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Dodd-Frank isn't the only financial law Trump should change

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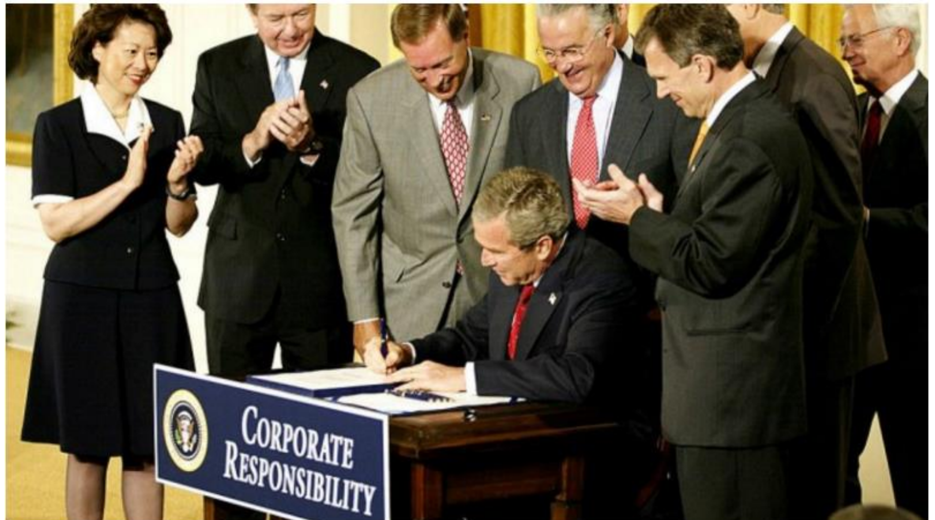

Today, President Trump signed an executive order that would roll back the landmark Dodd-Frank Act passed after the financial crisis, as part of his pledge to scale back regulations he says is holding down banks and businesses in the United States.

Critics have painted deregulation as simply a path to boosting financial sector profits at the expense of excessive risk-taking. Proponents believe that a more measured approach through a reduction of compliance burdens and increased availability of capital into the marketplace, will result in more job creation.

If the true goal of deregulation is to spur economic activity and create jobs, the Trump administration should look further back in history, instead of focusing on recent regulations such as Dodd-Frank. There was another period where regulatory “overcorrection” stifled access to public capital markets and lead to increased costs.

In 2002, long before the most recent financial crisis, Congress was faced with a different kind of crisis. In the wake of several high-profile accounting scandals at large companies such as Enron and Worldcom, Congress began a classic case of “overcorrection,” which ultimately caused the collapse of the world’s largest public accounting firm at the time.

Faced with media coverage of thousands of angry employees and investors with eviscerated retirement funds, Congress passed the Sarbanes-Oxley Act with one of its most burdensome mandates—Section 404—being the least defined. Section 404 requires public firms to have effective systems of internal controls, but only mandates that an outside accounting firm provide an attestation that these controls are effective in preventing fraud.

The subsequent interpretation and enforcement of Section 404 by the accounting oversight agency created by Sarbanes-Oxley resulted in Audit Standard No. 5, which requires an audit of the internal controls over financial reporting. Many believe the jump from Section 404 to this standard is larger than the original intent.

The manner that No. 5 defines “material weakness” to include “a combination of deficiencies” that could result in a “reasonable possibility that a material misstatement…would not have been prevented or detected” has resulted in Sarbanes-Oxley audits under Section 404 that go well-beyond detecting the large-scale corporate fraud and maleficence that gave birth to this law in the first place.

Should the Trump administration curtail Sarbanes-Oxley?

Given that Sarbanes-Oxley can be viewed as regulation preventing “Wall Street” from misleading “Main Street,” it’s reasonable to expect any effort to curtail Sarbanes-Oxley could be met with Dodd-Frank-like partisan fervor. A more nuanced examination reveals otherwise, giving hope of bipartisan reform efforts. A careful analysis of Sarbanes-Oxley “risk versus reward” with proposed reforms is all that’s needed.

Thankfully such an analysis exists and conveniently was created by the prior administration in a 2011 interim report by President Obama’s Council on Jobs and Competitiveness. According to the report, “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.”

In addition, a series of studies on recent U.S. labor data found that the primary driver of job growth over the last three decades has been new firms in their first five years of existence. The data clearly demonstrates high-growth companies are the driver of significant job gains over the long haul.

Eventual access to public capital markets is key for these high-growth businesses to continue their revenue and employment increases. The 2011 report supports this data, citing a number of studies that indicate 90 percent of job creation for public firms occurs after they gain access to public capital markets.

So how has access to public capital markets fared in the post-Sarbanes-Oxley world? The total number of public companies peaked in 1996 at 7,322. Even the post dot-com bubble era saw the total remain high at 5,550 in 2001, prior to Sarbanes-Oxley.

The total number of public companies today stands at 3,700, far fewer than even 1975 numbers, based on publicly available data for the three major U.S. exchanges. While large-dollar initial public offerings (IPOs) for companies such as Facebook dominate headlines, they distract from the real story. The number of IPOs smaller than $50 million, typical of young high-growth companies, accounted for roughly 80 percent in the 1990s. That figure has fallen to less than 20 percent in the 2000s.

Making matters worse, the alternative to accessing public capital markets is often selling to larger companies. As most American workers are painfully aware, such an acquisition often generates pink slips in an attempt to “synergize” the business.

Skeptics may cast doubt on whether Section 404 has been a driver away from public capital markets, but consider this. According to a 2009 study by the Securities and Exchange Commission (SEC), first-year Sarbanes-Oxley 404 audit fees are nearly six times greater as a percentage of assets for smaller companies versus larger companies. The financial and opportunity costs are very much a driver of companies seeking alternatives to the public capital markets.

So what’s the solution? The 2011 report from the Obama administration makes a number of sound proposals to help address this issue, with one proposal aimed directly at the Sarbanes-Oxley. It recommends amending the law to “to allow shareholders of public companies with market valuations below $1 billion to opt out of at least Section 404 compliance, if not to all of the requirements, of Sarbanes-Oxley; or, alternatively, exempt new companies from Sarbanes-Oxley compliance for five years after they go public.”

While originally proposed by Democrats under President Obama, if enacted by the Republicans under President Trump, regulatory reform that is risk-based, rather than the current "one size fits all" approach, would be a bipartisan boon to workers and the U.S. economy.

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