Sarbanes-Oxley:
Section 404 and the Death of
the Small Public Company

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Abstract

With the approaching implementation of § 404 of the Sarbanes-Oxley Act, there is widespread criticism of the enormous costs of complying with the section. Although § 404 arguably improves investor confidence by making the financial condition of a company more transparent, businesses argue that the costs are simply too high. The question remains as to whether high costs are a good enough reason to expose investors to the type of fraud Sarbanes-Oxley protects, or whether there are public policy reasons to ease the burdens.

This note examines the effects of § 404 on small businesses, and argues that public policy not only permits the SEC to ease the burden for small firms, but demands it. The high compliance costs implicate public policy by effectively pricing small businesses out of the public capital markets. Recent discoveries about the importance of small business to the economy reveal that this has the serious potential to send industry and the economy as a whole into ruin.

Moreover, the effects of § 404 on investor confidence are uncertain at best, with reason to believe that the financial transparency it creates does as much harm to investors as it does good. This is especially true for small businesses, which do not have as much of an impact on investor confidence as the Enrons and Worldcoms. As a result, it is imperative that the SEC remove some or all of § 404's burdens on small businesses.

Biographical Information

I received a B.A. in Economics from the University of California, Berkeley in 2003, and will receive a JD from the University of Florida in 2007. I am an Articles Editor for the University of Florida Journal of Law and Public Policy for the 2006-2007 school year. I have twelve years of experience in a securities law firm as a legal assistant and legal intern, and intend to practice in securities law.

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I. Introduction

When Congress enacted the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") [1] over the Enron debacle, debates raged over the impact the new, stringent rules would have on public companies.[2] These debates have been reinvigorated almost four years later as the most costly and controversial section of the Act, § 404, is implemented.[3] While on the surface this fight may seem like Corporate America's attempt to protect its profits, in reality it is more than that: it is a fight for the survival of the small public company, for the economy's elusive resurgence, and essentially even for the American dream.

As a response to the financial reporting scandals of Enron and others, Sarbanes-Oxley is a gallant attempt to protect the public at large from big bad business. Ironically, though, big business has taken the new requirements in stride while many small firms are facing a mortal wound. The debate now is to what extent small public companies should be made to pay the same costs as big ones.

On the one hand, financial reporting fraud is a real problem, and some kind of response was necessary. Enron proved that. Further, a search beneath the big-business publicity of Enron and Worldcom reveals that financial reporting fraud is not limited to handful of bad apples; it impacts the entire market, regardless of firm size.[4] In fact, smaller firms are more likely than larger ones to commit other types of fraud, such as pump-and-dump and Ponzi schemes.[5]

On the other hand, implementing Sarbanes-Oxley as is would cost so much to small businesses that it has the serious potential to eliminate their access to the capital markets.[6] Without access to the public finance market, small businesses cannot grow, and the economy will lose the advantages in technology and efficiency that it has enjoyed for most of the past century. Perhaps more importantly, overburdening small companies could carry significant social and political consequences, as the American public has always considered the promotion of small business important to American capitalism and democracy.

This debate raises several, seemingly disparate public policy issues. Should investors be exposed to fraud just to protect a quaint American ideal? Are there compelling public policy reasons to promote small public companies? Does the Act actually further any fundamental concerns of the public? This note examines the government policies affected by Sarbanes-Oxley, and analyzes whether it furthers or detracts from the fundamental concerns of society at large. Part II briefly explains the major provisions of the Act and their intended purpose. Part III examines the public policy concerns affected by the Act. Part IV presents the evidence to date on how the Act has affected these concerns, and how it will affect them in the future. Part V weighs the competing interests, and concludes that burdens of Sarbanes-Oxley must be reduced for small firms. The final parts address the possible solutions and the prospects for change.

II. Overview of Sarbanes-Oxley

Congress enacted Sarbanes-Oxley as a direct response to the financial reporting frauds of Enron, Worldcom, and others.[7] It gave the Securities and Exchange Commission ("SEC") a mandate to adopt a broad array of rules, ostensibly to prevent this type of fraud from occurring in the future. Following this mandate, the SEC has adopted rules enhancing financial disclosure, improving the independence of auditors, and requiring directors to certify financial reports. Further, the Act itself enhanced the criminal and civil liability of directors, created a new administrative agency to govern auditors, and gave the SEC increased enforcement powers. While the primary focus of the current Sarbanes-Oxley debate is on §

404, each of the other provisions of the Act has a substantial effect on the policy issues that § 404 implicates.

As a preliminary matter, it is important to point out that Sarbanes-Oxley makes no relevant distinction between large and small companies.[8] The Act applies to any issuer[9] required to make periodic reports to the SEC.[10] As a result, if a small business wants to go public it will have to comply with the stringent requirements of Sarbanes-Oxley.

A. Section 404

The primary focus of Sarbanes-Oxley critics, and of this note, is on the § 404 requirements regarding internal controls over financial reporting.[11] In particular, § 404 requires that management include in its annual report to the SEC (Form 10-k or Form 10-KSB) an assessment of the effectiveness of these controls.[12] The section also requires the company's external auditor to attest to, and report on, management's assessment.[13] In its implementation of this section, the SEC also required disclosure of any material weaknesses in the internal controls, a requirement not mandated by § 404.[14]

The ultimate goal of this section is to ensure the accuracy of financial reports, and thus improve investor confidence.[15] There had been some concern among regulators that a "'corner-cutting' culture" had developed among public companies in an effort to reduce costs, which resulted in internal controls unable to adequately prevent financial reporting fraud.[16] The hope is that the new controls requirements will cast a broad enough net to catch most fraudulent activity, and thus make investments less risky.[17] Logically, investors would be more willing to invest in a safer venture.[18]

Largely ignored at first,[19] § 404 is now the source of Sarbanes-Oxley's most staunch criticism.[20] The primary concern is the enormous costs, which are mostly attributable to fees associated with the auditor assessment and attestation requirements. As a result of the new rules affecting auditors, the accounting industry has responded to its § 404 duties with what some commenters believe is undue vigor.[21] Part III of this note will discuss the effects of § 404 more fully.

B. CEO and CFO Certifications

Section 404 is not the only provision causing substantial public dissent. The provisions initially thought to be the most controversial were § 302 and 906, which require a company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), or persons serving similar functions, to certify as to the accuracy of the company's financial reports.[22] Before, CEOs and CFOs at least publicly claimed that it was rare for them to review periodic reports; they would be prepared by the company's lawyers and accountants, and the managers would simply sign off on them.[23] The result was that it was harder to pin criminal liability on the individual managers.[24] In recent trials of pre-Sarbanes-Oxley frauds, some executives have escaped liability by characterizing themselves as oblivious to the contents of financial statements.[25] Sarbanes-Oxley has taken that argument away.

Now, § 302 and 906 make the CEO and CFO sign a sworn statement that they have reviewed the reports, and that they fairly present the financial condition of the company.[26] This makes it much easier to pin Rule 10b-5 liability, the SEC primary weapon against fraud, on these managers. Before *Enron*, individuals generally were "primary" violators of 10b-5 only if a material misstatement or omission was directly attributed to that person at the time of dissemination.[27] In effect, the certifications force them to make a public statement, specifically attributed to them, stating that the financial reports are accurate. This makes them primary violators for any fraud in the reports, liable under rule 10b-5.[28] In addition, the Act added a new crime, making it criminal just to violate the requirements of § 906.[29] This allows the Justice Department to prosecute without worrying about those pesky 10b-5 requirements.

The debate over the Act's certification requirements raises issues that deserve a fuller treatment than this note can provide. To what extent should CEOs and CFOs be made accountable for fraudulent reporting by their company? Should they have to pay for the actions of a rogue employee if they had no practical way of preventing them? Also, too much time spent on fraud prevention would take away from their primary duty: managing a profitable corporation for the benefit of its shareholders.[30] It will suffice for this note to say that certification has had a profound effect on the accountability of managing officers.

C. Criminal and Civil Penalties

In addition to casting a wider net to catch defrauding managers, Sarbanes-Oxley also enhanced how much that net could sting: The Act aggressively enhanced both criminal and civil penalties, and handed the SEC more powerful enforcement tools. The maximum penalty for criminal securities fraud is now twenty years, up from ten.[31] Maximum fines were increased from $1,000,000 to $5,000,000 for natural persons, and from $2,500,000 to $25,000,000 for corporations.[32] The maximum penalties for mail and wire fraud were also increased,[33] as were those for violations of the Employment Retirement Income Security Act ("ERISA").[34] The Act also added entirely new crimes. One is the certification failure provision discussed above.[35] Others include alteration or destruction of documents,[36] destruction of corporate audit records,[37] and attempt or conspiracy to commit mail fraud.[38]

Although the Act did not directly increase civil liability in this way, it does help investors actually get the damages due to them. First, civil damage awards for securities violations now survive bankruptcy.[39] Second, under the Fair Funds provision, any civil penalties the SEC receives for a violation can be given to victims of that violation.[40]

Complementing the changes in accountability are two sections giving additional authority to the SEC. One grants the Commission the authority to temporarily freeze "extraordinary payments" made during an investigation.[41] The other allows the SEC to prohibit any person who violates securities antifraud provisions from serving as the director of any public company.[42]

D. Accounting Changes

One significant part of Sarbanes-Oxley is its impact on the accounting profession, and more specifically the relationship between public companies and its independent auditor. Much of the blame for Enron was placed on Arthur Anderson, Enron's auditor, for being either unwilling or unable to keep Enron's management within the bounds of the law.[43] Most commenters believe that accounting firms simply had no leverage over their big business clients; if they insisted on proper internal controls to ensure accurate financial reporting, their clients would simply look elsewhere for auditing services.[44]

The Act takes several steps to combat this problem. First, it established the Public Company Accounting Oversight Board (the "PCAOB"), whose task is essentially to audit the auditors.[45] Second, it enhanced the independence of a public company's audit committee. The committee must now be composed solely of outside directors, and has sole authority with regards to the auditor and the audit.[46] Third, it enhanced the independence of the auditors themselves. To complete any public company audit, an auditor must register with the PCAOB,[47] cannot perform any other function for the issuer,[48] and must rotate the person heading the audit.[49] While these changes have shifted the balance of power over financial reporting to the accountants, allowing them to be better "gatekeepers,"[50] the vigor with which the profession has responded has had a significant effect on costs of Sarbanes-Oxley compliance.[51]

E. Other Provisions

Section 404 was not the only change to disclosure requirements. Other changes include disclosure of off-balance sheet transactions,[52] disclosure of whether the CFO is subject to a code of ethics,[53] disclosure of changes to any such code of ethics,[54] and disclosure of whether there is a financial expert on the audit committee.[55] Each of these disclosure items was a response to what Congress believed to be widespread weaknesses in corporate governance.[56] In addition, the SEC now requires financial projections to follow certain accounting standards,[57] and has accelerated the reporting requirement for any change in stock ownership by an insider.[58]

Other provisions only affect business indirectly. For example, the SEC implemented Part 205, dealing with an attorney's ethical duties, to comply with § 307 of the Act.[59] The Act also instituted new protections for whistleblowers and informants.[60] Along with the changes to the accounting industry,[61] these elements address the notion that the so-called "gatekeepers" of public companies, their employees, accountants and attorneys, were either unwilling or unable to keep management in check.[62]

Congress has attacked financial reporting fraud with a broad edged sword in response to a handful of highly publicized scandals. Did they overdo it? Part III examines the fundamental public policy considerations affected by this attack. The final Parts examine the effect that it has had, and will have, on those concerns.

III. Public Policy Considerations

Does Sarbanes-Oxley further or detract from public policy? The short answer is both; it arguably protects investors from fraud,[63] but makes it cost-prohibitive for most small businesses to enter the public market for financing.[64] The long answer requires an analysis of the fundamental concerns of society affected by the Act, and then an examination of how greatly the Act affects them. This part discusses the competing public policy concerns of investors and small business, why they are important, and how fundamental they are to society. Part IV examines the extent the Act furthers the concerns of investors, and detracts from the concerns of small business.

A. Investor Protection

In general, the purpose of Sarbanes-Oxley is the same as that of the ’33 Act and the ’34 Act: to protect investors by ensuring that their investments do not succumb to fraud.[65] Regulation serves two vital protective functions, one socio-political and the other economic. The primary concern is the normative, social idea that fraud is simply wrong.[66]

This ethical consideration has been the primary driving force of regulation since its inception. Securities regulation originated to protect the gullible American public from traveling swindlers, who offered “speculative schemes which have no more basis than so many feet of ‘blue sky.’”[67] Today this ethical ideal is still prevalent.[68] Even in an age wherein economics affects decisions far more often than ethics, there is still a sense that investors must be protected from fraud simply because society believes it is wrong to defraud investors.

It would be a farce, however, to say that the only benefit of regulation is to society’s sense of right and wrong. Regulation is also vital to the economy. With such a tenacious watchdog as the SEC and its regulatory authority, investors can be more confident that the securities they purchase are, if not sound investments, at least not shams. If investors know the securities they purchase are less likely to involve fraud, they will value their investments more, and thus will invest more.[69] This, in turn, stimulates the economy as a whole and benefits everyone. In an unregulated, *caveat emptor* regime where investors have no information about the validity of an offering, the market would eventually become flooded with scam securities.[70] Investment would dry up and the economy would stagnate.[71]

The concerns served by regulation are unquestionably vital. The importance of protecting the economy is well-documented and is beyond the scope of this note. The normative value of preventing fraud is no less important; certainly it is as socially valuable as preventing any criminal activity. As such, government policy must ensure that securities offerings are adequately regulated. The Enron scandal caused a mass belief that the current regulations were inadequate, and that something like Sarbanes-Oxley was necessary. At the very least it was certain that reporting fraud existed in all types of public companies.[72] Even if the previous regulations were truly inadequate,[73] however, the Act's effectiveness at furthering these public policy concerns is questionable, while its negative impact on other concerns is both certain and substantial.[74]

B. Small Business

Without question, Sarbanes-Oxley negatively affects the ability of small firms to turn to the public market for financing because of the substantial increased costs of compliance.[75] Accordingly, two questions must be answered to determine whether the Act implicates public policy: First, to what extent should government policy promote the growth and well-being of small business? Second, how important is a small firm's ability to enter the public capital market? As it turns out, the ability of small businesses to go public is vital not only for their own growth and well-being, but for the growth and well-being of industry and the economy as a whole.

1. Economic Importance of Small Business

The economic importance of small firms has been both ignored and misguided until quite recently.[76] For years, most scholars attributed the dominance of the American economy to the development of big business.[77] Particularly during the cold war, many economists even argued that small firms, which do not produce enough to take advantages of economies of scale,[78] were actually a drain on efficiency.[79] These analysts advocated any public policy that favored high industry concentration, with more large corporations and fewer small firms.[80] With the advent of revolutionary new theory and methodology, however, analysts have completely changed this belief.

Examining the organization of industry as a dynamic institution as opposed to a static one, economists now understand why small firms continue to be prevalent despite their supposed inefficiencies. Small and young companies are a primary source of innovation,[81] and are a significant, if not the primary source of new jobs.[82] Viewed in a dynamic frame, these aspects of small companies make them essential in the industrial renewal process as agents of change. Large firms have such large and complex infrastructures that they are simply not able to adapt to changes in technology. Instead, individuals with "a given endowment of new knowledge" are better served by entrepreneurship than by employment in large firms.[83] Without small business, this new knowledge would be under-utilized and industry would not evolve as fast as it has in recent years.[84]

This result makes empirical sense. Especially in high-technology fields, most break-through innovations come from start-up companies. Even in the lower-technology steel industry, new "mini-mills" entering the market have become profitable despite the fact that the incumbent giant mills had been losing money for years.[85] Classical industrial organization theory could not explain how firms could enter a market where there were no excess profits.[86] Economists now know that the success of small firms like these mini-mills is due to their flexibility and their ability to incorporate new knowledge in ways large firms simply cannot.[87]

As such, the importance of small firms is that they allow industry to the development and growth. Any policy that stunts the growth of small business has the potential to hurt the economy as a whole. Nevertheless, this is not the only compelling reason to support small business; protecting small business is also important to American society itself as a symbol of America's identity and the American Dream.

2. Sociopolitical Importance of Small Business

While the economic importance of Small businesses is just now being uncovered, the socio-political importance has been recognized since colonial times. Small firms represent "'a cornerstone of American democracy,'" and are seen as an institution that offers everyone a chance at the American Dream.[88] In fact, the small firm is the single most important vehicle for dissolving class barriers and promoting more equal economic opportunity. Since this country's inception, entrepreneurship provided Americans from every social background social mobility.[89] Small enterprises are particularly important for minorities and immigrants to integrate into American society.[90] This has also been important for women, who have faced and continue to face discrimination that hinders their ability to compete for jobs.[91]

Small business is not just important for these select groups, however; it is important to the entirety of American society. Even when big business was thought to be the driving force of the economy, the Government still felt pressure to protect the little guy.[92] This is why there was such vigorous antitrust prosecutions following World War II,[93] and again in recent years.[94] This is also why the Small Business Administration survived President Reagan's attempt to get rid of it in the 1980s.[95] The well-being of small business in America is indeed a driving political force.[96] It is no wonder that the SEC, which initially refused to ease the § 404 burdens for small businesses,[97] is now facing tremendous pressure to change its position.[98]

Whether to protect the economy or keep the American Dream alive, government policy must ensure that small businesses continue to thrive. As one prominent economist put it:

> The policy implications are clear. The crucial barometer for economic and social well-being is the continued high level of creation of new and small firms in all sectors of the economy by all segments of society. It should be the role of government policy to facilitate that process by eliminating barriers to entry and exit, lowering transaction costs, and minimizing anticompetitive behavior by large firms.[99]

Sarbanes-Oxley affects the ability of small firms to develop by effectively keeping many of them out of the public capital markets, and financially handicapping those able to stomach the costs.[100] This affront to the economic and social well-being of this country could only be justified if the corresponding investor protection either is more important or offers more benefits than it costs.

C. Protecting Access to the Public Capital Markets

Whether for economic or political reasons, government policy should promote the growth and well-being of small firms. What is less obvious is how important it is for small firms to be able to go public. The primary benefit to firms is that they can better finance their business, complete key acquisitions and grow. Public offerings offer a more valuable security to the public than exempt offerings,[101] and offer them to a much larger market.[102] The result is a much higher demand for their securities.[103] A corollary to that is that managers have more incentive to start the ventures in the first place, since their own stock in the company is more valuable if publicly tradable.[104] Of course, depriving businesses of these benefits would only implicate public policy if it affected the public at large.

One way that better financed small businesses benefit the general public is that it improves the economy as a whole. As discussed above, the importance of small business to the economy is that they are the seeds of the economy’s renewal process.[105] Without public market financing, small businesses are less able to develop and market new technology. In essence, making better financing available to small businesses keeps industry alive and kicking.

A second benefit is to investors; going public makes these companies more available to investors, and also increases the value of investing in them. Although registered public offerings are not the only way to sell securities, exemptions to registration are highly technical, and an offering fitting one will not be available to most investors.[106] Even if it is available, the lack of a public market and rules against resale reduce the security’s value.[107] The result is that the ability for small business to go public benefits the investor as much as it benefits the business.

The public policy concerns on both sides of the Sarbanes-Oxley debate are essential. In a perfect world, neither should be furthered at the expense of the other. As it is, government policy must weigh the costs to one side with the benefits to the other. The problem is that the Act has had a minimal effect on fraud prevention and investor confidence,[108] while making it prohibitive for small businesses to enter the public finance markets.[109] This discrepancy mandates relief to small firms, at least from the most costly aspects of the Act.

IV. The Effects of Sarbanes-Oxley

A. What Did Sarbanes-Oxley Accomplish?

The goal of Sarbanes-Oxley, and § 404 in particular, was to prevent financial reporting fraud and improve investor confidence.[110] In its attempt to accomplish these goals, Congress designed the Act to improve the accuracy of periodic reports and increase management's accountability.[111] Ostensibly, controls on financial reports and a higher likelihood of being held accountable would reduce the incidence of fraud. Less fraud, along with the impression that financial reports were more accurate, would supposedly boost investment.[112]

Whether the Act accomplished these goals is unclear at best, with many commenters arguing that it has done almost nothing for either fraud prevention or investor confidence.[113] The evidence that it is working is so far limited to anecdotes and inferences from indirect statistics. For example, in 2005 there were a record number of amendments to financial statements.[114] Some commentators attribute this at lease in part to Sarbanes-Oxley, particularly the recent implementation of § 404.[115] Supposedly, this is evidence that financial reporting is becoming more accurate.[116] Others argue that these restatements do not represent the Act's true target; rather, these are just the honest companies complying with the more stringent requirements of Sarbanes-Oxley, the same way they complied with the previous requirements.[117] Further, it is uncertain whether investors will characterize the increase in restatements as better accuracy in financial information, or as evidence of how inaccurate it was before the restatement.[118] The effect on investor confidence is thus ambiguous.

Other potential evidence involves the mandated changes in corporate makeup; the new requirement that audit committees be made up entirely of outside directors has arguably increased the quality of boards of directors.[119]

Another more certain effect is that the Act has significantly changed the accounting profession.[120] There is no question that auditors are being more thorough. Public company accountants now have the kind of leverage over their clients necessary to keep from being bullied, the way Arthur Anderson was by Enron.[121] There are questions, however, as to whether this has had any actual effect on fraud prevention.

In fact, there is highly partisan debate as to whether any of the evidence indicates an effect on fraud.[122] Analysts claiming that it does are generally accountants or SEC employees, and so lack impartiality.[123] Likewise, analysts claiming that it does not are generally pro-business.[124] Despite the disagreement, it will be several years before any data is available on the actual incidence of fraud. The costs to small issuers, however, are far more certain.

B. What Were the Effects on Small Business?[125]

1. The Pre-Implementation Outlook

The projected business costs of implementing § 404, especially with regards to small businesses, paled in comparison to the current figures. The SEC estimated that the average company would require 383 hours to implement, assess, and audit internal controls, costing only $35,286 per company in outside professional fees.[126] Further, the SEC concluded that the costs to smaller firms would be much less than that.[127] It reasoned that due to the far less complex internal controls of smaller firms, § 404 costs would be significantly less.[128] Finally, it assumed that most costs of compliance would be from designing and implementing the internal controls, which would be incurred in the first year. Accordingly, it predicted that costs would be much less from the second year on.[129] In fact, one study concluded that the imposition of such a rigid structure for internal controls would actually increase efficiency, since in recent years a "'corner-cutting' culture" among companies had led to lack of structure and hurt efficiency.[130]

The public comments received by the SEC on the proposed rules firmly disagreed. Most commenters argued that that the SEC vastly underestimated the number of hours companies would need to assess and audit the internal controls.[131] One commenter even postured that the figures were off by a factor of 100.[132] Moreover, many believed that the costs would not be proportionally lower for smaller firms.[133] The SEC's only response to these concerns was to only require § 404 compliance in the annual report (Form 10-k).[134]

2. Actual Effects to Date

According to mounting evidence, the public comments were right. Even ignoring the effects on small businesses, § 404 implementation is lot more costly in general than the SEC expected: costs are about four times higher across the board.[135] Also, many firms have now faced two years of § 404 compliance, but the rapid decline in costs regulators expected has not happened.[136] It is possible that the high costs still reflect implementation, and so will eventually decline. The fact that the companies in this sample are "accelerated filers,"[137] and thus are more experienced and better funded than most small businesses, makes that argument rather weak.

The most certain error, however, has been the disproportionate effects of § 404 on small public companies.[138] Relative to their market floats, small-cap issuers will incur much higher costs than large companies, with some estimating that audit costs could triple, quadruple, or more.[139] According to an interview with one securities law practitioner, the typical cost of compliance has risen from around $25,000 to $200,000 per year.[140] Of course, high costs alone are not compelling enough to mandate government policy; with the privilege of being a public company comes obligations to the public, and § 404 is part of those obligations. Rather, it is the effect these high costs have on society and the economy that implicates public policy.

The key effect is that the cost of § 404 is keeping small businesses out of the public capital markets. The last two years have been wrought with stories of small companies de-registering their stock, saying that the cost of being a public company has become prohibitive.[141] One analyst's study revealed that among the businesses that de-listed, compliance costs swallowed nearly a third of the firm's profits.[142] Some analysts claim this is not the norm for small public companies, but the issue is not just whether current public companies can stay public, but whether small firms in the future will go public at all. Since the initial registration process is a significant cost in itself, the marginal cost of going public is significantly higher than that of staying public.[143] The most troubling fact is that the number of small company public offerings has significantly decreased recently, despite the fact that the SEC has not yet implemented § 404 for small firms.[144] Thus, the mere possibility of having to face the costs of Sarbanes-Oxley in the future could be enough to damage the economy. The bottom line is that §

404 is making it more difficult for small companies to go public, and to some extent to stay public.

Since § 404 is not yet in effect for small businesses, this evidence illustrates only the tip of the iceberg of what the Act will do not to only small business, but to the economy as a whole. The most compelling reason to readdress the costs of § 404 is the economic impact it will have in the long run.

3. The Long Term Economic Outlook

The long run effects of Sarbanes-Oxley on the economy could be devastating. Small businesses will face compliance costs that make it difficult, if not impossible, to enter the capital market.[145] As such, small businesses will be under-funded and unable to develop. With the modern understanding of the importance of small firms to industry,[146] analysts can now predict the macroeconomic impact. With small firms unable to capitalize on the new knowledge they bring to industry, they are unable to act as agents of change. Essentially, if small business does not grow, the entirety of industry does not grow. Technology does not develop. Fewer new jobs appear. Profits disappear.

Further, the decline of industry affects not only the involved businesses, but the economy as a whole. The stranglehold on small business puts the entire industry at a cost, efficiency and technology disadvantage to foreign firms.[147] One of many macroeconomic implications is that the trade deficit, already a cause for concern, may get worse.[148] If the burden on small business is not lifted, there will be at the very least a noticeable strain on the economy. If small business is as important to America's economy as recent studies suggest, that strain could lead to mass unemployment, a deflated standard of living, and the end of any industrial dominance this country may still have.

V. Weighing Public Policy

Neither of the competing interests is compellingly more important or more fundamental than the other. While the bias towards investors in the Act itself might suggest such a bias in Congress, it is more credible to believe the Act was a hasty reaction to a sudden surge in the call for investor protection.[149] In fact, the evidence is that the political pendulum has swung the other way. Even Senator Oxley has expressed a willingness to revise the Act.[150] The one thing this political fence-sitting demonstrates is that there must be balance between the two competing interests. Accordingly, a change in securities policy should only occur if the total benefits outweigh the total costs. While neither the benefits nor the costs of regulation are easily quantifiable, and are fairly subjective depending on one's point of view, it is undeniable that the benefits of Sarbanes-Oxley do not outweigh its costs.

First, even if the Act had accomplished all of its stated goals, the costs to small businesses and the resulting harm to the economy are so exorbitant that the ends do not justify the means. As one analyst put it, "'I think what ultimately is going to happen is in an attempt to capture a few bad guys, you not only extinguish the spirit of entrepreneurialism, you extinguish the spirit of capitalism, and you introduce the kinds of bureaucracy that will make America less competitive over time . . . .'"[151] While this trivializes the goals of the Act a bit, it reflects the reality that a boost in investor confidence is trivial compared to the economic impact the Act could have. Congress wanted to make sure that companies, even small ones, are not reporting profits that are not there. Their solution: make sure there are no profits to report.

Another way to put it is in purely economic terms. The ultimate goal of congress, putting aside the ethical problem of fraud, was to stimulate the market by increasing investor confidence. In doing so, it has crippled the ability for most small firms to enter the market, and as a result has caused more harm to the market than good. Even if investors are confident in financial accuracy, they now have fewer places to invest. There is also reason to believe that any positive effect on investor confidence might be counterbalanced by an even larger negative effect.[152]

Moreover, it is not even clear that § 404, the catalyst of these enormous costs, is either effective or necessary to protect investors from small business fraud. Some commenters believe that the extensive internal controls required by § 404 are just controls for controls' sake, and do not actually prevent fraud any more than the internal controls currently used.[153] They make more sense in large companies, where the financial structure is so complex that there needs to be a high standard for internal controls. In small firms, even a drastically reduced standard for internal controls may be sufficient, since the structure is far less complex and the financial condition of the company is much more transparent.

Further, in the case of small firms it seems that other provisions of Sarbanes-Oxley are more than sufficient to accomplish the Act's purpose. Already there is an increased ability to prosecute executives, since the certification requirement takes away the unawareness defense.[154] Also, the enhanced independence of both the audit committee and the auditor take away the problem of leverage,[155] which ensures that an audit will not be the tongue-in-cheek farce that it had been with Enron and Worldcom. Auditors now have every incentive to report discrepancies to the audit committee, and have none to help management cover it up.[156]

In addition, recent history strongly suggests that investor confidence is not affected by financial reporting fraud in small firms nearly as much as in large firms. The type of fraud Sarbanes-Oxley was designed to prevent has existed for decades in smaller firms,[157] but investor confidence was not substantially affected until a handful of large companies were caught. The implication is that investor confidence is shaken far more by frauds in two or three Fortune 500 firms (in fact, enough to compel a Congressional mandate) than in hundreds of smaller firms. Sarbanes-Oxley may be necessary to protect investor confidence, but not when it comes to small issuers.

Another interesting, though troubling perspective is that at some point preventing fraud is no longer a compelling policy concern: "[l]ike it or not, a certain amount of fraud is optimal."[158] Eventually the cost of preventing one more fraud becomes more than it is worth, even to the potential victim. While shareholders prefer not to be defrauded, they also prefer to own stock in a profitable company. That requires that management engage in profitable activity, and the time spent on fraud prevention is time taken away from such activities.[159] From this point of view, it is possible that even investors feel the tremendous costs of § 404.

Even if investors do not consciously feel the effects, a certain amount of fraud on financial reports could actually be more important to investor confidence than the belief that the reports are accurate. This seems to be the case for two reasons. First, when companies include projections in their financial reports, missing expectations by even one cent per share can affect their market capitalizations by billions of dollars.[160] This puts tremendous pressure on companies to falsify reports.[161] The argument can be made that such fraud is acceptable so long as the misstatement is (1) minimal, and (2) intended to assuage investor confidence and protect the capital market systems. While no one could argue that Enron was good for investors, reporting earnings at $5.25 per share instead of $5.23, when done to protect the market, is hardly worthy of twenty years in a federal prison.

Second, the corrections to financial reports caused by heightened sensitivity under Sarbanes-Oxley could actually hurt investor confidence.[162] In 2005, a record of around 1,200 such restatements were made, often leading to a sharp decline in stock price.[163] Ostensibly, the heightened sensitivity was intended to improve investors' belief in the accuracy of these reports,[164] but the empirical results disagree. Even though most of these restatements are "[h]onest companies . . . just doing their best to keep their books accurate,"[165] the government's efforts to prevent fraud have actually hurt investor confidence. The implication is that there may be public policy reasons to let these companies hide minor discrepancies, ironically to protect investor confidence.

While no one could argue that fraud should be encouraged, at some point it becomes counterproductive to keep enhancing fraud prevention. Sarbanes-Oxley is a prime example of a laudable goal costing more that it's worth.

VI. Possible Solutions

Analysts have proffered four potential solutions to the problem small firms have with § 404: complete exemption, partial exemption, better guidance, and reduced standards. Some believed that the disproportionate impact on small business was due to their inexperience, and to the lack of formal structure in their internal controls.[166] This implied two things. First, once a formal, systematic set of controls was established, the costs to small business would decrease dramatically.[167] Second, regulators could significantly reduce costs to small business by providing a clearer, more structured guidance as to what kinds of controls are required, and how to maintain them.[168] The problem with this theory is that they have already done that,[169] and it has done nothing to calm the protests. Even with a crystal clear understanding of what types of controls the SEC expects, the costs will still be astronomical.

What most small business advocates have promoted is complete exemption from § 404. In fact, this is what the SEC's own advisory committee has recommended for smaller firms.[170] Since the impact of § 404 is undeniably greater than the intended benefits, this seems to be the best course of action.

It is also possible to reduce the impact of § 404 without completely removing its protections. The advisory committee recommended that, for mid-cap issuers, the SEC retain the requirements on internal controls but exempt the firms from having them audited.[171] This would remove the bulk of the cost while still requiring the rigid structure that the SEC believes will reduce the incidence of fraud.

Another possibility is reducing the requirements for internal controls while keeping the audit. The much simpler structure of small firms' financial organization justifies a much simpler structure in internal controls. If this can be done while maintaining adequate fraud protection, not only will it reduce the costs of implementing the controls, but also reduce the cost of the audit. Whether this is possible and how it could be done, however, is beyond the scope of this note.

VII. Conclusion and Prospects for Change

Public Policy demands that some measure be taken to reduce the Sarbanes-Oxley burden on small business, whether by exempting small firms from all or part of § 404, or by somehow making the requirements proportional to business size.[172] The problem is that while the SEC is quick to issue hasty rules in response to a perceived threat, it is much slower to fix them once unintended and unduly harsh consequences have been revealed.[173]

The Commission has not been completely deaf to these concerns. In response to the public outcry against § 404, the SEC has taken small steps to address the concerns of small issuers. First, it delayed the compliance date for smaller firms by a year.[174] The Commission believed that the delay would solve the problem by reducing the initial costs of implementing internal controls, which further demonstrates how vastly it underestimated the continuing cost burdens on small public companies.[175]

Second, and perhaps more significantly, the SEC commissioned an advisory panel to assess the effects of the new regulations on small business and propose changes.[176] The panel recently came back with its recommendations, proposing to exempt companies with market capitalizations less than $700 million from having their internal controls certified by independent auditors, and exempt companies with less than $100 million in public float from § 404 altogether.[177]

Whether the SEC will respond, and respond adequately, is a tenuous proposition. Commissioning the advisory committee is a good sign; at the very least the Commission recognizes that a problem exists and that some measure must be taken. Another good sign is that when SEC Chairman Christopher Cox took his position last year, he expected to use whatever recommendations the committee had.[178] In general, the political pendulum seems to be swinging towards relief. On the other hand, it has been months since the advisory panel has come back with its recommendations, and while the Commission has acted quickly on its recommendations about foreign issuers, it has so far dragged its feet on the small business issue. Also, most in Congress expect that the Act itself will not be amended.[179] Change will have to come from the SEC itself, which has always been hesitant to relax its regulations.[180]

The advisory committee's recommendation is as broad a stroke to help small business as the Act was to protect investors. The SEC has said before that, despite the high costs, it did not want to exempt small business from § 404.[181] The Commission must changes its stance, or else watch America's small businesses falter, and bring the entire American economy down with it.

[1] Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of the Securities Act of 1933 ("the '33 Act"), 15 U.S.C. 77a et seq.; the Securities Exchange Act of 1934 ("the '34 Act"), 15 U.S.C. 78a et seq.; 11 U.S.C.; 15 U.S.C.; 18 U.S.C; 28 U.S.C.; and 29 U.S.C.).

[2] *See*, *e.g.*, John C. Danforth, *When Enforcement Becomes Harassment*, N.Y. TIMES, May 6, 2003, at A31.

[3] *See*, *e.g.*, Holme, Roberts & Owen LLP, *At What Cost?*, 17 CORP. GOVERNANCE EXPERT COMMENTARY (2005).

[4] *See* JOHN C. BOGLE, BATTLE FOR THE SOUL OF CAPITALISM 18-23 (2005).

[5] *See* Joseph T. Wells, *Small Business, Big Losses*, J. ACCT. ONLINE EDITION, at http://www.aicpa.org/pubs/jofa/dec2004/wells.htm.

[6] *See infra* notes 141-144 and accompanying text.

[7] H.R. REP. NO. 107-414, section entitled "Background and Need for Legislation" (2002), *reprinted in* SARBANES-OXLEY ACT LEGIS. HISTORY, pt. 2 (2002).

[8] Holme, Roberts & Owen LLP, *supra* note 3; Management's Report on Internal Control Over Financial Reporting, Securities Act Release No. 8238, Exchange Act Release No. 47,986, 68 F.R. 36636, 36659 (June 5, 2003).

[9] The '34 act defines "issuer" as "any person who issues or proposes to issue any security," including both natural persons and companies. 15 U.S.C. 78c(8), (9) (1934).

[10] The Act applies to "each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934." Sarbanes-Oxley Act of 2002 § 302. Companies required to file periodic reports (forms 10-k and 10-q) under § 13(a) or § 15(d) either (1) have their securities listed on a national securities exchange, (2) have $10

million or more in assets, and 500 or more shareholders, (3) have had a registered offering within the last year, and have 300 or more holders of a registered security, or (4) voluntarily comply with reporting requirements. Exchange Act of 1934 § 13(a), 15(d), 15 U.S.C. 78m(a), 78o(d) (1934).

[11] Sarbanes-Oxley Act of 2002 § 404. Internal controls are:

> A process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting . . . including those policies and procedures that:
>
> (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
>
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
>
> (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.

Management's Report on Internal Control Over Financial Reporting, *supra* note 8, at 36640. *See also* THE TREADWAY COMMISSION, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING 26 (1987), *available at* www.coso.org/NCFFR.pdf. The vagueness of this definition has been a large part of the problem: the standard adopted by the SEC "does not provide any measure or standard by which a company's management can determine that internal control is effective, nor does it define what constitutes effective internal control." *See* Management's Report on Internal Control Over Financial Reporting, *supra* note 8, at 36639.

[12] Sarbanes-Oxley Act of 2002 § 404.

[13] Sarbanes-Oxley Act of 2002 § 404(b).

[14] Management's Report on Internal Control Over Financial Reporting, *supra* note 8, at 36642. *Cf.* Sarbanes-Oxley §

404(a)(2) (requiring only an assessment of the effectiveness of the company's internal controls).

[15] Management's Report on Internal Control Over Financial Reporting, *supra* note 8, at 36656.

[16] PROTIVITI, INC., CAPITALIZING ON SARBANES-OXLEY COMPLIANCE TO BUILD SUPPLY CHAIN ADVANTAGE: A BACK-TO-BASICS APPROACH TO INTERNAL CONTROL AND SUPPLY CHAIN TRANSACTION INTEGRITY 3 (2003), *available at* http://www.protiviti.com/downloads/PRO/pro-us/publications/SupplyChain_SOA.pdf.

[17] *See* Management's Report on Internal Control Over Financial Reporting, *supra* note 8, at 36656.

[18] *See id.*

[19] *See, e.g.,* STUART R. COHN, SECURITIES COUNSELING FOR NEW AND DEVELOPING COMPANIES 1-9 to 1-11 (2003) (discussing the Act's "principal measures," but not even mentioning § 404).

[20] Holme, Roberts & Owen LLP, *At What Cost?*, 17 CORP. GOVERNANCE EXPERT COMMENTARY (2005).

[21] *See infra* notes 120-121 and accompanying text. In fact, accountant's give the Act an alternative title: The "Full Employment Act for Accountants." Interview with M. Richard Cutler, Founding Partner, Cutler Law Group, a Professional Law Corporation, in Augusta, Ga. (Mar. 17, 2006).

[22] Sarbanes-Oxley Act of 2002 § 302, 906. Specifically, § 302 mandates rules requiring the officers to certify that (1) they have reviewed the report, (2) there is no misstatement or omission of a material fact, (3) the report fairly represents the financial condition of the company, and (4) they have complied with the rules promulgated under § 404 of the Act, which concern the company's internal controls over financial reporting. Sarbanes-Oxley Act of 2002 § 302. Section 906 adds a separate certification

requirement directly to the code itself, requiring certification that the report (1) complies with SEC reporting requirements and (2) fairly represents the financial condition of the company. Sarbanes-Oxley Act of 2002 § 906; 18 U.S.C. § 1350 (2002).

[23] *See*, *e.g.*, Floyd Norris, *In the Cendant Trial,* Ignorance *Was an Excuse,* N.Y. TIMES, Feb. 10, 2006, at C1.

[24] In fact, prosecutors in the fraud trial of former WorldCom CEO Bernard J. Ebbers were only successful because they convinced the judge to issue the jury favorable instructions, allowing them to find Mr. Ebbers guilty if they found mere "deliberate ignorance" or "conscious avoidance." *See* Alexei Barrionuevo, *Enron Prosecutors Have Another Key Witness, From Jail*, N.Y. TIMES, Mar. 20, 2006, at C1. Some authorities believe the prosecution of former

Enron executives Kenneth Lay and Jeffrey Skilling will only succeed if they can get the same instruction. *Id.*

[25] *See*, *e.g.*, Floyd Norris, *supra* note 23, at C1.

[26] *See supra* note 22.

[27] *See In re Enron Corporation Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d 549, 583 (S.D. Texas 2002). The "primary" violator issue first became relevant when the Supreme Court abolished rule 10b-5 aiding and abetting liability in 1994. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164, 191 (1994). In order to prosecute secondary actors (any individual not *directly* responsible for the fraud), it became necessary to establish them as a "primary" violator. A key issue left to the trial courts by *Central Bank of Denver* was whether a public statement must be directly attributable to secondary actors before they can be liable

under 10b-5, and many courts adopted that requirement. *Enron*, 235 F. Supp. 2d at 583. In *Enron*, however, the Southern District of Texas expressly rejected the requirement, holding:

> when a person, acting alone or with others, creates a misrepresentation [on which the investor-plaintiffs relied], the person can be liable as a primary violator . . . if he acts with the requisite Scienter. Moreover, it would not be necessary for a person to be the initiator of a misrepresentation in order to be a primary violator. Provided that a plaintiff can plead and prove Scienter, a person can be a primary violator if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the ideas for those misrepresentations came from someone else.

Id. at 587. *See generally* Douglas C. Conry & Ryan K. Roth Gallo, *In re Enron Securities Litigation: Central Bank Encounters the "Perfect Storm,"* 35 Sec. Reg. L. Rep. (BNA) 746 (May 5, 2005) (suggesting that *Enron* could lead to an abolishment of the publicly attributable statement requirement across the board).

[28] *See Enron,* 235 F. Supp. 2d at 587.

[29] Sarbanes-Oxley Act of 2002 § 906.

[30] *See* Henry T. C. Hu, *Enron Happens*, N.Y. TIMES, Jan. 30, 2006, at A26.

[31] Sarbanes-Oxley Act of 2002 § 1106.

[32] *Id.*

[33] Sarbanes-Oxley ACT of 2002 § 903. The maximum prison term rose from five to twenty years. *Id.*

[34] Sarbanes-Oxley Act of 2002 § 904. The maximum fine rose from $5,000 to $100,000, while maximum prison sentences rose from one to ten years. *Id.*

[35] *See supra* note 29 and accompanying text.

[36] Sarbanes-Oxley Act of 2002 § 802. The new law makes the alteration of any record, with the intent to impede a Federal investigation or chapter 11 bankruptcy, punishable by fine or up to twenty years in prison. 18 U.S.C. § 1519 (2002).

[37] Sarbanes-Oxley Act of 2002 § 802. The new law requires accountants to retain audit records for five years, punishable by up to ten years in prison. 18 U.S.C. § 1520 (2002).

[38] Sarbanes-Oxley Act of 2002 § 903.

[39] Sarbanes-Oxley Act of 2002 § 803.

[40] Sarbanes-Oxley Act of 2002 § 308. The provision applies when the company is subject to disgorgement, and is at the discretion of the SEC. *Id.*

[41] Sarbanes-Oxley Act of 2002 § 1103.

[42] Sarbanes-Oxley Act of 2002 § 1105. The section applies to violators of § 10(b) of the '34 Act and § 17(a) of the '33 Act, which are the principal antifraud provisions in those acts. *Id.*

[43] As Senator Sarbanes has said, the Act's fundamental purpose "'was to get auditors to start being auditors

again.'" Joseph Nocera, *For all its Cost, Sarbanes Law is Working*, N.Y. TIMES, Dec. 3, 2005, C1.

[44] *See id.* ("'There was concern that auditors were pulling their punches to get consulting fees.'")

[45] Sarbanes-Oxley Act of 2002 § 101 et seq.

[46] Sarbanes-Oxley Act of 2002 § 301. The section amends the '34 Act by requiring that the audit committee be "directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by [the] issuer," and that "[e]ach member of the audit committee . . . be a member of the board of directors of the issuer, and . . . otherwise be independent." 15 U.S.C. 78f(m)(2), (3) (2002).

[47] Sarbanes-Oxley Act of 2002 § 202.

[48] Sarbanes-Oxley Act of 2002 § 201.

[49] Sarbanes-Oxley Act of 2002 § 203. No one person can head the audit for the same issuer more than once in a five year span. *Id.*

[50] *See infra* note 62 and accompanying text.

[51] *See supra note 21*; *infra* notes 120-121 and accompanying text.

[52] Sarbanes-Oxley § 401(a). An off-balance sheet transaction is what got Enron in trouble. According to testimony in the ongoing trial, CEO Kenneth Lay and former CEO Jeffrey Skilling transfered $726 million in losses from the company's retail division to the more lucrative wholesale unit in order to deceive shareholders. Alexei Barrionuevo, *Money Shift Possibly Known Outside Enron, Witness Says*, N.Y. TIMES, Feb. 9, 2006, at C11.

[53] Sarbanes-Oxley Act of 2002 § 406.

[54] *Id.*

[55] Sarbanes-Oxley Act of 2002 § 407.

[56] H.R. REP. NO. 107-414, *reprinted in* SARBANES-OXLEY ACT LEGIS. HISTORY, pt. 2 (2002).

[57] Conditions for Use of Non-GAAP Measures, Securities Act Release No. 8176, Exchange Act Release No. 47,226, 79 S.E.C. Docket 1057 (Jan. 22, 2003). The rule promulgated under § 401(a) requires that any forward-looking financial figures either follow generally accepted accounting practices ("GAAP"), or be reconciled with figures that do. The purpose of this requirement was to make these "soft" figures less misleading. *Id.*

[58] Sarbanes-Oxley Act of 2002 § 403.

[59] Part 205 requires "up-the ladder" reporting: any attorney appearing before the commission to report any evidence of securities fraud to the company's CEO and CFO, and if the attorney does not reasonably believe that the response is

adequate, to the company's audit committee. 17 C.F.R. § 205.1 et seq. It is interesting to note that even after Enron and the government's response, attorneys have still evaded Rule 10b-5 liability. *See supra* note 27 for a discussion of the primary violator concept, and its applicability to background actors.

[60] Sarbanes Oxley Act of 2002 § 806 (whistleblower protection), 1107 (retaliation against informants).

[61] *See supra* notes 43-51 and accompanying text.

[62] *See* JOHN C. BOGLE, BATTLE FOR THE SOUL OF CAPITALISM xx-xxi (2005).

[63] *See infra* notes 113-124 and accompanying text.

[64] *See infra* notes 141-144 and accompanying text.

[65] *See* Management's Report on Internal Control Over Financial Reporting, Securities Act Release No. 8238,

Exchange Act Release No. 47,986, 68 F.R. 36636, 36656 (June 5, 2003).

[66] *See*, *e.g.*, *Boston Church Returns a Tainted Donation*, N.Y. TIMES, Mar. 18, 2006, at C6.

[67] *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917).

[68] *See*, *e.g.*, *Boston Church Returns a Tainted Donation*, *supra* note 66, at C6.

[69] "[C]apitalism requires a structure and a value system that people believe in and can depend on." JOHN C. BOGLE, BATTLE FOR THE SOUL OF CAPITALISM 5 (2005).

[70] *See* George Akerlof, *The Market for "Lemons:" Quality Uncertainty and the Market Mechanism, in* ESSENTIAL READINGS IN ECONOMICS 175, 176-177 (Saul Estrin & Alan Marin eds., 1995). Akerlof's Nobel-winning theory demonstrates that when buyers have less information about the quality of a good, devalue it based on how likely it is to be a "lemon." *Id.*

at 176. Since quality goods have higher costs than lemons, some will be priced out of the market. The result is a higher incidence of "lemons," a further devaluation, and even more quality goods being priced out of the market. The end result is a market where all goods are lemons. *Id.* at 177. By analogy, if investors had no way of discerning a good security from a scam, eventually the quality securities would be priced out of the capital markets.

[71] *See id* at 185-186.

[72] *See generally* JOHN C. BOGLE, *supra* note 69 (arguing that corporate corruption is not just the product of a few bad apples, but rather is spread throughout corporate America and the capitalist system itself).

[73] See Holme, Roberts & Owen LLP, *At What Cost?*, 17 CORP. GOVERNANCE EXPERT COMMENTARY (2005). (suggesting that Sarbanes-

Oxley was less a response to an actual need, and more a hasty reaction to a transitory change in public attitude).

[74] *See infra* notes 113-124, 141-144 and accompanying text.

[75] *See infra* notes 141-144 and accompanying text.

[76] Zoltan Acs, *The New American Evolution*, *in* ARE SMALL FIRMS IMPORTANT? THEIR ROLE AND IMPACT 1, 4 (Zoltan Acs ed., 1991). The first major study of the general impact of small businesses on the economy came in 1989. *See generally* William A. Brock & David S. Evans, *Small Business Economics,* 1 Small Bus. Econ. 7 (1989).

[77] Acs, *supra* note 76, at 4.

[78] *See generally* George J. Stigler, *The Economies of Scale,* 1 J. L. & ECON. 54 (1958). The primary benefit of large firms is that, by reducing transaction costs, they are able to produce larger amounts with a lower average cost of production. *See* Ronald H. Coase, *The Nature of the Firm*,

in ESSENTIAL READINGS IN ECONOMICS 37, 38-39 (Saul Estrin & Alan Marin eds., 1995).

[79] *See* Leonard W. Weiss, *The Survival Technique and the Extent of Suboptimal Capacity*, 72 J. POL. ECON. 246, 246 (1964); F. M. Scherer, *The Determinants of Industry Plant Sizes in Six Nations*, 55 REV. OF ECON. & STAT. 135, 139-140 (1973).

[80] *e.g.*, Leonard W. Weiss, *The Structure-Performance Paradigm and Antitrust*, 127 U. Pa. L. Rev. 1104, 1117-1118 (1979) (arguing that Antitrust policy, which favored small business, competition, and low industry concentration was damaging to the economy).

[81] John R. Baldwin & Joanne Johnson, *Entry, Innovation and Firm Growth*, *in* ARE SMALL FIRMS IMPORTANT? THEIR ROLE AND IMPACT 51, 52 (Zoltan Acs ed., 1991).

[82] The extent to which small firms are responsible for job creation has been highly debated over the last twenty five years. In 1981, David Birch argued that firms with 100 or less employees accounted for as high as 80% of new jobs. David Birch, *Who Creates Jobs?,* 65 PUB. INT. 3, 7 (1981). The Small Business Administration reported the number closer to 40%. MANSEL G. BLACKFORD, A HISTORY OF SMALL BUSINESS IN AMERICA 115 (1991). It is nevertheless undisputed that, relative to the absolute number of jobs, the share of new jobs created by small companies is quite significant. *Id.* at 116. *See generally* Andrew Henley, *Job Creation by the Self-employed: The Roles of Entrepreneurial and Financial Capital*, 25 Small Bus. Econ. 175 (2004), for a more recent study, using modern econometric analysis to determine the factors that affect job creation in small business. *But see* John Haltiwanger & C. J. Krizan, *Small Business and Job*

Creation in the United States: The Role of New and Young Businesses, *in* ARE SMALL FIRMS IMPORTANT? THEIR ROLE AND IMPACT 79, 79-80 (Zoltan Acs ed., 1991) (cautioning that the tumultuous entry and exit of new and young firms makes measuring their contribution to job creation tenuous).

[83] Zoltan Acs, *The New American Evolution*, *in* ARE SMALL FIRMS IMPORTANT? THEIR ROLE AND IMPACT 1, 10-11 (Zoltan Acs ed., 1991).

[84] *Id.*

[85] ZOLTAN ACS, THE CHANGING STRUCTURE OF THE U.S. ECONOMY: LESSONS FROM THE STEEL INDUSTRY 1 (1984).

[86] David B. Audretsch, *Small Firms and Efficiency*, *in* ARE SMALL FIRMS IMPORTANT? THEIR ROLE AND IMPACT 21, 22-24 (Zoltan Acs ed., 1991).

[87] *See id.* at 25.

[88] MANSEL G. BLACKFORD, A HISTORY OF SMALL BUSINESS IN AMERICA 66 (1991).

[89] *Id.*

[90] John S. Butler, *"Don't call me Small": The Contribution of Ethnic Enterprises to the Economic and Social Well-Being of America*, *in* ARE SMALL FIRMS IMPORTANT, 129, 129 (Zoltan Acs ed., 1991).

[91] Candida Brush, *Women-Owned Businesses: Why Do They Matter? in* ARE SMALL FIRMS IMPORTANT, 111, 111 (Zoltan Acs ed., 1991). Since 1970, the percentage of woman-owned small businesses has ballooned from five percent to nearly forty percent. *Id*.

[92] MANSEL G. BLACKFORD, *supra* note 88, at 77.

[93] The 1950s and 1960s saw several landmark Supreme Court antitrust decisions. *See*, *e.g.*, United States v. Aluminum Co. of America, 377 U.S. 271, 272 (1964) ("Alcoa"); United

States v. E.I. Du Pont de Nemours & Co., 351 U.S. 377, 378 (1956) ("the Cellophane case").

[94] *See* United States v. Microsoft Corp., 87 F. Supp. 2d 30, 35 (D.D.C. 2000).

[95] The SBA had to that point accomplished almost nothing for small business, and had been criticized for discriminatory practices. MANSEL G. BLACKFORD, *supra* note 88, at 109. Nevertheless, President Reagan was unable to abolish the administration due to the political pressure supporting small business. *Id.*

[96] As another example, Congress enacted the Regulatory Flexibility Act in 1980, which encourages regulatory agencies to ease the regulatory burdens for small businesses. 5 U.S.C. § 501 et seq (1980).

[97] Management's Report on Internal Control Over Financial Reporting, Securities Act Release No. 8238, Exchange Act Release No. 47,986, 68 F.R. 36636, 36659 (June 5, 2003).

[98] Securities Act Release No. 8607, Exchange Act Release No. 52,329, *at* 2005 WL 2043761 (August 24, 2005).

[99] Zoltan Acs, *The New American Evolution*, *in* ARE SMALL FIRMS IMPORTANT? THEIR ROLE AND IMPACT 1, 17 (Zoltan Acs ed., 1991).

[100] *See infra* notes 141-144 and accompanying text.

[101] STUART R. COHN, SECURITIES COUNSELING FOR NEW AND DEVELOPING COMPANIES 4-36 (2003).

[102] *Id.* at 4-35.

[103] *See generally* J. R. Hicks, *The Law of Consumer Demand*, *in* ESSENTIAL READINGS IN ECONOMICS 1 (Saul Estrin & Alan Marin eds., 1995).

[104] *see* COHN, *supra* note 101, at 4-35.

[105] *See supra* notes 81-84 and accompanying text.

[106] *See* COHN, *supra* note 101, at 1-17. For example, a private offering under Rule 506 or § 4(2) requires that investors be "sophisticated" or "accredited." 17 C.F.R. 240.506(b)(2)(ii) (requiring Rule 506 purchasers to be either sophisticated or accredited); SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (holding that § 4(2) offerees must be able to "fend for themselves").

[107] *See* COHN, *supra* note 101, at 4-36.

[108] *See infra* notes 113-124 and accompanying text.

[109] *See infra* notes 141-144 and accompanying text.

[110] *See*, *e.g.*, Management's Report on Internal Control Over Financial Reporting, Securities Act Release No. 8238, Exchange Act Release No. 47,986, 68 F.R. 36636, 36656 (June 5, 2003).

[111] H.R. REP. NO. 107-414, section entitled "Purpose" (2002), *reprinted in* SARBANES-OXLEY ACT LEGIS. HISTORY, pt. 2 (2002).

[112] *Id.*

[113] See Holme, Roberts & Owen LLP, *At What Cost?,* 17 CORP. GOVERNANCE EXPERT COMMENTARY (2005).

[114] Stephen Labaton, *Earnings Restated? Don't Blame a Lawsuit for It*, N.Y. TIMES, Feb. 3, 2006, at C7. There was a record of about 1,200 earnings restatements in 2005 despite only five investor class action law suits, which Professor Joseph A. Grundfest of Stanford Law School attributes at least in part to Sarbanes-Oxley. *Id.*

[115] *Id.*

[116] *Id.*

[117] "'Honest companies are just doing their best to keep their books accurate.'" *Id.*

[118] *See also infra* notes 157-165 and accompanying text (discussing the ambiguous effects of Sarbanes-Oxley on

investor confidence, and arguing that heightened disclosure may actually hurt it).

[119] In particular, there is a trend emerging of small public companies hiring retired chief executives, in an effort to improve corporate governance. Glenn Rifkin, *Corporate Boards Call on Expertise of Retired Executives*, N.Y. TIMES, Feb. 9, 2006, at C4. This, incidentally, is another one of the biggest costs of Sarbanes-Oxley. Small companies have a serious problem paying for Director and Officer ("D&O") insurance, which can run more than $50,000 a year. Interview with M. Richard Cutler, Founding Partner, Cutler Law Group, a Professional Law Corporation, in Augusta, Ga. (Mar. 17, 2006). Quality outside directors refuse to join boards without D&O insurance; since audit committees have to be composed entirely of outside directors now, this effectively forces small issuers to incur this cost. *Id.*

[120] Joseph Nocera, *For all its Cost, Sarbanes Law is Working,* N.Y. TIMES, Dec. 3, 2005, at C1.

[121] *See id.*

[122] *See*, *e.g.*, Holme, Roberts & Owen LLP, *At What Cost?*, 17 CORP. GOVERNANCE EXPERT COMMENTARY (2005).

[123] *See* Practicing Law Institute, *Speech By SEC Staff: Remarks Before the 2003 Thirty-First AICPA National Conference on Current SEC Developments, U.S. Securities and Exchange Commission, December 11, 2003*, 1434 PLI/Corp 111, 113; Joseph Nocera, *For all its Cost, Sarbanes Law is Working*, N.Y. TIMES, Dec. 3, 2005, at C1.

[124] For example, groups criticizing the Act include the Biotechnology Industry Council, the National Venture Capital Association, the Advanced Medical Technology Association, and other industrial coalitions. *See* Tricia Bishop, *Changes Sought in Fraud Law Investment Groups*

Criticize Section of Sarbanes-Oxley Act, BALT. SUN, Dec. 10, 2005, at C9. Historically pro-business politicians have also opposed parts of the Act. *See, e.g.*, *Sen. Snowe Concerned Sarbanes-Oxley Could Impede Small Business Job Growth, Competitiveness*, U.S. FED. NEWS, Oct. 28, 2005. It is interesting to note, however, that one of the § 404 critics is PCAOB chairman William McDonough. Floyd Norris, *Top Regulator Says Sarbanes-Oxley Act Audits Are Too Costly and Inefficient*, N.Y. TIMES, Dec. 1, 2005, at C4.

[125] The prohibitive effect on small business is not the only public policy concern implicated by the Act. Among the implicated concerns beyond the scope of this note is international economic policy. *See* Holme, Roberts & Owen LLP, *supra* note 122. The securities requirements in this country are well beyond that of any other country; Sarbanes-Oxley only compounded that fact. The effect is

that companies, both domestic and international, are shunning the U.S. public market in favor of others. *Id.* Note that in response to an advisory committee, the SEC has proposed rules easing the burden on foreign issuers, while it has not yet acted on proposals by the same committee to ease the burden on small companies. *See Termination of a Foreign Private Issuer's Registration,* Exchange Act Release No. 53,020, 70 F.R. 77688, 77688 (Dec. 23, 2005); Floyd Norris, *Moves at S.E.C. to Loosen Rules at Many Companies*, N.Y. TIMES, Dec. 15, 2005, at C14.

Another issue is that the Act has compounded other touchy corporate issues, such as executive compensation. *See* Dan Mitchell, *The Director's Cut*, N.Y. TIMES, Jan 21, 2006, at C5. Some executives are requesting bonuses for their work done to comply with § 404. Shareholders are understandably outraged, not wanting to give extra compensation to executives for doing no more than what is required of them anyway. *Id.*

[126] Management's Report on Internal Control Over Financial Reporting, Securities Act Release No. 8238, Exchange Act Release No. 47,986, 68 F.R. 36636, 36659 (June 5, 2003).

[127] *Id.* at 36659.

[128] *Id.* at 36655. The analysis it used, however, was seriously flawed. It made an express assumption that costs would be directly proportional to business size, and then concluded, essentially, that costs would be directly proportional to business size. *See id.*

[129] *Id.*

[130] PROTIVITI, INC., CAPITALIZING ON SARBANES-OXLEY COMPLIANCE TO BUILD SUPPLY CHAIN ADVANTAGE: A BACK-TO-BASICS APPROACH TO INTERNAL CONTROL AND SUPPLY CHAIN TRANSACTION INTEGRITY 3 (2003), *available at*

http://www.protiviti.com/downloads/PRO/pro-us/publications/SupplyChain_SOA.pdf.

131 Management's Report on Internal Control Over Financial Reporting, *supra* note 126, at 36654.

132 *Id.*

133 *See id.*

134 *See id.* at 36654.

135 Floyd Norris, *Top Regulator Says Sarbanes-Oxley Act Audits Are Too Costly and Inefficient*, N.Y. TIMES, Dec. 1, 2005, at C4.

136 "When complaints arose about the costs of Section 404, regulators hoped that they would decline rapidly after the first year, but so far it appears that has not happened." *Id*.

137 Under Rule 12b-2, an "accelerated filer" is an issuer with a market float of at least $75 million and at least 12

months of experience filing periodic reports to the SEC, including at least one annual report. 17 C.F.R. 240.12b-2. Issuers eligible to use forms 10-KSB and 10-QSB cannot be accelerated filers. *Id.*

[138] See Holme, Roberts & Owen LLP, *At What Cost?*, 17 CORP. GOVERNANCE EXPERT COMMENTARY (2005); Tricia Bishop, *Changes sought in fraud law Investment groups criticize section of Sarbanes-Oxley Act*, BALT. SUN, Dec. 10, 2005, at C9.

[139] Ellen Rosen, *Not-Giants Seek Relief from Cost of New Audit Rules*, N.Y. TIMES, June 16, 2005, at C6.

[140] Interview with M. Richard Cutler, Founding Partner, Cutler Law Group, a Professional Law Corporation, in Augusta, Ga. (Mar. 17, 2006). The specific compliance costs reflect audit costs, time costs due to delays in audits, D&O insurance increases, and compensation for outside directors. *Id.*

[141] *See, e.g.*, Andrew R. Sorkin, *Kissing the Public Goodbye*, N.Y. TIMES LATE ED., Aug. 8, 2004, at 34.

[142] *Relief for Small Companies*, WASH. TIMES, Aug. 17, 2005, at A16. Including non-Sarbanes-Oxley regulations, compliance costs cut profits approximately in half. *Id.* The implication is that, for these small businesses, Sarbanes-Oxley has tripled an already burdensome cost of compliance. *See id.*

[143] This is because current public companies have already sunk their registration costs, costs they cannot get back, and thus it does not affect future economic decisions. *See* REID HASTIE & ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD: THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING 36-41 (2001). The only cost they face is cost of periodic reporting that Sarbanes-Oxley has engorged. An initial offering faces both.

[144] *See* Victor Godinez, *IPOs Expected to be Limited for Firms Funded with Venture Capital*, DAL. MORN. NEWS, Dec. 13, 2005, *available at* 2005 WLNR 19968045.

[145] *See supra* notes 141-144 and accompanying text.

[146] *See supra* notes 81-84 and accompanying text for a discussion of the dynamic model of industrial organization.

[147] This is compounded by the fact that foreign countries, none of which have as stringent regulations as the United States, have been luring companies away from the U.S. capital market. *See supra* note 125.

[148] *See generally* ALLEN SINAI, MACROECONOMIC CONSEQUENCES AND IMPLICATIONS OF THE U.S. TRADE AND CURRENT ACCOUNTS DEFICIT (2000), *at* http://govinfo.library.unt.edu/tdrc/research/trade12-5.pdf.

[149] Holme, Roberts & Owen LLP, *At What Cost?*, 17 CORP. GOVERNANCE EXPERT COMMENTARY (2005).

[150] *Id.*

[151] Victor Godinez, *IPOs expected to be limited for firms funded with venture capital*, DAL. MORN. NEWS, Dec. 13, 05, *available at* 2005 WLNR 19968045.

[152] *See infra* notes 157-165 and accompanying text.

[153] *See*, *e.g.*, Holme, Roberts & Owen LLP, *supra* note 149.

[154] *See supra* notes 23-29 and accompanying text. This seems to be making a real difference, as recent prosecutions of post-Sarbanes-Oxley frauds under § 906 have ended in quick settlements. News Digest, *Robert Guccione Settles Cease-and-Desist Proceeding*, SEC NEWS DIG., Jan. 24, 2005, *available at* 2005 WLNR 988389.

[155] *See supra* note 43-44 and accompanying text.

[156] *See also* Henry T. C. Hu, *Enron Happens*, N.Y. TIMES, Jan. 30, 2006, at A26 (arguing that "concentrating less on fraud prevention and more on overseeing management may not only enhance corporate performance but can sometimes also reduce

fraud," because properly supervised management will have more incentive to be diligent in preventing fraud).

[157] MARK S. BEASLEY ET AL., FRAUDULENT FINANCIAL REPORTING: 1987-1997 (COSO, 1999), *available at* www.coso.org/publications/FFR_1987_1997.pdf.

[158] Henry T. C. Hu, *supra* note 156, at A23.

[159] "Shareholders want management to take steps to deter fraud, but they also want management to use the same benefit-cost calculus in determining how much time and money to devote to fraud control that it uses to engage in activities that may enhance profits." *Id.*

[160] *See* JOHN C. BOGLE, BATTLE FOR THE SOUL OF CAPITALISM xviii (2005).

[161] "Not surprisingly, then, companies rarely report earnings that disappoint the omnipotent market." *Id.*

[162] *See supra* note 114 and accompanying text.

[163] Labaton, Stephen, *Crime and Consequences Still Weigh on Corporate World; Four Years Later, Enron's Shadow Lingers as Change Comes Slowly*, N.Y. TIMES, Jan. 5, 2006, at C1.

[164] *See supra* note 116 and accompanying text.

[165] Glenn Rifkin, *Corporate Boards Call on Expertise of Retired Executives*, N.Y. TIMES, Feb. 9, 2006, at C4.

[166] *See* Management's Report on Internal Control Over Financial Reporting, Securities Act Release No. 8238, Exchange Act Release No. 47,986, 68 F.R. 36636 (June 5, 2003).

[167] *See id.*

[168] In fact, most of the commenters on the § 404 rule proposal felt that what was required by the section was patently ambiguous, and that they would need further guidance before they would know specifically how to comply. *Id*.

[169] Anonymous, *COSO Releases Exposure Draft*, PRACTICING CPA, Dec. 1, 2005, at 3.

[170] Floyd Norris, *Moves at S.E.C. to Loosen Rules at Many Companies*, N.Y. TIMES, Dec. 15, 2005, at C14. The committee recommended complete exemption for firms with a market float less than $100 million, and exemption from having their internal controls audited for those with a market float less than $700. *Id.*

[171] *Id.*

[172] *See supra* notes 168-171 and accompanying.

[173] Holme, Roberts & Owen LLP, *At What Cost?*, 17 CORP. GOVERNANCE EXPERT COMMENTARY (2005).

[174] Deborah Solomon, *The Economy: Small Businesses to Get Extension on Sarbanes Rule*, WALL ST. J. ABSTRACTS (USA), Sept. 13, 2005, at A2.

[175] In its cost analysis of § 404, the SEC made two key assumptions: (1) that the cost of complying with the section would decrease dramatically after the first year, and (2) that costs would be proportional to business size. Management's Report on Internal Control Over Financial Reporting, Securities Act Release No. 8238, Exchange Act Release No. 47,986, 68 F.R. 36636, 36655 (June 5, 2003). Neither assumption comports with reality. *See supra* notes 135-136 and accompanying text.

[176] Ellen Rosen, *Not-Giants Seek Relief From Cost of New Audit Rules*, N.Y. TIMES, June 16, 2005, at C6; S.E.C. Securities Act Release No. 8607, Exchange Act Release No. 52,329, *at* 2005 WL 2043761 (August 24, 2005).

[177] Floyd Norris, *Moves at S.E.C. to Loosen Rules on Many Companies*, N.Y. TIMES, Dec. 15, 2005, at C14.

[178] Editorial, *Relief for Small Companies*, Wash. Times, Aug. 17, 2005, at A16.

[179] Molly M. Peterson, *No Major Changes Likely for Sarbanes-Oxley, Hagel Says*, CONGRESS DAILY, Oct. 5, 2005, *available at* 2005 WLNR 16212219.

[180] *See* Holme, Roberts & Owen LLP, *At What Cost?*, 17 CORP. GOVERNANCE EXPERT COMMENTARY (2005).

[181] Management's Report on Internal Control Over Financial Reporting, Securities Act Release No. 8238, Exchange Act Release No. 47,986, 68 F.R. 36636, 36659 (June 5, 2003).