existing federal corporate governance rule book should at least become part of an optional opt-in regime and thereby allow a firm's shareholders to determine whether the federal arrangement is best for their particular firm. But arguing for removal of current federal encroachments on state corporate law contained in Sarbanes-Oxley and Dodd-Frank is just the beginning. This chapter goes on to explore how other existing federal laws can be molded to empower the states to compete with each other in corporate law. A number of institutional changes will be needed to develop the foundations necessary to facilitate innovation and economic growth in state corporate law.

Dodd-Frank, legislation built on an improper understanding of the factors leading to the 2008 financial crisis, ultimately threatens the competition and flexibility required for consumer benefits created via innovation. Specifically, Title IX, Subsection G, of Dodd-Frank continues the trend of centralizing corporate law by consolidating regulatory power over corporate governance in the federal government, thus preempting the ability of states to be competitive in chartering. State chartering may be competitive within the modes of governance permitted by the federal overlay.[5] This chapter's examination of a range of innovations that would be clearly helpful in experimental environments, like crowdfunding, will demonstrate that the federal footprint in corporate law stifles the chartering race by inhibiting innovation.

Business entity law has been around since the establishment of the firm and has remained an important contributing factor to the economic systems that develop and utilize them. Corporate law was key to building the Roman aqueducts and critical to the Industrial Revolution. The advent and public embrace of innovative business models like Kickstarter's crowdfunding approach and Uber's sharing-economy structure demonstrate demand for a more flexible approach toward corporate governance. With each unique business model comes the necessitation of an equally unique corporate structure. However, the mere fact that the economics of new-age firms suggest a demand for flexible innovation in corporate governance does not mean that states are in a position to make that innovation available.

For example, Stephen Bainbridge at the UCLA School of Law and M. Todd Henderson of the University of Chicago Law School recently designed a novel approach to the structure of boards of directors in which other business entities can themselves serve as members of the board, which would allow board member companies to economize on scale and scope, have more directed compensation and liability incentives than the current model, better expose the market for board membership to market forces, and provide reputational constraints for repeat player board member firms.[6] Bainbridge and Henderson note that federal rules that would prevent their idea were not necessarily even designed to prevent entity membership on the board, but the references to natural persons in the federal rules effectively preclude their innovation from being implemented.[7] Moving forward, a competitive model for the production of corporate law will be critical to make the most of technological advances that are reducing the cost of individual interaction. In this chapter I suggest that the reinvigoration of state law federalism can serve to support such a competitive model.

CORPORATE FEDERALISM UNDER THE THREAT OF FEDERAL PREEMPTION

The corporate codes that govern business entities have been the lynchpin of America's economic development since the start of the industrial age. Business entities with separate existence, able to protect their shareholders from liability for corporate actions, were essential to facilitate the first large-scale industrial investments in the late nineteenth and early twentieth centuries. States competed to offer increasingly accommodative corporate codes, and eventually Delaware became a dominant player in that race by allowing companies to own stock in other companies—something its chief competitor, New Jersey, prohibited until the middle of the twentieth century.

This competitive state system, in which states compete to attract out-of-state entrepreneurs to form corporations in their state, has also been beneficial to shareholders. A study found that firms incorporated in Delaware, the current winner of the incorporation race, experience an increase in shareholder value at the initial public offering (IPO) stage over other firms solely by virtue of being incorporated in Delaware.[8]

Roberta Romano of Yale Law School has described this state system as allowing states to serve as laboratories in which new corporate governance arrangements can be invented and measured against offerings from competing states. While not every state actively competes in this arena, smaller-population states like Delaware have been eager to compete for incorporation fees from newly formed companies.

A more recent innovation in business entity law has been the widespread use of limited liability companies, or LLCs, which have a greater degree of flexibility in designing the range of fiduciary obligations that boards and CEOs owe to their shareholders. While that degree of flexibility is greater than the flexibility afforded CEOs and boards of corporations, it remains somewhat limited. Delaware still maintains an obligation of "good faith and fair dealing" that shareholders are not permitted to opt out of in favor of contractually specified obligations. The late Professor Larry Ribstein also notes a number of cases in which Delaware courts have struggled to uphold the Delaware legislature's intent to promote freedom of contract in LLC agreements.

While Delaware competes to maintain its advantage in new business entity formation, Jonathan Macey of the Yale Law School and Geoffrey Miller of the New York University School of Law suggest that the state may enjoy an extent of market power that allows it to also maximize the litigation fees enjoyed by Delaware law firms that help to craft Delaware's code.[9] That would certainly explain Delaware's reaction in 2015 to a court ruling that companies are allowed to adopt bylaws that force losing plaintiffs to pay a company's legal fees in shareholder actions. The Delaware bar, fearing a loss in litigation business, immediately moved to change the Delaware code to reverse the Delaware Supreme Court's ruling and prohibit such "loser pays" bylaws.[10]

Many of Delaware's critics suggest that it does not actually actively compete for business entity formation any longer, and that the idea of state competition in business entity formation is largely a myth at this point. They argue that Delaware has a hundred years of precedent behind it, and as such its advantage is insurmountable for new states that might attempt to compete with Delaware by improving on its code. For example, if another state wanted to take Delaware's code, improve on it, and thereby compete with Delaware, it would find the Delaware code filled with nebulous concepts like "good faith" obligations and a "duty of care" and "duty of loyalty" that have slowly been defined over a hundred years and thousands of pages of precedent. States may feel Delaware's body of precedent is an insurmountable obstacle in trying to make their own codes work.

Supporters of Dodd-Frank's corporate governance reforms latched on to that argument and urged that Delaware failed investors by not adopting corporate governance reforms they favored. Ann Yerger of the Council of Institutional Investors testified with respect to the proxy access rule included in Dodd-Frank that "the States have failed investors too long, Delaware in particular, and it really only acted when it had to. And I think it is important that the SEC take action on this important reform."[11] Relative to other states in the incorporation race, it is not clear that Delaware is failing shareholders. For example, as noted earlier, companies incorporated in Delaware enjoy a premium in their average market value compared to non-Delaware companies at the time they go public. Relative to the range of options for shareholders that could be observed in a more competitive chartering environment free of a federal footprint, which stamps out more competitive innovations, Yerger may well be right. But relaxing federal incursions into state law is the answer to the problem.

Delaware's critics may certainly have a point that Delaware imperfectly competes in the race to charter new businesses and to innovate in corporate governance. Those critics, however, have made the wrong diagnosis. Federal preemption of state corporate law, and the specter of future federal preemption, discourages other states from challenging Delaware. The state laboratories described by Romano do not really work if the innovators must work under the threat that their innovations may be destroyed by federal action. Indeed, Professor Mark Roe argues that Delaware is uniquely adept among the states at responding to the specter of federal preemption with narrowly tailored changes that outmaneuver some of the goals of blunt federal legislation.[12]

The threat of federal action has important consequences for arbitration as a means to invigorate state competition. The market power that Delaware enjoys in the chartering race could be sidestepped with an entirely new corporate governance system designed to be enforced in an entirely different way. Rather than litigating nebulous "fiduciary duties" in court, like the current model most states use and which was inspired by Delaware, an arbitration-based system could design duties through contract, and rather than relying on judges in states without Delaware's judicial expertise, it could rely on industry veterans specializing in arbitration of complaints. Such an approach would allow other states to break Delaware's market power and shake the very foundations of American corporate law.

And yet, the SEC has strongly discouraged firms going public from requiring that investors arbitrate claims against the company. This restriction should be expected to apply to crowdfunded firms as well. The SEC has refused to approve the offering documents of firms including arbitration in their offering documents, despite the fact that the Federal Arbitration Act provides investors with such a right. This is but one example of how federal preemption of state corporate law actually impedes state competition and thereby provides an advantage to the currently dominant state of Delaware.

Some protection of federalism, and therefore the states' ability to compete via governance innovation, is supposed to be offered via the internal affairs doctrine, a rule of construction created by judges that applies both in interpretation of federal statutes and an interstate choice of law rule. The doctrine holds that the "internal affairs" of corporations, or the contractual relationship between shareholders, directors, and officers of corporations, should be determined pursuant to the laws of the state of incorporation.[13] While many states respect the doctrine, New York and California abandon it in the context of companies not traded on a national securities exchange.[14] And while some federal court interpretations of the securities laws demonstrate respect for the internal affairs doctrine,[15] others do not. At times, Congress will either explicitly preempt matters covered by the internal affairs doctrine through statute or the SEC will infringe on the matters within the internal affairs doctrine through administrative action.

The internal affairs doctrine has been a vital component in sustaining interstate chartering competition. This doctrine has been one by which federal judges, in interpreting the federal securities laws, have tended to read the securities laws as not intending to preempt state law unless such intent is clear from the statute. This doctrine also has been used by state judges to give mutual respect to each other's corporate law (e.g., a shareholder in a Delaware corporation, suing in California, has traditionally seen the claim determined pursuant to Delaware law). And yet the internal affairs doctrine has begun to come apart at the seams, further threatening to limit competition in the state system. This is true both insofar as discrete incursions into state law are occurring at the federal level, and also with respect to states that have refused to fully give deference to the laws of a company's state of incorporation when suits or administrative action are brought in other states.

While the internal affairs doctrine has at some points limited the SEC from undertaking to preempt state law, it has not always served as a binding constraint on the SEC's use of discretionary power to preempt state corporate law. Further, California and New York have adopted statutes that ignore the internal affairs doctrine for companies with a large number of shareholders in their states.

The mere existence of a threat of federal preemption can dissuade states from pursuing corporate innovation. This chilling effect on innovation is not new. Delaware judges William Chandler and Leo Strine previously expressed the frustration of state corporate innovators regarding the prospect of federal preemption when they noted in response to Sarbanes-Oxley, "What's next? A ban on going private transactions? Or on options-based compensation of executives? Or on interested transactions?"[16] This manifestation of concern is not contained to existing innovations, either. The incompatibility and lack of clarity inherent to one-size-fits-all regulation results in a restriction on competition, as it discourages states from deviating from the status quo.

The Sarbanes-Oxley Act, for example, set mandatory requirements for independence of certain committees, mandatory CEO certification of financial systems, and a prohibition on loans to corporate officers. The footprint of preemption is probably wider than originally intended by the drafters of the statute: if, for example, some method of governing firms is stricter than the board-centric model that was in vogue during the passage of Sarbanes-Oxley, states would be precluded from developing it because Sarbanes-Oxley entrenches a board-centric approach.

To this point, Professors Kobayashi and Ribstein note that one prerequisite for a quality sorting model, or interstate competition, to be effective is that "jurisdictions are free to select any set of laws they desire."[17] However, Roe's extensive analysis of the extent to which federal law preempts state corporate law demonstrates the constraints on a full Tiebout model in the corporate federalism context. Roe defines the problem of the federal overhang succinctly:

> Federal authorities can, and do, confine state competition. They have made rules—such as vast parts of the securities laws—that are functionally part of America's corporate law. They could do more, were they so inclined. In nearly every decade of the twentieth century, the decade's major corporate law issue either went federal or federal authorities threatened to take it over—from early twentieth century merger policy, to the 1930s securities laws, to the 1950s proxy fights, to the 1960s Williams Act, to the 1970s going-private transactions. Even if the states never adjust to the federal presence, Washington is a player in American corporate governance.[18]

Roe's conclusion: "Because Delaware players can never be oblivious to the possibility of being displaced, we have never had, and we never could have, a full state-to-state race in corporate law."[19] While Roe is correct that the federal overhang inhibits competition, he overstates the case, particularly with respect to the prospect of significantly enhancing interstate competition through self-enforcing limits on the federal overhang.

Roe notes that federal preemption breaching the internal affairs doctrine frequently occurs both through statute and through the SEC's discretionary authority.[20] Roe generally points to sources of federal preemption such as the SEC, the Congress, federal courts interpreting securities law cases (the existing internal affairs doctrine notwithstanding), and the national exchanges.[21] Romano notes that the SEC typically strongly pressures the national exchanges to adopt uniform corporate governance provisions.[22]

Roe goes on to state that "Presidents Roosevelt, Taft and Wilson each sought mandatory federal incorporation."[23] Each of those attempts failed, however, suggesting that full-scale nationalization of corporate law is constrained by interest group dynamics. Macey described in 1990 that dynamic as one in which "Congress can amass significant political support by refraining from preempting state law in this area. The fact that Congress has not enacted a national corporate law indicates that deference to the states is in fact its political-support-maximizing solution."[24] Though large-scale incursion into state law did not occur, Congress did find discrete incursions helpful, as for instance with the Williams Act's regulation of takeovers. And at times the SEC used authority delegated to it to undertake preemptive actions under its own initiative. Furthermore, since the time of Macey's exploration, a number of large-scale federal incursions into discrete pieces of state corporate law have occurred, usually during times of national attention to corporate governance scandals or crisis.

But even the larger-scale incursions do not preempt completely. For example, proposals to mandate an independent board chairman and impose constraints on executive compensation were pared back in favor of optional approaches for public companies in Dodd-Frank. So while bulwarks against federal incursion can be sustained in part, they must also be built in advance of crisis-induced legislation. Reforms to strengthen additional states' interest in preventing future preemption, and making it difficult for the federal government to selectively preempt and instead leaving full-scale preemption as its only option, may fortify the bulwark against federal incursions into state corporate law.

Roe concludes that one of the earliest forms of preemption in the Securities Exchange Act of 1934 was preemption of shareholder voting disclosure and voting processes, stating, "The wide SEC regulation of proxies determines what goes into the proxy request to shareholders, what gets onto the ballot, who gets access to shareholder lists, and how a proxy fight . . . is waged. . . . Voting is probably the single most important internal corporate affair."[25]

Similarly, Michael Greve of the Antonin Scalia Law School at George Mason University and his co-author Ashley Parrish point out an increasing level of agency delegation by Congress and cite Dodd-Frank as an example.[26]

This delegation provides the SEC with an opportunity to expand the reach of its authority into traditionally state areas. If the internal affairs doctrine were codified and a procedure for states to challenge its violation were adopted, it would be harder for the SEC to unilaterally expand its reach through purely administrative preemption, even if Congress continues to practice excessive agency delegation.

This practice is no longer limited to the SEC, however, as other federal agencies are increasingly seeing preemption of state corporate law as a means to enhance their authority over the entities they regulate. Federal Reserve Board Governor Daniel Tarullo recently proposed the notion of a massive expansion of fiduciary duties for banks regulated by the Federal Reserve, arguing for a change in which:

> the fiduciary duties of the boards of regulated financial firms . . . reflect what I have characterized as regulatory objectives. Doing so might make the boards of financial firms responsive to the broader interests implicated by their risk-taking decisions even where regulatory and supervisory measures had not anticipated or addressed a particular issue. And, of course, the courts would thereby be available as another route for managing the divergence between private and social interests in risk taking.[27]

It was not clear whether Governor Tarullo was suggesting a change to state law or instead was suggesting a federal preemption of state fiduciary duties. At present, the fiduciary duties owed by banks to their shareholders with respect to chartered banks are a function of federal law that itself references state corporate law. It may have represented both: pressure on states to reform their fiduciary duty jurisprudence backed up by an implicit threat of federal preemption. The Roe thesis suggests Delaware may respond to that threat. Certainly this proposal was highly provocative and has not been directly adopted by the Federal Reserve. But it presents an extreme case of the threat of federal preemption. Governor Tarullo additionally suggested federal rules concerning executive compensation, management reporting systems, and board structure as additional corporate governance avenues that federal regulators might regulate.[28]

CORPORATE GOVERNANCE NEEDS OF CROWDFUNDED FIRMS: A MICROCOSM OF THE DAMAGE FEDERAL PREEMPTION CAN DO TO ECONOMIC GROWTH

One development in the capital markets world that promises to renew innovation in methods of business financing is a new regime of crowdfunding that has been facilitated by regulations at the SEC, adopted pursuant to the Jumpstart Our Business Startups (JOBS) Act of 2012, to allow very small and early-stage companies and investment projects to access public markets.[29] This new innovation will of necessity require a new corporate governance system designed for the unique needs of crowdfunding, but unfortunately the existing federal overhang in corporate law threatens to impede the promise of crowdfunding.

The regulatory regime for crowdfunding is relatively new. It remains to be seen whether crowdfunding will reshape startup financing. And if it does not, it also remains to be seen whether crowdfunding will be primarily held up by regulatory constraints that remain despite the JOBS Act. Crowdfunding is nevertheless a helpful microcosm for the experiment.

The questions at the heart of this chapter are simple: In the absence of federal preemption in corporate law, what range of alternative innovations would be possible? And in the absence of federal preemption, how much more competitive would the state system for creating corporate law become?[30]

Answering these questions also calls for a difficult thought experiment, because one must consider a world in which a range of institutional constraints in corporate law and financial markets that presently exist are eliminated, and consider a world in which the path dependencies in the law and the institutional design of the industry itself would disappear.

The environment best suited for this thought experiment is crowdfunding. It is presently at a nascent stage with respect to the regulatory regime that governs it. The financing mechanism also was allowed to grow, in a limited capacity, before the federal regulatory regime went online.[31] The institutional dynamics seen in that early precursor to crowdfunding afford sufficient data to begin the necessary thought experiment.

Crowdfunded firms are expected to be designed around a number of "quasi for-profit" models that will require legal duties and structures very different from those popular in previous models. Some crowdfunded firms, for example, are expected to specialize in funding drug research to find cures for ailments with small patient populations. Such a firm could face difficult choices in the tradeoff between searching out the most profitable drugs and maximizing the odds of finding a cure.

Indeed, one would expect that funders would go into the investment expecting the possibility that the firm might stretch the boundaries of traditional fiduciary obligations, or the residual obligation of good faith and fair dealing, in the initial search for a cure if necessary, but would subsequently seek to maximize profits obtained by successful research. Such a mixed-motive firm will of necessity require a corporate code that maximizes freedom of contract to define the obligations owed by a board to shareholders and one that permits use of arbitration rather than litigation to enforce any contractual duties.

It is already clear that crowdfunded firms, much like master limited partnerships (MLPs), are likely to utilize nontraditional monitoring to protect against fraud. A study by Wharton Professor Ethan Mollick on a platform similar to crowdfunding found that funders of most projects were highly involved and provided ideas from the design of consumer products to the development of business strategy.[32] That study also found that fraud detection was essentially "crowdsourced" with rapid detection of fraudulent projects through user commentary on platform blogs and comment sites.

A large community of users can maximize on the low costs of communication in the era of social networking to better police fraud.[33] This new model of corporate governance is vastly different from the current model, which is based on a theory developed by Berle and Means and premised on an assumption that small shareholders face insurmountable costs in communicating with each other and with directors of the firms they own.[34]

Some crowdfunded firms may find that shareholder participation is useful, although not necessarily through the rigid mandates established by federal law. Other firms may find shareholder participation harmful. Entertainment projects, like fan-based movie funding, have been particularly successful on crowdfunded platforms that predated the new crowdfunding regulatory regime. Those projects tend to center on a specific director or actor as a necessary element in the project and may therefore seek to limit the ability of shareholders to interfere in decisions by that individual. Thus old models of the fiduciary duties that companies owe to their shareholders will be largely outdated for this new model.

An explicit recognition of the right of investors and firms to choose arbitration to resolve claims against public companies, whether through SEC guidance or statutory reform of the Securities Act of 1933, is vital to assist the development of new publicly traded small businesses like those expected to evolve under crowdfunding. One reason arbitration is so important is that firms funded under crowdfunding will have unique designs vastly different from those seen in the publicly traded space thus far. Crowdfunded firms will be much smaller, will be publicly traded much earlier in the innovation life cycle than any firms previously seeking public capital, and will go public with the assumption that multiple rounds of future funding will be required.

The fact that the suggestions in this chapter are designed to facilitate crowdfunding will also serve to generate retail support from individual investors, in much the same way the ride-sharing app Uber has managed to generate strong retail support that has allowed it to successfully challenge the powerful lobby of incumbent taxi cabs. Crowdfunding, like Uber, is a service that directly challenges the incumbent methods of financing and whose most cogent threat is the regulatory barriers to entry supported by incumbent firms. And crowdfunding, like Uber, is poised to utilize technological improvements in the cost of communication that are popular among millennial consumers.[35]

While crowdfunding platforms may escape most of the requirements put into place by Dodd-Frank and Sarbanes-Oxley, those crowdfunded firms that hope to evolve and grow into larger public companies listed on exchanges may nonetheless feel compelled to abide by securities laws' strictures anyway. Furthermore, while crowdfunding is used as an example for how the federal government encroaches on the states, that is merely a microcosm for the broader damage to innovation in the state-based corporate law system caused by federal preemption.

WHEN THE FEDERAL OVERLAY IS ROLLED BACK, INNOVATION SPROUTS: THE CASE OF PUBLICLY TRADED MASTER LIMITED PARTNERSHIPS

The governance of publicly traded master limited partnerships provides a small-scale case study in the adaptability and heterogeneity of businesses' organizational form. MLPs form a small subset of publicly traded companies in which the federal overlay has been moderately lifted by the exchanges. They were created pursuant to a tax exemption for energy companies that allows them to avoid entity-level taxation if they make regular distributions of earnings to investors. Looking more broadly to the MLPs that continue to operate using a limited partnership form, John Goodgame notes that as of 2012, there were eighty-seven energy-related MLPs traded on public markets.[36] While they have traditionally been organized as limited partnerships, more recently some of them have organized as LLCs.[37] These energy firm MLPs make up the vast majority of publicly traded alternative entities on US exchanges.

Under exchange listing rules, MLPs are not required to have a majority of independent directors, a nominating committee, or a compensation committee.[38] MLPs and other public companies are otherwise subject to the same set of federal securities laws.[39] Thus, with this relatively minor exception from the federal overlay, a wide diversity of governance arrangements has evolved.

Goodgame generally describes a great deal of heterogeneity in organizational form, as some MLPs provide for annual elections and some have staggered boards. Some MLPs have poison pills, others do not. Some choose default fiduciary duties, and some opt out of fiduciary duties. But they generally choose to opt out of rules favored in the public context as they have stronger contractual requirements to distribute all their earnings on a quarterly basis. That mandatory quarterly earnings disbursement in the partnership or LLC agreement essentially substitutes for the traditional monitoring mechanisms of corporate law, like fiduciary duty litigation or board committee oversight. And it is structurally a much stronger means of policing against fraud, as equity owners see hard cash flow every quarter (and the firm does not regularly take in large amounts of new capital such that a Ponzi scheme–type fraud would be possible). It is very difficult for these companies to mask losses.

MLPs further have a governance innovation similar in many ways to the organization board member proposal advanced by Bainbridge and Henderson (and referenced earlier in this chapter).[40] MLPs are typically controlled by a sponsoring general partnership, which reserves contractual control of the board of directors for itself by reserving a majority of board seats for individuals selected by the general partnership. Structural heterogeneity in governance tends to adapt to the particular needs of individual firms; those with more dependable and steady streams of cash flow tend to substitute for traditional governance arrangements earnings distribution and regular fundraising from capital markets as agency monitoring measures.[41]

One can readily think of other governance arrangements that could be useful for other types of firms, from crowdfunding to unique industries, which states could develop if freed from the overbroad federal footprint. One could imagine a different appraisal process tailored uniquely to handle the needs of biotech firms that lack cash flow for long periods. This limited innovation leads one to wonder what level of innovation may have been possible in the absence of the full federal overlay. At this point one can only guess the possibilities.

RECOMMENDATIONS

Repeal Federal Corporate Governance Mandates

The struggle of meshing the needs of new business models with rigid federal regulation prompts a larger consideration of the current state of interaction between states and the federal government in corporate law. This leads to the claim of this chapter that state competition is currently not robust enough to support novel corporate structures because states are hindered by an ever-expanding federal overlay of blanket regulation. Title IX of Dodd-Frank perpetuates this federalization of corporate law in the face of the internal affairs doctrine. As noted in the MLP case study, reducing regulation that results in the allowance of innovation can have an immediate beneficial effect in the form of firms' willingness to innovate. Revitalizing state federalism in pursuit of genuine competition, as opposed to the centralization purposes of Title IX's corporate governance provisions, would serve to incentivize states to create and promote innovative and more effective corporate law.

Codify the Internal Affairs Doctrine as a Binding Constraint on Federal Regulatory Agencies, with Express Standing for States to Challenge Federal Action

The internal affairs doctrine has helped to maintain a vibrant competition between the states in the development of corporation law. This has helped to develop a rich body of law that has made it possible for large-scale industrial development through the twentieth century. But the internal affairs doctrine is under siege from regulators who have preempted large swaths of corporate law, and other regulators who continually look to sidestep it. A clear and binding constraint on federal regulators will be necessary in order to allow corporation law to undergo a renaissance for a new and vibrant century of capital markets.

For a federalist system to survive, it must be self-enforcing. In other words, it must be able to survive future attempts to slowly erode the federalist system in corporate governance. The explicit standing of individual states to challenge violations of the internal affairs doctrine helps to create that self-enforcing character.

Give Statutory Recognition to Publicly Traded Companies' Right to Require Investor Arbitration

This chapter has demonstrated that permitting arbitration for shareholder claims against companies, whether under the federal securities laws or pursuant to state corporate law, is a vital component to reinvigorating interstate competition. It is also clear that many crowdfunded firms would benefit from an alternative corporate law model grounded in a more flexible and adaptable arbitration-based approach to adjudicating corporate disputes. The SEC should not prohibit arbitration for investor claims in any instance in which a state's corporate law permits it. Delaware appears to presently discourage an arbitration alternative, but under a more competitive system some state would likely design an alternative that more directly used arbitration as a means of resolving shareholder complaints.

Preempt Authority of State Attorneys General to Bring Investor Claims against Out-of-State Firms

Yet another threat to state chartering competition is in the form of state attorneys general who bring claims on behalf of investors in companies outside of their state. In particular, New York attorneys general have brought many claims under New York's overly broad Martin Act against companies incorporated outside of New York for claims between investors and companies that should be resolved pursuant to the other state's corporate code.

An analyst writing for *Legal Affairs* described former New York Attorney General Eliot Spitzer's use of the Martin Act as follows:

> To win a case, the AG doesn't have to prove that the defendant intended to defraud anyone, that a transaction took place, or that anyone actually was defrauded. Plus, when the prosecution is over, trial lawyers can gain access to the hoards of documents that the act has churned up and use them as the basis for civil suits.[42]

Limiting the authority of state attorneys general for investor fraud actions to companies incorporated in their home state will more faithfully respect the internal affairs doctrine and provide those attorneys general with an incentive to balance any desire to bring meritless litigation against out-of-state firms for political motivations.[43]

In the event state competition for corporate chartering becomes markedly more competitive as a result of the suggestions in this chapter, states may then be tempted to use the power of state attorneys general to engage in unfair competition with other states. Corporate governance practices that give other states a competitive advantage in the chartering race may be deemed "unfair" under a nebulous statute like the Martin Act.

Out-of-state attorneys general could then threaten innovations in other jurisdictions that are otherwise beneficial to shareholders. If instead state attorneys general are limited in their authority to bring investor fraud claims against entities incorporated in their own states, then they will be better incentivized to consider the collateral consequences of any abuse of their authority.

Out-of-state attorneys general have no incentive to consider the collateral consequences of their actions on the broader investing public. One might imagine, for example, the New York attorney general forcing companies as part of settlement agreements to regularly require that all members of the board be independent of the company, thereby discouraging other states from beneficial innovations in the design of boards of directors to leverage the expertise of nonindependent directors.

This is a critical distinction to appreciate in discussions about federal preemption. When states create law, as through the creation of a corporate code, and when states internalize much of the impact of their lawmaking, as through chartering fees, a competitive race is possible and principles of federalism apply. But in the use of state attorney general power, states create law in the use of enforcement actions. They craft new law through enforcement settlements, and the institutional actors with the power to craft that law have no balancing force to discourage abuse of their power.

If a New York attorney general oversteps and presses initiatives that destroy shareholder value, his influence and political standing will be unaffected. Shareholders and incorporators cannot choose to avoid the law effectively created by New York in this way; they cannot choose corporate law created by enforcement action the way they can choose statutory corporate law by selecting a particular state of incorporation. All publicly traded companies have many of their trades routed through the various exchanges that operate in the jurisdiction of the New York attorney general.

The recommendation offered here will encourage a more federalism-based approach to the use of this executive authority. State attorneys general would be more sensitive to the impact of their decisions if the rate of incorporation in their home state were linked to the enforcement environment they provide. Furthermore, any under-enforcement by an attorney general that left shareholders exposed to fraud would result in a discount to the traded value of firms incorporated in that state.

Thus this suggestion creates an institutional environment in which state enforcement actions premised on investor claims are more balanced and responsive to the costs of over- or under-enforcement relative to legitimate shareholder fraud claims.

CONCLUSION

When the SEC was created in the 1930s, the state-based system of corporate law was kept in place. That system had helped to facilitate the accumulation of wealth necessary for large-scale capital investments during the Industrial Revolution. When SEC Chairman William Cary suggested in 1970 that a federal corporate law be adopted, the suggestion was largely ignored. Even in the wake of the Enron scandal and, later, the 2008 financial crisis, the federal response did not include a wholesale preemption of state corporation law. This indicates an enduring, centuries-long respect at the federal level for the vital role of the states as sources of corporation law.

The slow preemption of discrete pieces of state corporate law has, however, taken its toll on the state-based corporate law system. The discrete preemptions have a much larger impact on the state system than the sum of their parts, as they discourage innovation in corporate governance and impede state competition to create new legal and contractual regimes to govern the relationships between investors of capital and managers of capital.

At each major turn in human history, corporate law has served as a foundation for mankind's forward progress. In ancient Babylonia, a version of partnership law helped farmers band together for mutual investments in farming infrastructure. A more sophisticated form of corporate law developed to facilitate Roman-era investments in large capital projects like the aqueducts. America's first major evolution in corporate law facilitated the Industrial Revolution, and the next spurt of ingenious innovations helped America's post–WWII economic boom.

Looking forward, an entirely new era in which investors are likely to interact with their investments in an increasingly low-cost, app-based environment is possible. Crowdfunding in particular promises to allow small-dollar investors to invest in very early stage ventures like never before. Innovation's promise will be lost, however, if the federal overlay in corporate law does not stand aside to allow renewed competition and innovation in the state-based corporate law system.

NOTES

1. See Gallagher and Cook, "Shareholder Proposals."
2. "Triumph of the Pygmy State."
3. Piwowar, "Dissenting Statement."
4. See generally Romano, "Sarbanes-Oxley Act."
5. Roughly half of all publicly traded companies are incorporated in Delaware. Romano describes Delaware's dominance of the corporate chartering market as a feature, not a bug, of a successful race to the top. Bilateral investments by both users of corporate law and by Delaware in the production of corporate law may make it difficult for another small state to compete with Delaware, but at the same time those bilateral investments serve to enhance the quality of Delaware's code. She describes it as "development of transaction-specific human capital [which] establishes what Oliver Williamson terms a 'mutual reliance relation' creating a reciprocal vulnerability on both sides of the charter market that joins the parties together in a cooperative long-term relationship." See Romano, "Law as a Product," 225–26.
6. Bainbridge and Henderson, "Boards-R-Us."
7. Ibid., 1100.
8. Daines, "Does Delaware Law Improve Firm Value?"
9. See Macey and Miller, "Toward an Interest Group Theory."
10. Verret, "Uber-ized Corporate Law," 964.
11. Yerger, Testimony before the Senate Subcommittee.
12. Roe, "Corporate Shareholder's Vote," 9.
13. For a possible definition of the internal affairs doctrine from the Restatement (Second) Conflict of Laws, see "Internal Affairs Doctrine."
14. "Internal Affairs Doctrine."
15. Edgar v. MITE Corp., 457 U.S. 624, 645 (1981).
16. Chandler and Strine, "New Federalism," 953, 974.

17. Ribstein and Kobayashi, "Economics of Federalism," 3.

18. Roe, "Delaware's Politics," 2498. While Roe overstates the case by describing Delaware as thus a "monopoly," he nevertheless accurately sketches Delaware's relationship to the federal government. See Roe, "Delaware's Politics." In "Delaware and Washington as Corporate Lawmakers," 10–11, Roe goes on to describe the ways in which the federal government can and has preempted state corporate law:

    "Washington makes corporate law. From 1933 to 2002, that is, from the passage of the securities laws to the passage of Sarbanes-Oxley, Washington has made rules governing the voting of stock and the solicitation of proxies to elect directors. It has made the main rules governing insider trading, stock buybacks, how institutional investors can interact in corporate governance, the structure of key board committees, board composition (how independent some board members must be), how far states could go in making merger law, how attentive institutional investors must be in voting their proxies, what business issues and transactional information public firms must disclose (which often affect the structure and duties of insiders and managers to shareholders in a myriad of transactions), the rules on dual class common stock recapitalizations, the duties and liabilities of gatekeepers like accountants and lawyers, and more. Even when the SEC cannot, or does not, make the substantive rule, its capacity to force disclosure of numbers and transactions can turn a spotlight onto those transactions and numbers, thereby affecting whether or not they happen."

19. Roe, "Delaware's Competition," 592.

20. Ibid., 597.

21. Ibid., 598–99.

22. Romano, "States as a Laboratory," 209, 220.

23. Roe, "Delaware's Competition," 601.

24. Macey, "Federal Deference to Local Regulators," 279.

25. Roe, "Delaware's Competition," 611.

26. Greve and Parrish, "Administrative Law without Congress," 501, 505.

27. Tarullo, Speech at the Association of American Law Schools.

28. Ibid., 7.

29. A corollary regime of state-based crowdfunding has also sprung up (though the state version requires that investors be circumscribed within a particular state or geographic area).

30. Note that this chapter considers the damaging effects of preemption of corporate governance rules. Preemption of state securities regulations of out-of-state offerings, as was necessary in the crowdfunding context, is subject to a different set of institutional incentives in which states do not internalize the effect of their regulations on out-of-state offerings. This costly effect at the state level is similar to that analyzed below in the attorney general context.

31. Crowdfunders were allowed to raise money by offering benefits like advanced purchases or participation in the project, but prohibited from selling actual stock. For more detail on this question, see Verret, "Uber-ized Corporate Law."

32. Mollick, "Dynamics of Crowdfunding."

33. Agrawal, Ajay K., Christian Catalini, and Avi Goldfarb. "Some Simple Economics of Crowdfunding." NBER Working Paper 19133, National Bureau of Economic Research, Cambridge, MA, June 2013.

34. See Berle and Means, *Modern Corporation and Private Property*.
35. For additional discussion about how crowdfunding bears similarity to Uber, see Verret, "Uber-ized Corporate Law."
36. Goodgame, "New Developments," 81, 83.
37. Ibid., 84.
38. Ibid., 98.
39. Ibid.
40. Bainbridge and Henderson, "Boards-R-Us."
41. Goodgame, "Master Limited Partnership Governance," 471, 480.
42. Thompson, "Sword of Spitzer."
43. For an extended argument about how many of Eliot Spitzer's prosecutions under the Martin Act were based on questionable assertions of fact and politically motivated, see Greve, "Federalism's Frontier," 93. See also Greve, "Business, the States," 895.

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July 27, 2017

The Honorable Bill Huizenga
Chairman
Subcommitee on Capital Markets, Securities and Investment
Committee on Financial Services
United States House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Carolyn B. Maloney
Ranking Member
Subcommitee on Capital Markets, Securities and Investment
Committee on Financial Services
United States House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Re: July 18, 2017, hearing entitled "The Cost of Being a Public Company in Light of Sarbanes- Oxley and the Federalization of Corporate Governance"

Dear Chairman Huizenga and Representative Maloney,

On behalf of Institutional Shareholder Services (ISS), I am writing in follow-up to the hearing held last week by the Subcommitee on Capital Markets, Securities and Investment entitled "The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance."

The purpose of this letter is twofold: (1) to reiterate ISS' opposition to the provisions in Subtitle Q of Title IV of the Financial CHOICE Act (which provisions were referred to generally during the hearing as the "Corporate Governance Reform and Transparency Act"); and (2) to provide you with ISS' perspective on, and clarification of, some of the assertions that were made during the hearing about the proxy advisory industry generally and ISS in particular.

We respectfully request that this letter be included in the hearing record.

Corporate Governance Reform and Transparency Act

ISS reiterates its opposition to the Corporation Governance Reform and Transparency Act. If enacted into law, this would establish a costly new regulatory regime for proxy advisory firms, destroy the fiduciary responsibility that proxy advisory firms have to the institutional investors who hire them, and make it more difficult for shareholders to cast informed proxy votes, thereby decreasing the transparency of corporate boardroom decisions.

This new regulatory regime is not needed, and – given the strong public opposition to these provisions from major pension funds and other institutional investors—it is clearly not wanted by those that the provisions are intended to protect.

ISS is currently regulated as an investment adviser under the Investment Advisers Act of 1940 and has been for over 20 years. Under that Act, the Securities and Exchange Commission has promulgated a strong, investor-centric regulatory regime that governs *all* investment advisers, including those whose advice pertains only to proxy votes and other matters of corporate governance. ISS is supportive of clarifying guidance from the SEC and/or an adjustment to the Investment Advisers Act making it clear that all proxy advisory firms must be registered under that Act.

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In short, the requirements in the bill would destroy the ability of proxy advisory firms, such as ISS, to provide timely, independent and impartial research and recommendations to those who have hired them. This and other concerns with the legislation, along with a detailed description of ISS, how we operate and how our clients use our services, are provided in my statement for the record which was submitted to the Financial Services Committee's Subcommittee on Capital Markets and Government Sponsored Enterprises on May 17, 2016.

Assertions at the Hearing

Regarding last week's hearing, we believe it is important to provide you with ISS' perspective on, and clarification of, some of the assertions that were made by some of the witnesses during the hearing.

"Proxy advisory firms generally refuse to engage in a productive or transparent dialogue with smaller issuers." (John Blake, Senior Vice President of Finance, aTyr Pharma, Inc., speaking on behalf of the Biotechnology Innovation Organization)

Robust engagement with corporate issuers is an integral part of ISS' day-to-day operations. Each proxy season, ISS engages with thousands of corporate executives, board members, institutional investors and other constituents via in-person meetings, conference calls and participation in industry events. The purpose of such engagement is for ISS to obtain, or communicate, perspectives about governance and voting issues, in order to ensure that its research and policy-driven recommendations are based on the most comprehensive and accurate information available. Notably, ISS' engagement activities with corporations are not limited to companies that fit any particular size or other formulaic criteria. ISS' engagement process is explained in great detail on our public website.[1]

"Proxy advisory firms rely on one-size-fits-all recommendations that do not take into account a company's or its shareholders' unique circumstances." (John Blake, Senior Vice President of Finance, aTyr Pharma, Inc., speaking on behalf of the Biotechnology Innovation Organization)

All proxy analysis at ISS is undertaken in accordance with a publicly disclosed analytical framework comprised of voting policy guidelines chosen by ISS' clients. ISS offers a wide range of proxy voting policy options. In addition to customized client policies as described below, ISS provides to its clients both a standard benchmark policy focused solely on maximizing shareholder value and mitigating governance risk, and a wide array of specialty policies that evaluate governance issues from the perspective of sustainability, socially responsible investing, public pension funds, labor unions or mission and faith-based investing. Case-by-case analytical frameworks, which take into account company size, financial performance and industry practices, drive the vast majority of ISS' vote recommendations, such as those pertaining to the election of corporate directors and compensation matters.

ISS also makes and implements proxy voting recommendations based on clients' specific customized voting guidelines, and may assist clients in developing such custom guidelines as well. In fact, ISS currently implements over 400 custom voting policies on behalf of close to 400institutional investors.

"Proxy advisory firms should be transparent about how they go about evaluating companies."

We agree. ISS provides a high level of transparency regarding the policy frameworks it uses to evaluate companies. The proxy voting policy options which I've outlined in the previous section are described in explicit detail on our public website, including guideline summaries and FAQs and methodology documents on issues that tend to be more complex.[2]

[1] https://www.issgovernance.com/contact/faqs-engagement-on-proxy-research/

[2] https://www.issgovernance.com/policy-gateway/2017-policy-information/

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Proxy advisory firms should be transparent about how they manage their conflicts of interest.

As a registered investment adviser, ISS is obligated to design, maintain and periodically update a program designed to eliminate, or manage and disclose conflicts of interest. ISS addresses conflicts, first and foremost, by being a transparent, policy-based organization. Its use of a series of published voting policies provides a very practical check and balance that ensures the integrity and independence of ISS' analyses and vote recommendations. While these policies allow analysts to consider company- and market-specific factors in generating vote recommendations, the existence of a published analytical framework, coupled with the fact that vote recommendations are based on publicly-available information, allows ISS clients to continuously monitor the integrity and consistency of ISS advice.

In the hearing, it was suggested that ISS may have an internal conflict of interest in its ownership of ISS Corporate Solutions, Inc. ("ICS"). In fact, we have taken great care to prevent this. ICS provides governance tools and services to clients that may be corporate issuers. ISS and ICS are two independent businesses that function in full transparency to our clients, competitors and regulators. Further, ISS and ICS are separated by a rigorously maintained "firewall" that includes a physical and functional separation, with a particular focus on the separation of ICS from the ISS Global Research team. A key goal of the firewall is to keep the ISS Global Research team from learning the identity of ICS' clients, thereby helping to ensure the objectivity and independence of ISS' research process and vote recommendations.

In parallel with the internal limitations on information about the ICS clients, investors subscribing to ISS' research and recommendations do have access to this information and it is provided to them in a way that is designed to protect and preserve the firewall described above. Specifically, ISS' institutional clients are entitled to receive information about the identity of all ICS clients, the products/services purchased by those clients and the fees paid for those products/services. In support of the key objective of preventing members of ISS' Global Research team from learning the identity of ICS' clients, the information about ICS' clients is made available to ISS' investor clients in a confidential manner through ISS' Compliance department and also through an access-limited section of ProxyExchange, the client-facing platform used by ISS' investor clients.

"It has been estimated that ISS and Glass Lewis effectively "control" 38% of the shareholder vote."

ISS clients control both their voting policies and their vote decisions. ISS is generally not a discretionary proxy voting manager, except in rare situations where a client has an actual conflict of interest (for example, a financial institution that holds and must votes the shares of its parent company), and asks ISS to make a proxy voting decision on the client's behalf,

In fact, ISS is charged by its clients in the vast majority of cases to work with institutional investors to take their fiduciary responsibilities regarding proxy voting very seriously, and they understand their duty to vote proxies in their clients' or beneficiaries' best interests. Many proxy advisers' research and vote recommendations are just one source of information used in arriving at an institutions' voting decisions. Many investors have internal research teams that conduct proprietary research and use proxy advisory research to supplement their own work. Some investors use third-party proxy research as a screening tool to identify non-routine meetings or proposals. A number of institutional investors use the services of two or more proxy advisory services. These views are consistent with the results of a recent survey of asset managers by Tapestry Networks that found proxy advisory firms' "role as data aggregators" has become increasingly important to asset managers, and that even if smaller managers are more reliant on such advisory firms, they still acknowledge that responsibility for voting outcomes lies with investors.[3]

[3] Bew, Robyn and Fields, Richard, Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers (June 2012) at 2. Available at SSRN: http://ssrn.com/abstract=2084231. ("Across the board, participants in our research said they value proxy firms' ability to collect, organize, and present vast amounts of data, and they believe smaller asset managers are more reliant on those services. Nonetheless, participants emphasized that responsibility for voting outcomes lies with investors").

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Moreover, in their paper, *The Power of Proxy Advisors: Myth or Reality?*,[4] University of Pennsylvania Law School Professor Jill Fisch, along with colleagues from New York University, analyzed the effect of proxy adviser recommendations on voting outcomes in uncontested director elections. The authors estimate that, after controlling for underlying company-specific factors that influence voting outcomes, an ISS recommendation appears to shift 6 to 10 percent of shareholder votes, but that this influence may stem from ISS' role as information agent:

> *[W]e find evidence that ISS's power is partially due to the fact that ISS (to a greater extent than other advisors) bases its recommendations on factors that shareholders consider important. This fact and competition among proxy advisors place upper bounds on ISS's power. Institutional Shareholder Services cannot issue recommendations arbitrarily if it wants to retain its market position. Doing so would lead institutional investors to seek the services of other proxy advisory firms. Thus, ISS is not so much a Pied Piper followed blindly by institutional investors as it is an information agent and guide, helping investors to identify voting decisions that are consistent with their existing preferences.*[5]

Thank you for considering our views, and we are happy to answer any questions you may have.

Sincerely,

Institutional Shareholder Services Inc.

Gary Retelny, President and Chief Executive Officer

[4] Choi, Stephen J., Fisch, Jill E. and Kahan, Marcel, The Power of Proxy Advisors: Myth or Reality? 59 Emory L. J. 869 (2010); University of Pennsylvania, Institute for Law & Economics Research Paper No. 10-24. Available at SSRN: http://ssrn.com/abstract=1694535.

[5] *Id.* at 906.