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

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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

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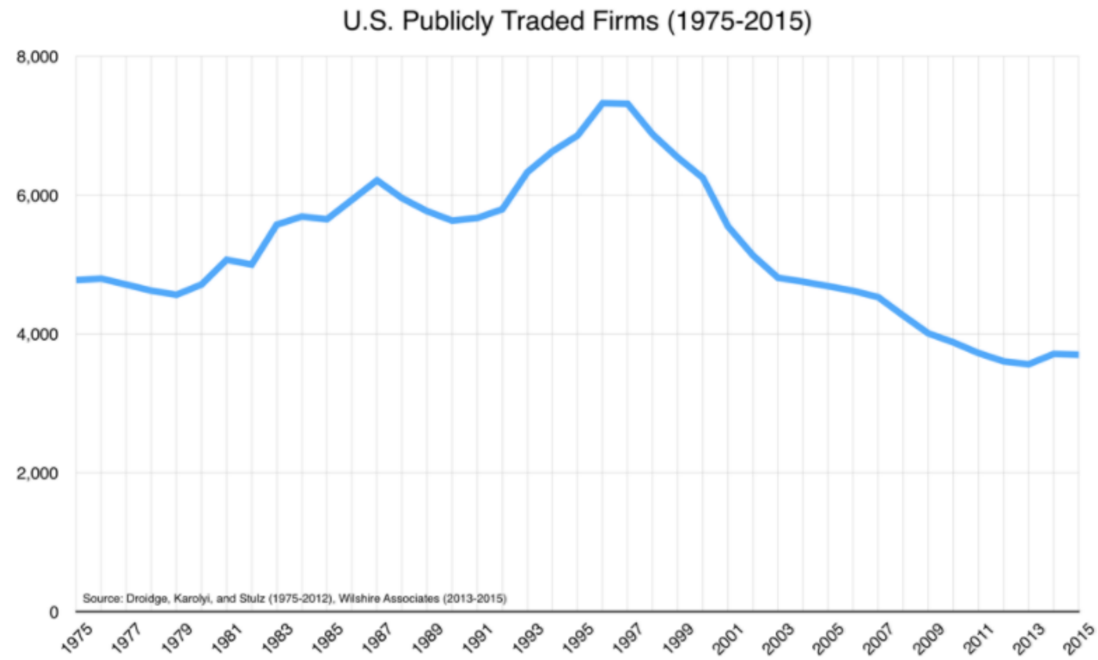
[1] Post-IPO Employment and Revenue Growth for U.S. IPOs June 1996-2010 http://innovation.ucdavis.edu/people/publications/kenney-m.-patton-d.-ritter-j.-2012.-post-ipo-employment-and-revenue-growth

[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.