Ownership Society

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Steve Boyko and Merle Coe

President Bush's domestic vision for his second term is to create an "ownership society." On June 17, 2004, the President stated "...if you own something, you have a vital stake in the future of our country. The more ownership there is in America, the more vitality there is in America, and the more people have a vital stake in the future of this country."[1]

Reality is contextual. Like the authors of this article, President Bush is a baby-boomer and is well aware of the large societal incentives for education and home ownership. However, today's young professionals can spend $1 million obtaining an undergraduate degree, an MBA, and a home "Inside the Beltway". This is approximately 10 times the cost baby boomers faced. So what is the affordable venue for today's youth to become societal stakeholders?

Marilyn Kourilsky, Vice President of the Center of Entrepreneurial Leadership stated that "One of the ways for today's youth to achieve a lifestyle better than that of their parents is through entrepreneurship."[2] Ownership stimulates economic, territorial imperative incentives that enable small-to-medium enterprises (SMEs) to achieve their corporate missions.[3]

Robust economies depend on processes that drive their citizens' core competencies and comparative advantages to their highest and best use. This provides the rationale for young people to participate in the ownership of appreciating enterprises. The Small Business Administration (SBA) reports small businessmen create more than half of new jobs in the U.S. and entrepreneurs are a major source of technological innovation.[4] What is truly noteworthy is that these societal achievements were underwritten with a small percentage of the total amount of equity raised in the U.S. capital market.[5]

History is replete with examples of societies that turned inward, away from experimentation and exploration. Without exception, such societies withered and the quality of life declined. To constrain commercial experimenters is to deny who we are and from whence we came. Consider Edison's thousands of experiments to find the right filament. Entrepreneurial experimentation and innovation are basic to our nature—from the simplest life form to the most complex. Thwarting economic Darwinism is done at great peril.

Entrepreneurs are pragmatic solvers of unrecognized societal problems. In a competitive environment, entrepreneurs provide products that consumers have always wanted but never quite knew how to produce and/or acquire. Yet these unique individuals require societal reform if an ownership transformation is to occur. The core components of this reform can best be understood through an analysis of the entrepreneurial genetic code, B^3: "brains", "bucks", and "been-there".[6]

Brains – Entrepreneurs have a unique ability to conceptualize. Entrepreneurship is as much a way of thinking as it is a business concept. A century ago our leaders were men of commerce who were hailed as heroes. Children in middle-class families were weaned on the ruggedly individualistic, self-sufficient, don't-be-afraid-of-failure messages of Thoreau, Emerson, and Whitman.

Today, US students are falling behind in the rigorous mastery of basics. Their capacity to conceptualize what might be and dream new dreams is atrophying. Could a lack of an *epic challenge* be the root of student lethargy?   Consider organisms examined in *Territorial Imperative*. All—including earthworms, wrens, and humans—live on a higher plane (have more energy, emit more body heat, accomplish more) when experiencing the responsibilities and challenges of turf (a nesting area, a farm, an industry transformation). Organisms without territory are more lethargic, less energetic.

When schools do add discussions of risk to the curriculum, it is usually in the form of conventional calculations using probabilities of a predicted future enterprise's worth to provide an expected value. Seldom are students engaged in the higher, more creative *epic challenge* form of risk – confronting the unknown and dealing with uncertainty. Rarely are students challenged to develop a roadmap in uncharted territory. A common trait of outstanding teachers is that they demand much, force students to "go to failure" and, by so doing, provide a path to self-actualization. Educators need to better define their curricula to better position a student's core competencies as they relate to the realities of their global comparative advantages.

Bucks – SMEs around the world face a common problem: obtaining a "sliver of equity" to enable their operations to achieve growth and positive cash flow. This is alarming as SMEs are crucial to economic growth. We argue that the core difficulty SMEs face in their pursuit of equity financing is not investor indisposition to SMEs, but a fundamental need for the Securities Exchange Commission's (SEC) to reform its one-size-fits-all approach when regulating equity securities. We have proposed the formation of an Entrepreneurial Exchange (EntEx) with a governance approach that is specifically tailored for SMEs.[7]

Consistent with this recommendation, the SEC has just announced the establishment of an advisory committee to assist the Commission in examining the impact of the Sarbanes-Oxley Act and other aspects of the federal securities laws on smaller public companies. The SEC will direct the committee to conduct its work with a view of protecting investors, considering whether the costs imposed by the current securities regulatory system for smaller public companies are proportionate to the benefits, identifying methods of minimizing costs and maximizing benefits, and facilitating capital formation by smaller companies.

Been-there – "Been-there" is the institutional knowledge provided to entrepreneurs by Boards of Directors and advisory consultants for addressing industry-specific and governance issues. But two traditional sources of corporate governance, directors and CPAs, have become more expensive and increasingly more difficult to employ.

Unlike the verifiable results from earnings-driven stocks in large-cap markets, the results from event-driven stocks in the micro-cap market can only be falsified when the critical event does not happen. Risks that do not correlate create uncertainty. They are triggered by entirely different loss-producing events that disproportionately increase the cost of directors and officers liability insurance for micro-cap companies. It is estimated that D&O insurance premiums for micro-cap companies cost approximately $30,000 per year, which results in a decrease of qualified directors.

In response to the wave of large-cap corporate crises, the Sarbanes-Oxley Act (SOX) included a provision regarding mandatory audit partner rotation for firms auditing public companies. The Act requires the lead audit partner and audit review partner (or concurring reviewer) to be rotated every five years on all public company audits. As a practical matter, Big Four Accounting firms find it unprofitable to audit public companies that generate less than $150,000 in annual fees. To complicate matters, smaller accounting firms that can profitably engage micro-cap clients for less than the $150,000 threshold lack the diversity of staff to address the mandatory audit partner rotation provision. This results in a "null-set" compliance dilemma for micro-cap companies. SOX has given rise to unintended consequences and produced what large corporations have long sought—a barrier to entry and a consolidation of market share into a few entities.

To re-invigorate competitive forces, the SEC must evolve its regulatory scope beyond "risk" issues (i.e., probabilistic top-tier NASDAQ and NYSE securities) to develop a regulatory regime for those issues that are uncertain. The dictionary defines "risk" as the chance of loss. Risk is probabilistic and thus presents foreseeable consequences, whereas "uncertainty" is indeterminate and characterized by unforeseeable consequences. These terms should be carefully defined to ensure that the cost of compliance is calculated accurately in determining whether capital market regulation provides a societal net benefit.[8]

Troubling Trends

Although SMEs generate significant innovation and job growth, their ability to access the capital market for needed "slivers of equity" is becoming less efficient as measured in terms of cost, time, and effort; and shows signs of becoming ineffective as fewer issuers migrate from the micro-cap market to the large-cap market and more firms are going private.

The robust growth of SME-driven commerce and related private equity markets that occurred at the end of the Twentieth Century has witnessed a reversal. Between 1995 and 2000, venture capital funding expanded from $6.3 billion to $90 billion, while angel investments rose to about $40 billion annually.[9] However, the level of private equity market financing proved unsustainable when the dot-com bubble burst. Venture capital and angel investing retrenched to an annual funding level of $30-35 billion. A critical funding gap emerged, making it difficult to capitalize startup and early-stage companies requiring $2-to-$5 million.[10] The funding gap is further compounded by an information gap that finds many promising innovations overlooked.[11]

Regulatory proposals designed for top-tier market, risk-management regimes are disproportionate when applied to the micro-cap market. This top-tier perspective was recently illustrated by Paul Volcker and Arthur Levitt, who defended the added cost of Sarbanes-Oxley by stating that “$5 million down and $1.5 million a year is not too much to pay for a multibillion-dollar international company compared to how much investors have lost.”[12] But what about the SMEs that cannot afford such added costs? Do we continue to treat SMEs as if they were large corporations? This is very much a case of mixing apples and oranges.

Consider the fate of the Ziegler Companies, Inc., a 100-year-old company that became one of the highest profile casualties of the economic effects of Sarbanes-Oxley on small companies, as it applied to voluntarily de-list from the American Stock Exchange. And it was not that the company was not doing well. It reported third quarter revenues of $19.9 million, compared to $17.3 million in 2002.

Wharton Professors Brian J. Bushee and Christian Leuz examined the economic consequences of SEC disclosure requirements using a recent regulatory change on the OTC Bulletin Board. They documented that SEC disclosure requirements imposed significant costs on smaller firms that forced many SMEs from the OTCBB.[13] In a follow-up study, Luez noted that some smaller businesses have decided to go private rather than spend the money to comply with the rules. The study found that the number of companies that delisted their common shares from stock exchanges nearly tripled in 2003, in part to avoid some of the regulations required by Sarbanes-Oxley.[14] De-listings can lead to decreased transparency for shareholders of such companies—the reverse of what the regulation was meant to accomplish.

Conclusion

How to reverse these “troubling trends” that militate against the “ownership society”? Unleash entrepreneurs. Encourage those who strive by being more tolerant of errors of commission rather than accepting errors of omission. Aristotle wrote, "What belongs in common to the most people is accorded the least care: they take thought for their own things above all, and less about things common, or only so much as falls to each individually.” Entrepreneurial ownership of capital assets has many benefits for society. People who have a greater stake in their community tend to become better citizens.

Conversely, over-controlling business activity in an attempt to ensure systemic predictability constrains commercial experimentations and unforeseen mutations that lead to innovation. As the Soviet Union learned, consumer wants increase exponentially; whereas centralized commands are a linear function. To realize President Bush’s vision of an “ownership society”, the *Information Age* challenge for policy makers is to change their governance emphasis from “no” to “know”.

The “know” governance regime of the capital market employs metrics similar to those by which investors allocate their funds. Like Gaul, we advocate the division of the capital market into three separate regulatory regimes:

1. Government securities that are bought for savings accounts;
2. Top-tier issues that are bought for investment portfolios; and
3. Micro-cap SME stocks that are sold to speculators.

We propose a new approach specifically tailored for SMEs that shifts the regulatory emphasis from investor financial *capacity* to investor financial *capability*. This regulatory approach would require advisors and investor to demonstrate that they have sufficient sophistication to allow them to analyze and value young entrepreneurial firms without a history of cash flows. Entrepreneurial firms are characterized by constant transformation. A regulatory model focused on advisor and investor capabilities can adapt to change as these developments occur.[15] Knowledge ensures a solid foundation from which to build a robust "ownership society".

Stephen A. Boyko is president of Global Market Thoughtware, Inc., an international consulting company that specializes in economic governance issues. Merle Coe, CEO of Cash & Carry America, is an entrepreneur specializing in technological transformations of the food industry.

Endnotes

[1] http://www.whitehouse.gov/news/releases/2004/08/20040809-9.html

[2] Marilyn Kourilsky, http://www.entre-arc/intro.htm.

[3] Ibid.

[4] Small-to-medium enterprises (SMEs) consist of small businesses and entrepreneurial enterprises, reference the article "Exploring Entrepreneurship" for a delineation of commercial governance structures. http://appserv.pace.edu/execute/page.cfm?doc_id=13771

[5] The objective is to increase the "net amount" of working capital available to fund SME operations. This requires increasing investment and decreasing costs. To this point, regulation is an operational tax. Disproportionate regulation, such as Sarbanes-Oxley section 404 relating to internal controls and accounting treatment that expenses management-incentive options, which may be suitable for large-cap issuers but not SMEs, are regressive operational taxes.

[6] Boyko and Gottesman, Understanding Entrepreneurs (March 31, 2004)

http://inthenationalinterest.com/Articles/Vol3Issue13/Vol3Issue13Boyko.html

[7] Boyko and Gottesman, Small is Beautiful", The National Interest, No. 77 – Fall 2004.

http://www.findarticles.com/p/articles/mi_m2751/is_77/ai_n6353167/print

[8] The last twenty-five years of the Twentieth Century witnessed dramatic changes in the capital market as it evolved from a niche to a mass market and from a domestic to a global market. Efficient utilization of regulatory resources requires a modification of the Commission's centralized command and control organizational structure. Robust markets create an exponential demand for products in comparison to the Commission's linear ability to supply regulatory resources This creates a Hobson's choice for the SEC either to constrain market dynamics (errors of omission) or fall behind the compliance curve (errors of commission). To reconcile this dilemma, the capital market governance should be organized into three separate regulatory regimes along functional lines based on the predictability of cash flow and related variability from price equilibrium. Government and municipal securities whose securities are valued as a function of their tax authority trade in virtual-equilibrium conditions and are regulated under separate regulatory regimes. Mature NYSE and NASDAQ issuers with probabilistic cash flows are "risky" issues that trade in near-equilibrium conditions. These securities should be afforded separate regulatory treatment from "uncertain" issues that trade in far-from-equilibrium conditions. This segments the capital market in a manner that is similar to ways that investors organize their funds in savings, investment, and speculative accounts. http://sec.gov/rules/policy/s72204/saboyko060904.pdf

[9] Jeffrey Sohl, http://www.bowne.com/newsletters/newsletter.asp?storyID=740.

[10] Jeffrey Sohl, The private equity market: lessons learned from volatility, http://www.angelcapitalassociation.org/downloads/resources/Research_LessonsVolatility.pdf.

[11] Leone, Marie, "Sell Side analysts dropping small caps", CFO.com, July 8, 2004.

[12] June 14, 2002 *Wall Street Journal*, page A16.

[13] Brian J. Bushee and Christian Leuz, "Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board" September 2002.

[14] Christian Leuz, Wharton Newsletter, http://www.philly.com/mld/inquirer/business/10410106.htm?1c

[15] Reference the following articles for further discussion of the knowledge paradigm shift for capital market governance.

[16] Can Real Regulatory Reform Lead to Job Growth? (February 11, 2004) http://www.inthenationalinterest.com/Articles/Vol3Issue6/Vol3Issue6Boyko.html

[17] Entrepreneurial Exchange (October 2003) http://www.buyside.com/archives/2003/0310/html/0310gst.asp

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