# Staging and Scaling Regulation: Strategies to Cope with Surprise

By

**James D. Cox**
**School of Law**
**Duke University**

Not since the 1964 expansion of the mandatory disclosure system to over-the-counter traded securities has there been a more significant action enhancing the quality of financial disclosures Congress' enactment of section 404 of the Sarbanes-Oxley Act of 2002. Section 404 not only mandates management's annual assessment of the firm's internal controls, but subsection (b) of the provision requires annual attestation by the firm's independent auditors of management's assessment. Internal controls are not just the first line of defense to financial frauds but more importantly have long been understood to be the bedrock by which the external auditor builds her audit program. Unfortunately, for the quarter century leading up to SOX internal control procedures atrophied in response to auditors pursuing market share and lucrative consulting profits at the expense of higher quality, but pricey, audits. The multiple reforms introduced by SOX addressed the environment that had corrupted the auditors and the financial reporting process. A major innovation in this reform was the requirement for auditors to independently attest to management's assessment of the firm's internal controls.

WORKING PAPER: DO NOT CITE OR CIRCULATE WITHOUT PERMISSION

Section 404(b), however, never applied to firms with a market float of less than $75 million, the so-called non-accelerated filers. The SEC provided repeated postponements to SOX becoming fully applicable to all reporting companies. Just as the last dispensation was about to disappear, the historic Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 permanently removed non-accelerated filers from the reach of section 404(b); the exempted group represent approximately sixty percent of all SEC reporting companies. Moreover, Dodd-Frank mandated that the SEC to consider whether further exclusions are in order[1] and continue to consider whether regulations is adopts disproportionately impact small issuers.

Last summer's exclusion of non-accelerated filers from the internal control attestation requirement is a significant step backwards in the march toward improved disclosure for publicly traded firms. That this occurred within what is seen as one of the most sweeping financial regulatory laws since the New Deal makes the exclusion perversely curious. This paper examines the repeal of section 404(b) for non-accelerated filers in the context of what regulatory strategies may better have prevented the firestorm that accompanied the implementation of section 404(b). Part I reviews the empirical data capturing the multiple benefits of section 404(b), particularly for non-accelerated filers, and also reviews the costs companies incurred to experience those

[1] The resulting study was recently released, advising against further relaxation of section 404(b) for issuers with a market capitalization of $75-250 million. *See* SEC, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers with Public Float Between $75 and $250 million, [current] Fed. Sec. L. Rep. (CCH) ¶ 89,425 (April 22, 2011).

benefits. Part II explains the reasons for the significant compliance costs associated with section 404(b). In light that the SEC (and other regulatory agencies) frequently changes course and introduces a new regulatory paradigm, Part III reviews two such changes, the elimination of off-board trading restrictions and the up-tic rule that for decades regulated short selling, where profound change was introduced to markets but without the level of discontent that accompanied the implementation of section 404(b). In each of these changes the change was preceded by a long-experimental period in which only a few companies were subject to the new rule. Thus, what lessons might be drawn from the earlier staged introductions of regulatory change. Part IV examines another feature of regulatory change, namely that compliance, and particularly initial compliance, with a new regulatory requirement, or simply regulation, impacts more severely smaller firms. We see that regulation inherently has a fairly fixed cost component, i.e., a significant portion of any regulatory burden does not vary with the size of the particular firm's assets or its annual revenues. Thus, Part IV considers whether some regulations can be "scaled" as well as staged. The paper concludes with a call for thoughtful experimentation in both staging and scaling regulatory change.

## I. The Benefits and Burdens of SOX 404(b) for Small Issuers

As a generalization, non-accelerated filers and more broadly yet, small cap companies (most market professionals consider a market capitalization of less than $1 billion to be small), have more limited product lines, possess fewer financial resources, trade in thin markets (frequently on the non-regulated OTCBB market), are followed by few, if any analysts, and enjoy a limited following among institutional investors. It is not surprisingly that the shares for this group of firms are valued inefficiently. One implication of this lack of efficient pricing in the security's of such firms is that the market cannot be expected to price disclosure laxity, even if understood, across firms. This is an inefficiency that breeds opportunity both for investors, but also insiders. Accordingly, and somewhat more positively, returns for small cap firms historically are higher, reflecting their need to yield greater financial rewards to investors to compensate for their greater risk.[2]

WORKING PAPER; DO NOT CITE OR CIRCULATE WITHOUT PERMISSION

It is hard to say that Section 404 was without material social benefits.[3] For example, studies of accounting restatements consistently track significant increases in the number of accounting restatements following partial implementation of Section 404. The restatements peaked in 2006 with 1,564 [888] reporting issuers recording material restatements and have declined each year since that time to reach 630 [374] restatements in 2009.[4] The numbers in

2 *See e.g.,* Fidelity Supplement to Small Cap Stock Fund, Fidelity Mid-Ca; Stock Fund and Fidelity Large Cap Stock Fund, June 29, 2005 (reviewing risks and returns of three major categories of indexed funds).

3 The SEC's Chief Accountant during the early implementation period of the internal controls requirement observed, "I believe that, of all the recent reforms, the internal controls requirements have the greatest potential to improve the reliability of financial reporting. Our capital markets run on faith and trust that the vast majority of companies present reliable and complete financial data for investment and policy decision-making." Donald T. Nicolaisen, Keynote Speech, 11th Annual Midwestern Financial Reporting Symposium (Oct. 7, 2004).

4 Audit Analytics, 2009 Financial Restatements: A Nine Year Comparison 18 (Feb. 2010). See also the study commissioned by the U.S. Treasury, Susan Scholz, The Changing Nature And Consequences Of Public Company Financial Restatements 1997-2006 (April 2008)(reflecting that greatest percentage of restatements are for firms that do not trade on a major stock exchange and that restatements began to accelerate prior to the enactment of Sarbanes-Oxley).

brackets report the number of non-accelerated filers reporting restatements. The data reflects the well-documented phenomenon that the number of restatements is inversely related to market capitalization.[5] Moreover, nearly 70% of firms reporting material weaknesses in their internal controls that had not been remediated within the study period were firms with market capitalizations less than $75 million.[6] Even more disturbing, in the years 2004-2007, the vast percentage of firms receiving a qualified audit opinion on their internal controls were firms with a market capitalization below $75 million and this group also experienced the highest percentage of auditor changes among all reporting companies.[7] Since there seems little basis to contest the notion that greater accuracy in financial reporting leads to improved pricing of the company's securities, reduction in the number of restatements should be viewed positively. Moreover, there is evidence that SOX introduced reporting requirements also reduced "financial slack" in complying firms where post-SOX implementation studies report that mandatory filers cut total CEO compensation (most through reductions in stock-based compensation), increased payouts to shareholders, and reduced investment and employment) relative to what occurred with comparable non-404 filers.[8] Also, post compliance with section 404 mandatory filers experienced longer maturities for their debt than was the experience for non-filers.

While the earlier report that significant numbers of restatements occur with non-accelerated filers may suggest that restatements will be detected even though there is no mandated compliance with section 404, there has long been a good deal of concern that absent formal independent assessment of a firm's internal controls that weak systems will exist and substantial numbers of reporting problems are going undetected.[9] To be sure, not all reports of material weakness in internal controls elicit strong market adjustments; markets more likely adjust, and negatively, for matters that are less auditable, when the accompanying disclosures are vague, and when the reporting company is not audited by as Big 4 auditor.[10] But the benefits of

WORKING PAPER: DO NOT CITE OR CIRCULATE WITHOUT PERMISSION

---

5 *See e.g.,* Glass Lewis & Co., The Tide is Turning, 3 Charts 3 & 9 (Jan. 15, 2008).

6 Glass Lewis & Co., The Tide is Turning, 8 Tbl. 2 (Jan. 15, 2008).

7 *See* Glass Lewis &Co., The Tide is Turning, Tbl. 4 at 9 and Tbl. 13 at 11.

8 *See* Jun Qian, Philip E. Strahan & Julie Zhu, The Economic Benefits of the Sarbanes-Oxley Act? Evidence from a Natural Experiment, Working Paper Dec. 2009.

9 Glass Lewis & Co., The Tide is Turning (Jan. 15, 2008)("If microcap companies disclosed this many material weaknesses on their own – without having to comply with SOX 404 – how many more material weaknesses would be discovered if independent auditing firms were required to conduct internal-control audits at these companies?"); Melissa Klein Aguilar, 404 Disclosure Show Dramatic Improvement 2 (Nov. 27, 2007)(quoting Mr. Robert Benoit, partner at Lord & Benoit an auditing firm which focuses on small issuers, "Almost none of the smaller public companies have done any SOX work."). Available at http://www.complianceweek.com/index.cfm?printable=1&fuseaction=article.viewAritcle&article_ID=3804.

10 *See* Jacqueline S. Hammersley, Linda A. Myers & Catherine Shakespeare, Market Reactions to the Disclosure of Internal Control Weaknesses and he Characteristics of those Weaknesses under Section 302 of the Sarbanes Oxley Act of 2002 (working paper January 2007), available at, http://ssrn.com/abstract=951085. Moreover, the strongest reaction appears to accompany disclosures of internal control weaknesses by smaller firms rather than larger firms. *See* Messod Daniel Beneish, Mary Brooke Billings & Leslie D. Hodder, Internal Control Weaknesses and Information Uncertainty, 83 Accounting Review __ (2008)(material weakness disclosures by non-accelerate filers were accompanied by significant negative price reductions whereas 404 disclosures for larger filers did not suggesting that the latter group operate in as richer information environment than do the non-accelerated filers).

improving the quality and trustworthiness of financial reporting came at a significant cost.[11] These costs were greater in the early years of section 404, reflecting not just the “deferred maintenance” that had to be addressed with the SOX-imposed requirements, but also the poor implementation of section 404 by the regulators and the auditors.[12] There were plenty of problems in the early years of implementing section 404 for accelerated filers. Indeed, it is likely that the now permanent exemption for small issuers, as well as the broader recognition that financial reporting regulation disproportionately impacts small issuers, would not have occurred had there been a less troubled experience in the early years of section 404. In any case, concern for regulation and particularly reporting requirements having a disproportionate impact on smaller companies is well document. For example, median audit fees in 2003 and 2004 that implemented internal control reports were 1.14% of reported revenues for non-accelerated filers but 0.13% for firms with a market capitalization greater than $1 billion.[13] Interestingly, for non-accelerated filers not providing a report on internal controls their fees were 0.35 *less* than their reporting cohort whereas this difference was 0.06 for filers with a market capitalization greater than $1 billion. Thus, it is not surprising that while cost of being a reporting company was identified by 12 percent of the companies as a reason for deregistering that percentage jumped to 62 percent in 2005.[14] Interestingly, less than 20 percent of the companies deregistering were listed on either the NYSE or NASDAQ; the largest percentage traded on the OTCBB (36.9%) or had no formal market (24.8%).[15]

On special concern for reporting in small companies is that among public companies with a market capitalization of $125 million or less, the SEC Office of Economic Analysis reports that insiders own an average of 30 percent of the company’s shares. To the extent one of the goals of financial reporting is to diminish opportunities for opportunistic behavior by managers versus outside owners the smaller firm may well be seen as posing greater risks because of the significant interest held by managers. There has long been concern in small companies that their

WORKING PAPER: DO NOT CITE OR CIRCULATE WITHOUT PERMISSION

[11] *See e.g.,* Charles River Associates, Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates From A Sample of Fortune 1000 Companies (April 2005)(reporting firms average cost to comply with the internal control requirement was $5.9 million). Of interest here is the now much discredited SEC estimate of compliance cost averaging $91,000 per issuer. SEC, Final Rule: Management’s Report on Internal Controls Over Financial Reporting And Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Rel. No. 8238 (Aug. 14, 2003). Internal controls attestation contribute substantially to the audit fees during the first year’s of compliance, but on a declining basis. *See* R. Mithu Dey & Mary W. Sullivan, What Will Non-Accelerated Filers Have to Pay for the Section 404 Internal Control Audit, Working Paper April 16, 2009 (median cost of internal control assessment for previously non-accelerated filers represented 42% of total audit fees in 2006 and declined modestly to 37% in 2007 with the introduction of Auditing Standard No. 5).

[12] For a review of these problems, see Joseph Grundfest & S. Bochner, Fixing 404, 105 Mich. L. Rev. 1643 (2007).

[13] GAO, Sarbanes-Oxley Act, Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies 16, Fig. 1 (GAO-06-361, April 2006). The study reflects ever diminishing median costs as a percentage of revenues as company size increases. *See also Id.* Tbl. 4 (reflecting the same relationship between size of revenues and direct IPO expenses). *See also* Finance Executives International Annual Survey and The 404 Cost Study (Sept. 2009)(U.S. companies with revenues exceeding $5 billion spent 0.06% of revenue on Sarbanes-Oxley compliance while companies with less than $100 million in revenue spent 2.55% (in 2004 these cost represented about 40% of total audit fees and had declined to approximately 32.5% in 2007).

[14] *Id.* at 22. There is, however, a good deal of evidence that SOX was a rationalization for other reasons for companies going dark.

[15] *Id.* at 25, Fig. 3.

large block holders can reap rewards at the expense of outside owners through a variety of strategies. One such strategy is going private. Many have reported that the number of going private transactions increased following the passage of Sarbanes-Oxley. Share prices of firms announcing in their Exchange Act section 13(e) filing that they would be going private increased. This prompted some to reason that the observed increase reflected, at least in part, the cost of being a public firm.[16] Another interpretation is part of the price change is the cost so-called unresolved agency problems between the minority and controlling insiders. The going private transaction in effect reverses the valuation discounts that were caused by unresolved agency problems. [17] There is a small but growing body of evidence that heightened reporting post Sarbanes-Oxley have improved the quality of disclosure and reduced the negative effects of unresolved agency costs. Examples of this work include studies reflecting declines in earnings management[18] and reductions in the firms' costs of capital.[19]

Because of the substantial insider ownership that frequently exists among non-accelerated filers, there are greater challenges confronting activist investors seeking to alter prior practices that are believed to adversely impact shareholder value. This occurs not solely because the insider's holdings pose a serious obstacle to wresting control but also because the smallness of the firm combined with the insiders' holdings likely tend to attract to the board friends and associates of the insiders rather than more independent representatives of the shareholders at large.[20]

There is also evidence that firms not only exited Sarbanes-Oxley by going dark, but that many public firms have pursued strategies to remain non-accelerated filers. That is, firms below the $75 million market capitalization level have remained small by undertaking less investment, increasing their cash payouts to shareholders, reducing the number of shares held by non-affiliates, make more bad news announcements, and report lower earnings than a matched sample (control group) of firms.[21] Interestingly, firms that "crossed" from being a non-

WORKING PAPER: DO NOT CITE OR CIRCULATE WITHOUT PERMISSION

[16] *See* Ellen Engel, Rachel M. Hayes & Xue Wang, The Sarbanes-Oxley Act and Firms' Going Private Decisions, 27 J. Law and Econ. (2006). There are other explanations, namely the increase in the number of private equity firms and the availability of low interest loans for such transactions. Moreover, the pattern observed in the U.S. began before Sarbanes-Oxley was passed and paralleled the trend in Europe. *See* Christian Leuz, Was the Sarbanes-Oxley Act of 2002 Really This Costly? A Discussion of Evidence from Event Returns and Going-Private Decisions, __ J. Accounting Research __ (2007). Professor Leuz makes the point that we need to distinguish going dark from going private transactions such that the former are really more a response to heightened reporting costs, does appear to be related to the passage of Sarbanes-Oxley, and this group of firms were smaller, more distressed, and had weaker performance and governance than firms going private. *Id.* Indeed, the increase in deregistrations post Sarbanes-Oxley was primarily driven by going dark rather than going private transactions.

[17] *See* Christian Leuz, Alexander Triantis & Tracy Wang, Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations, __ J. Accounting and Economics __ (2007).

[18] *See e.g.,* Daniel Cohen, A. Dey & T. Lys, Trends in Earnings Management and Informativeness of Earnings Announcements in the Pre- and Post-Sarbanes Oxley Periods, Working Paper (2006).

[19] *See e.g.,* H. Ashbaugh, D. Collins, W. Kinney & R. Lafond, The Effect of Internal Control Deficiencies on Firm Risk and the Cost of Capital, Working Paper University of Iowa (2006).

[20] *See e.g.,* Stephen Dsavis & Jon Lukomnik, How to Improve Governance at Small Companies, Compliance Week (Aug. 10, 2010), available at http://complianceweek.com/article/6104/how-to-improve-governance-at-small-companies (discussing efforts of two shareholders to introduce change to a company whose yearly compensation was twice the cumulative profits of each of the preceding two years).

[21] *See* Unintended Consequences of Granting Small Firms Exemptions from Securities Regulation: Evidence from the Sarbanes-Oxley Act, 47 J. Accounting Research __ (May 2009).

accelerated filer to a mandatory filer, and firms that remained a non-accelerated filer, each increased their percentage of independent directors after the passage of Sarbanes-Oxley but also decreased the size of their boards. It also appears that firms more likely to pursue strategies to be a non-accelerated filer were more complex with more international operations so that they likely would incur greater internal control auditing costs than firms that crossed to become a mandatory filer.

A further reflection of the risk posed by small companies is the migration of non-accelerated filers away from Big 4 accounting firms to other auditors. This migration picked up pace after SOX and is in part identified as being a reflection of the Big 4 firms' decision to manage their risks by ridding themselves of smaller companies that were believed to pose serious audit risks.[22] This is not to suggest that second- or third-tier auditing firms are less professional, skillful or diligent than their Big 4 counterparts; the migration supports the view that firms discarded by the Big 4 are believed ex ante to pose risks that do not justify from the accounting firm's perspective sufficient rewards to justify continuing the relationship.

As seen, non-accelerated filers operate in an environment that is quite different from that of mandatory filers. Because of their small market capitalizations, they do not attract institutional owners and similarly they are not closely followed by analysts. Thus, they trade in a less informationally rich environment than do mandatory filers. They trade largely in the more unregulated market of the OTCBB and overall there is reason to believe their securities are not priced efficiently. To be sure, such OTCBB traded companies are reporting companies, but those reports do not have the reassurance of the CPA's attestation of internal controls. Moreover, for three years they are immune from the proxy access proposals which make them less attractive to the disciplining forces of activist stockholders. We might wonder whether the proxy access provision will, like section 404 meet a series of delays beyond the three-year introductory period. We have yet to see what other dispensations will be accorded small issuers.

WORKING PAPER: DO NOT CITE OR CIRCULATE WITHOUT PERMISSION

## II. Why So Expensive?

Compliance with SOX 404(b) is expensive, and initially was even more so. The call for SOX 404 was driven by the belief that firms and their accountants had long neglected internal controls. The above-reported figures for compliance costs document these fears, but also is consistent with other contributing causes. Regulatory guidance and requirements had their own hand in substantially driving up the compliance costs. The template for the auditors' assessment of internal controls was Auditing Standard No. 2 issued by the newly minted board of the newly established Public Company Accounting Oversight Board. AS 2's broad commands, unqualified calls for support, and open-ended nature was an invitation for what occurred: overkill in many instances and particularly a failure to focus on material lapses in internal controls. The errors of AS 2 were later corrected by Accounting Standard No. 5, but by then the reputational injury to SOX 404(b) had been done.

[2222] GAO, Sarbanes-Oxley Act, Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies 7 (GAO-06-361 April 2006).

A further contributing feature to the high compliance cost was the dearth of experience at all levels of public accounting to carry out a probing examination of internal controls. In the decades preceding the enactment of SOX, the accounting profession systematically had passed on assessment of internal controls, rightly believing that to do so would increase audit costs and either reduce the auditor's profits or drive the client into the hands of a competitor. Hence, the wisdom: better to retain a client than produce a good audit. Moreover, audit clients, generally working through their audit committees, complemented the auditors slackness by measuring the committee's worth by how low the audit fee was rather than by the quality of the audit. You get what you pay for and they did not pay much, or enough. Thus, in the wake of SOX 404(b) there was not a lot of experience within public accounting in evaluating internal controls. Auditors thus faced a steep learning curve in their compliance with SOX 404(b) and were more than happy to pass their costs on to their captive clients.

A third, and perhaps most significant of all, contributing factor is that across all public companies there was a lot of deferred maintenance on internal controls due to the lack of attention to internal controls prior to 2002. Auditors confronted problematic reporting and operational problems that mandated that additional inquiry and testing be conducted to overcome lacunae and other problems that arose from weak internal controls. Clients were required to reorganize not just their records, but personnel, and to document transactions and processes that had a long history. This required a good deal of client and auditor time. As a result, internal control portion of the audit fee was significant. Playing catch up always is an expensive process.

## III. The SEC's Dabbling with Staging Regulation

WORKING PAPER: DO NOT CITE OR CIRCULATE WITHOUT PERMISSION

For decades, the exclusive domain for trading in stocks listed on the New York Stock Exchange was the NYSE. This was not because of any natural forces; it was because the NYSE's Rule 390 that prohibited off-board trading. This comfortable monopoly, comfortable for the NYSE and its members, less comfortable for others, began to weaken when the SEC in June 1980 adopted Rule 19c-3, permitting securities listed after April 26, 1979, to be traded elsewhere. In this way, the SEC created natural conditions for observing the pricing and general market effects for securities that were traded exclusively on the NYSE and those that were traded in multiple venues, including the NYSE.

More recently, the SEC purposely created a climate for a natural experiment when, in May , 2005, it commenced a Pilot Program whereby one-third of the Russell 3000 Index constituent stocks with high levels of liquidity were exempted from the uptick rule. The uptick rule, former Exchange Act Rule 10a-1, was designed to prevent short sellers from accelerating a declining market by providing that a listed security might be sold short only at either a price above the immediately preceding sale was effected (the plus tick) or at the last price if it was higher than the last different price (zero-plus tick). With very limited exceptions, short sales were prohibited on the minus tick or zero-minus ticks. Collectively these are known as the Uptick Rule.

[insert history of empiricism surrounding each of the above]

## IV. The Benefits of Staging

Both Rule 19c-3 and the Pilot Program preceded radical changes in the operating rules of trading markets. The Uptick Rule had been a feature of American securities regulatory policy since 1938; the bar to off-board trading has an even longer history since exchanges historically embodied this anticompetitive feature. Thus, the SEC, perhaps timidly, but certainly wisely, tested the waters before launching these reform efforts. This not only made good politics, but as reviewed below better informed regulatory policy.

The most obvious benefit of staging is it informs the ultimately embraced regulatory policy. The SEC's actions with both Rule 19c-3 and the Pilot Program created a natural experiment by which the impact of differing regulatory treatments could be empirically tested. Not only did this make the careers of many an academic for whom the currency of the realm is a working paper focused on a real problem, but their work produces valuable input to the regulator, and free of charge. To be sure, the SEC has a very able and relatively well supported group of economists who regularly opine on the costs and benefits of a proposed rule. But, one empirical study rarely can be expected to reflect the full field of possible inputs on a matter. The SEC's budget is limited in the number of studies it can launch, and the internal time constraints for the agency to consider a single issue all weigh in favor of creating an environment for others to carry out the empirical inquiry, invites the assistance of tenure- and chair-bound empiricists.

Staging has another virtue. Each of the securities laws mandate, among other matters, that the SEC "consider" the costs and benefits of a regulation, consider its impact on competition, and, after Dodd-Frank, consider whether it will have an adverse disproportionate impact on small companies. The D.C. Circuit, the venue challenges to SEC rules are reviewed, has in a series of opinions transformed "consider" to mean the regulatory provision's benefits must exceed its costs, will promote competition, and not harm small companies. That is, the D.C. Circuit is not content that the SEC reflect on these questions; the wake of D.C. Circuit opinions rejecting SEC initiatives make clear that administrative reflection alone is not sufficient but rather a convincing record must be compiled supporting regulatory action under each of these litmus tests. While this seems not to be a fair interpretation of "consider" it nonetheless means that in today's climate the SEC faces much greater challenges sustaining its rulemaking than it has in a more supportive D.C. Circuit. Thus, within the D.C. Circuit maelstrom for review of agency rules, the SEC and other regulatory agencies are well advised to get their regressions in order. Heretofore, there were no regressions since rule making was pretty ad hoc and with only good or bad assumptions to support surmises on the question of costs, benefits, competition and disparate impact on small companies. Staging fosters an environment where much more will be at hand before the final regulatory step is taken.

WORKING PAPER: DO NOT CITE OR CIRCULATE WITHOUT PERMISSION

Costs are very different from benefits. Costs are tangible, can be not just observed but measured, and pose few doubts about correlation versus causation. Benefits are quite the opposite, particularly ex ante. Ex parte research on both of these might well be seen as more credible and what is observed ex post is likely to be received as even more credible than what is conjectured ex ante. Discrete staging allows evidence to be gathered as to costs and allows the researcher to gather information as well as to the probable benefits.

## V. Can the Public Interest be Scaled?

Business groups and blue ribbon advisory groups have long advised that regulation shoud be scaled to firm size. Indeed, the earlier report of the Advisory Committee on Smaller Public Companies called for scaling of disclosure regulation. The Advisory Committee's report was short on details except their view of scaling for internal controls was to exempt 97 percent of all public companies from the requirement.

Scaling regulation so as to provide important dispensations to smaller companies immediately confronts serious public interest concerns because studies continue to reflect, as captured above, that there is a higher frequency of financial fraud and more generally reporting weaknesses in smaller companies than larger companies. That is, reporting problems are in a sense reverse scaled.

Another problem with scaling is that the SEC has really only dabbled in the experiment, and episodically. Its last entry into this area was in 2007 when it tweaked some of its disclosure requirements so as to lighten somewhat the demands on smaller issuers. Just where to begin in shedding the detailed requirements of SEC Regulations S-X and S-K that guide general disclosures and financial statements, respectively, is not an easy undertaking to begin?

There is, of course, the threshold question whether the costs small issuers identify with disclosure are largely linked to the issuer's financial statements. That is, the financial statements are the most essential link that a public company has to its owners and potential investors. It is unlikely that compromises on their quality can be justified for a public company. Thus, if the bulk of the costs of being a reporting company are due to the burdens of maintaining the integrity of the particular firm's financial statements, the ultimate area where savings can be achieved are fairly circumscribed and likely small.

WORKING PAPER: DO NOT CITE OR CIRCULATE WITHOUT PERMISSION

Thus, any effort toward scaling regulation likely needs a good deal of information on the precise reporting areas that small companies incur costs if they are a reporting company.  That is, any serious discussion of scaling regulation must isolate the various sources of costs of being a public company. Absent this input, it is not likely to be possible to scale the public interest in fair and complete disclousure.