

CHAIRMAN'S CORNER

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Deregulation? Bad News for Investors

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There is no denying that investors have suffered heavily in this era of deregulation.

Beginning in the 1990's, various administrations have taken steps to diminish the rules and regulations that protected investors. These initiatives ranged from dismembering the Glass Steagall Act, to changing the law to protect corporations from legal action by shareholders, to declawing the SEC by withholding funding and selecting pro-business leadership. The consequence of these calculated efforts has been a rampant increase in fraud and in relentless risk-taking at the expense of shareholder value and corporate stability.

Two positive outcomes of the last decade's disaster were the establishment of the Sarbanes-Oxley Act and the creation of the Public Corporation Accounting Oversight Board. Unfortunately, despite the Madoff scandal, the collapse of Countrywide Financial and AIG, and current insider trading abuses, the investor now faces yet another crisis: both Sarbanes-Oxley and the PCAOB are under attack.

In the second week of November, 2009 the House Financial Services Committee voted to amend the Sarbanes-Oxley Act to permanently exempt companies valued at less than \$75 million market capitalization from the audit portion of the law. Initiatives are underway to increase the exemption threshold to \$250 million. The argument for exempting smaller companies rested on two issues: (1) the costs of compliance and (2) the stifling of companies' access to public markets.

The first argument may hold some water. While the costs of compliance with SOX have dropped dramatically over the last five years, small companies are still disproportionately burdened with additional expense required to meet regulatory standards. However, we must consider not only the cost, but the value of compliance. From a personal standpoint, given the lack of investor protection in today's environment, I think the additional costs are worth the protection.

Of course the counter-argument is that SOX has not prevented corporate fraud. That statement is true, but I dare say that the number of frauds committed might have been substantially higher without SOX, given the rising trend in the years preceding its implementation.

The second argument, that the cost and the complexity of SOX compliance reduce a company's access to capital markets, is of particular interest to me, so I took a look at the 8,000 North American companies that Audit Integrity rates. Of these, 3,125 have a market capitalization of \$75,000,000 or less, and 1,400 have market capitalization of less than \$10,000,000. The vast majority of these companies are very illiquid, trade irregularly, and have little (if any) research coverage. The primary reason for their Initial Public Offering was not to raise additional capital, but to provide liquidity for the owners. Most IPOs in this group failed miserably for both owners and shareholders. The majority of these companies should never have gone public in the first place. If SOX did serve to reduce the number of new issues, I would cheer – but in truth, it's market conditions, not regulations, that allow undeserving companies to go public.

All things considered, I think exempting companies from compliance with SOX is unwise. In the Land of the Blind, a one-eyed man is King, and some control is better than none. Companies that go public have an obligation to be publicly accountable, and to protect the interests of their shareholders. The internal controls required under SOX provide some of that protection.

The challenge to the constitutionality of the PCAOB should be of even greater concern to the investor market. The "Free Enterprise Fund Political Action Committee" has brought suit against the PCAOB based on Unitary Executive Theory. The Free Enterprise Fund PAC "works to elect to Congress those candidates who best represent the principles of the free enterprise agenda." The purpose stated is "Education and issue advocacy regarding the free enterprise system and pro-growth, free-market economic principles (such as lower taxes, smaller government/less government regulations (*sic*), sound fiscal policies, litigation reform, and free trade."¹[1]

Just what the investor needs: "less government regulations" in a time of crisis made possible by prior deregulation and lack of enforcement!

Most alarming is not just the fact that anti-regulatory campaigns continue, but that the Supreme Court is willing to hear the argument. There has not been a split between district courts and appellate courts on this matter. In fact, the only case that rose to the appeals court level was thrown out. This case, brought by the Free Enterprise Fund PAC and a small Nevada accounting firm, claims the law violates separation of powers because the PCAOB Board is appointed by the SEC and cannot be removed by the President. The Court's action could be an indication of what limits they will place on financial regulators going forward.²[2]

While the Supreme Court may be interested in the issue from the point of constitutional law (which I doubt), I sense there are strong political overtones to the case. These overtones may overpower our need for protection from corporate recklessness.

Trust in our financial and regulatory systems is at an all-time low – and deservedly so. Contrary to reasonable expectations following the exposure of abuses by Enron and Worldcom, corporate malfeasance is still widespread. Are we to believe that more deregulation would increase our level of trust? I think not.

Strong regulation and enforcement exist to protect our economy from the kind of serious manipulations that have caused so much damage in the recent past. Only regulation can hold the promise that investors' dollars will be handled responsibly and that the reports they receive will reflect a company's actual financial condition.

A recent study of 50,966 company-year observations published in the *Financial Analysts Journal*³[3] found that analyst coverage plays a more important governance role in countries where investor protection is weak. If the rules are gutted and oversight bodies are hamstrung in favor of complete autonomy by corporate management, investors' only line of defense will be independent researchers such as Audit Integrity.

That would be good for us – but tragic for the U.S. financial system.

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1[1] <http://www.enterprisepac.com>

2[2] "Supreme Court Grants Cert on PCAOB Challenge," www.professorbainbridge.com, May 18, 2009

3[3] "Governance Role of Analyst Coverage and Investor Protection," *Financial Analysts Journal*, November/December 2009

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