Are Regulatory Costs Impeding Innovation?
Keynote Address by Cynthia A. Glassman
Under Secretary for Economic Affairs
U.S. Department of Commerce

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I am delighted to be here today to talk about the intersection of two topics that are of considerable interest to me – regulatory costs and innovation. And, since I am particularly interested in hearing the views of my fellow panelists, I will be brief in setting the stage for our discussion.

I expect you are all aware that I was an SEC Commissioner from 2002 until last July. I was there when Sarbanes-Oxley was enacted, and I was there when the SEC drafted, solicited comments on and approved the implementing regulations.

I suspect you are less aware of what I am currently doing and what that has to do with innovation. So let me start there and tell you something about that.

Last October, I was sworn in as Under Secretary for Economic Affairs at the U. S. Department of Commerce. In that capacity I oversee the work of the Census Bureau and the Bureau of Economic Analysis, and I serve as principal economic advisor to Secretary Gutierrez.

The part of the job I want to talk about today is my involvement with the Secretary's Innovation Measurement Advisory Committee. The Committee's formal name is the "Measuring Innovation in the 21st Century Economy Advisory Committee" but I expect you will understand when I do not give the whole title each time. It does not even have a catchy acronym. What it does have is a mandate to figure out how we should be measuring innovation and a very impressive and enthusiastic group of members who have taken on the assignment.

The Advisory Committee was established in September 2006. The Committee charter provides that the Committee shall "advise the Secretary on new or improved metrics on innovation in the economy."

It also required that it consist of 15 members selected from business and academia who are either "acknowledged experts in their academic fields or knowledgeable about their industry sector."

We sought members through a variety of means including publication of a Federal Register notice inviting applications. We were delighted with the response. The 15-member panel, chaired by Carl Schramm, Chief Executive Officer of the Kauffmann Foundation, consists of CEOs of a number of companies you may recognize – including Microsoft, IBM, and UPS – among others. And we also have five outstanding academics. I will not name every one of the members but I have a few copies of list of the members available. You can find that and other information on the Committee's website at www.innovationmetrics.gov.

The first meeting of the Advisory Committee was held in February, and the group has established a tight schedule that calls for them to present their recommendations to Secretary Gutierrez this fall.

The recommendations will cover four major categories identified by the members at the original meeting. These categories are: (1) Improvement of the underlying architecture of the U. S. System of National Accounts to facilitate development of improved and more granular measures of innovation and productivity; (2) Identification of appropriate economy-wide and sector-specific statistical series or other indicators that could be used to quantify innovation and/or its impacts; (3) Identification of firm-specific data items that could enable comparisons and aggregation; and, lastly, (4) Identification of specific "holes" in the current data collection system that limit our ability to measure innovation.

On behalf of the Advisory Committee, we have published a Federal Register notice requesting comments and advice on innovation measurement in each of the categories I just mentioned. Comments are due tomorrow but we will try to consider proposals received after the published due date. So, if you have any good ideas, please check the notice on the website and submit your thoughts to us.

I want to emphasize that the work of the Advisory Committee is measurement of innovation. We want to figure out how to measure innovation better. Therefore, the Committee is NOT focusing on issues such as innovation drivers or impediments to innovation.

Now let's get back to the intersection of regulation and innovation and why we are here today. While not topics for the Advisory Committee, the issues of drivers of and impediments to innovation came up in my discussions with members of the Committee. I have been fortunate to have individually spoken to or met with all of the Committee members as well as with a number of other stakeholders in the measurement of innovation. While most of the focus of our discussions has been on their own innovation activities and measurements, a number of the conversations also turned what motivated and what impeded innovation. What we heard a number of times is that key drivers of

innovation are: first, the “tone at the top” -- that is, the culture; second, encouragement of risk taking; and third, acceptance of failure.

Also, several industry-specific regulatory impediments were mentioned, but there were two crosscutting impediments. Immigration caps are sorely felt by the companies, especially those in need of highly skilled workers. Another concern, and the one I want to turn to now, is the impact of Section 404 of Sarbanes-Oxley, the section that deals with internal controls.

During my term as SEC Commissioner, I had numerous discussions with various stakeholders about the impact of 404 implementation and had raised my own concerns about its mis-focus. I was – and remain – concerned that what was meant to be a top-down, risk based management exercise had become a bottom-up, check-the-box auditor exercise.

While strong internal controls over financial reporting are necessary, in my view, it should be the role of management, not the auditors, to determine from a risk perspective which controls are the most important to ensuring accurate financials. The original PCAOB AS2 approach seemed to take away that judgment from management, resulting in significant costs that did not seem to add much value to the overall process, and that did not meet the spirit of SOX – which was to put this responsibility in the hands of management. After all, they were the ones that had to certify the financials and include in the annual report an assessment of the company’s internal control over financial reporting.

During my earlier conversations, I had heard about various unintended consequences of the implementation of 404. One was that Boards and management spent so much time on compliance issues that they could not focus sufficiently on strategic business issues. Another was that 404 made companies more risk averse, not just in maintaining good controls – which is what we wanted – but also in running their business – which is not necessarily what we wanted.

It is only recently, however, in my discussions about innovation, that I have begun to understand the real concerns of those who say that Section 404 – at least as implemented – is a significant barrier to innovation and that it has reduced the willingness of companies to take risk. Let me briefly outline what I understand to be the major specific concerns and then we will move into the panel discussion.

- Risk aversion. Innovation requires risk taking, but SOX has created a risk-averse culture. There is a fear that if an innovation does not pan out as expected, it will be seen as a material weakness in an internal control.

- Regulatory burden. To the extent that the regulatory burden adds to the time it takes to implement an innovation and get it to market, the level of return and certainty of return are reduced. As a result, some innovations will no longer be worth doing.

- Timing. My understanding of the issue here is that the rigidity of the timing of the auditors' reviews inhibits any new initiative that cannot be completely tested before the internal controls audit. This affects not just innovations, but also system upgrades, mergers and acquisitions, and other major changes.

- Management and Board distraction. As I mentioned, I hear that Boards and management continue to spend more time on compliance and less on business strategy. And, as I mentioned, it appears that some, if not most, of the 404 compliance efforts are spent on activities that do not add much, if any, value. There is an opportunity cost here, and the lost opportunities include innovative products, services, and processes

- Cost. In addition to the opportunity cost, there are monetary costs. While many critics of 404 implementation focus on the impact on small business, we should not lose sight of the fact that there is a cost to all businesses. What I have heard from larger companies is disturbing. Statements like "It's another cost of doing business" or "We can absorb $X million dollars" where X is 5, 10, 20 million dollars or more, should not be acceptable, when they are accompanied by views that the benefits are not commensurate. This means less money for innovation, for price reductions, and for higher returns to shareholders. In economists' jargon, this is dead weight loss.

You have probably recognized – as I have gone through this litany of problems – that the managerial climate that they engender is the direct opposite of the climate that drives innovation. As I mentioned earlier, the themes we observed when talking to our innovation committee CEOs and others were: first, the "tone at the top;" second, encouragement of risk taking; and third, acceptance of failure. The complaints about SOX 404 are – simply put – that CEOs are distracted, risk taking is chilled, and failure is not acceptable.

I realize that the SEC and PCAOB are working to improve the implementation of 404, and think they are moving in the right direction with their proposed management guidance and AS5 respectively.

But I would like to hear the panelists' thoughts on these issues – and I hope the panel will not only react to the problems I have identified, but also think about ways we can achieve balanced regulation that meets its objectives while encouraging, rather than discouraging, innovation. In particular-

- I would like to hear the panelists' perspectives on the impact of 404 as it has been implemented to date and whether the proposed changes will make a difference, specifically addressing the concerns I have raised.

- If it is correct that Section 404 of SOX has contributed to a slowdown of the U. S. IPO market, would fixing 404 alone solve the problem or are there other economic or business factors contributing to a slowdown?

- From your experience in observing private companies go public or be acquired by public companies and thereby coming under the 404 requirements, to what extent has the process reduced the risk of materially inaccurate financial reports that could result from an internal control failure? In other words, are the 404 requirements different from what management was doing (presumably yes) – and if so – did they provide a better result – or just a more costly one?

- And, as Secretary Gutierrez's economic advisor, I would like to know what thoughts I should bring back to him about how these matters will affect the broader economy – in the near and longer term.

We have a lot to cover, in a short time, so now I will turn to Peter to begin the panel discussion.

Thank you.