Sarbanes-Oxley and Small Business: Section 404 and the Case for a Small Business Exemption

Joseph A. Castelluccio, III
NOTES

Sarbanes-Oxley and Small Business: Section 404 and the Case for a Small Business Exemption

I. INTRODUCTION

A frantic bull market propelled the stock market to dizzying heights and brought unprecedented paper wealth to a broad cross-section of Americans.¹ A catastrophic stock market collapse followed, wiping out a large percentage of stock investors’ wealth and heralding the start of a recession. Widespread revelations of fraud and deception, both by companies and their financial advisors, wrecked confidence in the capital markets and the economy as a whole. Widespread public outcry and demands for change created a congressional mandate to make drastic changes to the existing system of protections for investors in the stock market.

This story describes two time periods, 70 years apart, that saw tremendous upheaval in the U.S. stock markets and the economy as a whole. Two sets of congressional hearings, 70 years apart, were held in response to widespread public outrage regarding massive losses in the stock markets and pervasive corporate fraud that led to the bankruptcies of some of America’s largest corporations. Two sets of laws, 70 years apart, shaped the federal securities regulations in the United States.

The first set of hearings took place in the 1930s and led to the creation of the federal securities laws,² while the second

---

¹ Arthur M. Louis, Individual Investors Gaining Status, San Francisco Chron., Dec. 28, 1999, at D1 (stating that “[I]ndividuals entered the stock market in great numbers for the first time during the widespread economic prosperity that began in the mid-1920s. The value of stocks owned by individuals swelled to $5 billion in 1929 from less than $2 billion at the start of the decade.”) Similarly, by the end of 1999, more than 50% of U.S. households owned stocks. At that time, those holdings had a total value of approximately $10 trillion. Id.

² Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance 1 (3d
set of hearings in 2001 and 2002 resulted in the most sweeping changes to the federal securities laws since their enactment. Each time, the result was new federal securities rules and regulations that were designed to prevent future fraud and financial losses. The most recent overhaul – the Sarbanes-Oxley Act of 2002 – is the most aggressive and prescriptive securities law in the world today. It not only expands on the existing laws’ underlying philosophy of full and fair disclosure, but goes further to dictate how companies must be organized and what procedures companies must use to ensure compliance. This note will focus on this last type of regulation,

---


4 SELIGMAN, supra note 2, at 2 (stating that the purpose of the hearings was to prevent another stock market crash).


6 See Joel Seligman, A Comment on Accounting and Auditing, 47 ST. LOUIS U. L.J. 967, 969 (2003) (regarding the disclosure requirements and accounting standards of the United States after Sarbanes-Oxley as the most rigorous in the world). See also Bryan Frith, National Australia Bank Faces Big Brother’s Rule Call, THE AUSTRALIAN, Feb. 27, 2004, at 21 (stating that the United States was already the world’s most heavily regulated corporate jurisdiction even before Sarbanes-Oxley added additional regulations and restrictions); Jill P. Giles et al., The PCAOB and Convergence of the Global Auditing and Accounting Profession, THE CPA JOURNAL, Sept. 1, 2004, at 36 (stating that the SEC governs the world’s most heavily regulated market).


which dictates an inflexible standard without regard for the fundamental differences in companies of different sizes.

Congress passed Sarbanes-Oxley in the summer of 2002, in the wake of the financial scandals at Enron\(^9\) and WorldCom.\(^10\) The abbreviated process that spawned this sweeping legislation, however, ignored the potential unintended consequences of the law on small businesses, such as the high relative costs of complying with its new requirements.\(^11\) Sarbanes-Oxley's most problematic provisions apply uniformly to almost all publicly held companies.\(^12\) The

---

\(^9\) Enron began in the 1980s as a traditional energy company but quickly expanded its interests under the guidance of its top executives with investments in such varied projects as a British water business and a Brazilian power distributor. In order to hide these and other questionable investments, Enron used increasingly complex and risky off-balance sheet devices to provide financing and liquidity for its expansion plans while disguising the true amount of debt that the company was carrying. Eventually, the house of cards that Enron had built collapsed under the weight of declining asset values and its own deception. In October 2001, the company announced unexpected quarterly losses and a drastic reduction in shareholder equity. In November 2001, energy concern Dynegy agreed to buy Enron for $9 billion in stock and the assumption of $13 billion of debt. After discovering the extent of Enron's disastrous finances, however, Dynegy walked away from the merger. Four days later, Enron filed the second-largest bankruptcy in United States history. See Richard A. Oppel, Jr. & Riva D. Atlas, *Enron's Collapse: The Overview; Hobbled Enron Tried to Stay on Its Feet*, N.Y. TIMES, Dec. 4, 2001, at C1; Wendy Zellner et al., *The Fall of Enron*, BUS. WK., Dec. 17, 2001, at 30; Alex Berenson & Andrew Ross Sorkin, *Rival to Buy Enron, Top Energy Trader, After Financial Fall*, N.Y. TIMES, Nov. 10, 2001, at A1. For a description of the complex financial maneuvers used by Enron to disguise its true financial condition, see Rebecca Smith & John R. Emshwiller, *Combination of Brilliance, Overconfidence Helped Enron Fly High and Plummet Fast*, WALL ST. J., Nov. 8, 2001, at A1.


\(^11\) See infra notes 217-34 and accompanying text.

law also ignores the special needs and concerns of small publicly held companies in the economy as well as the well-established precedent for creating special provisions in federal regulations for small businesses.\(^{13}\)

This note will argue that the current state of the law does not properly balance two prominent national interests – protection of investors and encouragement of small business growth.\(^{14}\) In doing so, this note will propose a partial small business exemption from Sarbanes-Oxley Section 404, the section which establishes the framework for the mandatory reports on a company’s internal controls that must be prepared by the company’s management and its auditors.\(^{15}\) This proposed small business exemption would be based on the same policies and rationale as Regulation D, a federal securities law exemption that allows some securities offerings to be made without registering with the Securities and Exchange Commission ("SEC").\(^{16}\) Regulation D is a partial exemption that benefits small issuers by permitting them to avoid the substantial costs of registration when selling securities.\(^{17}\) In doing so, Regulation D maintains other limitations on the issuer that prevent fraud and protect


\(^{14}\) 15 U.S.C. § 77b(b) (2005) (stating that the Securities and Exchange Commission endeavors to protect investors and promote efficient capital markets). See also Karmel, supra note 12, at 144 (stating that two important justifications for federal securities regulation are to protect the savings of millions of workers with reasonable safeguards and to promote capital formation by fostering investor confidence).


investors, such as restrictions on the number and type of investors that can buy the securities.\footnote{18} While the proposed exemption in this note differs from Regulation D in that the proposed exemption is based on the size of the company and not the size of the transaction,\footnote{19} both exemptions alleviate some of the costly burden of regulatory compliance on small companies. At the same time, both exemptions also preserve antifraud liability, including liability under the strengthened provisions of the Sarbanes-Oxley Act.\footnote{20} The proposed exemption will allow small companies to access capital for growth while continuing to protect investors and deter corporate fraud.

Part II of this note will describe briefly the Securities Act of 1933\footnote{21} and the Securities Exchange Act of 1934\footnote{22} by explaining the history and circumstances under which they became law. Part III will then define “small business” and describe the role that small businesses play in the American economy. This section will also explain why small businesses have historically received special treatment in federal regulations by analyzing one significant small business exemption – Regulation D of the Securities Act of 1933. Part IV of this note will describe the history and impetus behind the Sarbanes-Oxley Act and compare the environments in which Sarbanes-Oxley and the Securities and Exchange Acts were passed.\footnote{23} Part IV will also examine Section 404’s requirements, document the drastic costs involved with Section 404 compliance, and scrutinize the process that Congress used to create the law. Part V will then argue for a specific exemption from Section 404 for small businesses similar to Regulation D. This exemption is both necessary and feasible because the reasoning and concepts behind other securities law exemptions, including Regulation D, can apply to a Section 404 exemption as well.

\footnote{18} 17 C.F.R. § 230.501(e) (2005).
\footnote{19} See infra Part V.D.
\footnote{23} See William S. Lerach, Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders – The Rise of the New Corporate Kleptocracy, 8 STAN. J. L. BUS. & FIN. 69, 73 n.9 (2002) (“The current climate is regularly compared to the 1930s.”).
II. HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934

The Securities and Exchange Commission was created as a result of two years of hearings by the Senate Banking and Currency Committee to investigate securities dealings and banking practices.24 From 1932 to 1934, these investigations, often referred to as the Pecora Hearings,25 examined the stock exchange practices that were prevalent in the years leading up to the stock market crash of October, 1929.26 Among the revelations uncovered by the Committee was evidence of the enormous financial losses experienced by investors as a result of the market crash. In the decade following World War I, for example, companies in the United States sold $50 billion in new securities.27 The stock market crash rendered $25 billion of them worthless.28 The market effects were not limited to new issues, however. On September 1, 1929 – less than two months before the crash – the aggregate value of all the stocks listed on the New York Stock Exchange was $89 billion.29 Two and a half years later, in 1932, the aggregate figure was down to $15 billion – a loss of over eighty-three percent.30

These and other reports of massive financial losses combined with the crash and the Great Depression to provide

---

24 See S. REP. NO. 73-1455, at 1 (1934); SELIGMAN, supra note 2, at 1.
25 The hearings are named after Ferdinand Pecora, who played an influential role in the hearings as the Committee’s counsel. An Italian immigrant born in Sicily, he eventually became known as the “hellhound of Wall Street.” After a successful career in the office of New York City’s district attorney in which he was credited with the successful prosecution of over 150 fraudulent securities salesmen, he was offered the position of counsel to the Committee in 1933. His political ambitions, however, were not as successful. He failed to become the Democratic nominee for district attorney in 1930, and later ran unsuccessfully as the Democratic nominee for mayor of New York City in 1950. SELIGMAN, supra note 2, at 20-21.
26 Lerach, supra note 23, at 75 (“In the wake of the 1929 Crash, Congress’s Pecora [sic] hearings exposed the rawest kind of self-dealing, abuse and fraud by corporate insiders, Wall Street bankers (coining the term ‘banksters’), and the accounting firms during the 1920s.”).
28 Id.
30 Id. Adjusted for inflation, the $74 billion decline in aggregate market value during that time period is equivalent to a decline of over $1 trillion in 2004 dollars. Figures adjusted for inflation using the Consumer Price Index; CPI statistics obtained from the Bureau of Labor Statistics, available at ftp://ftp.bls.gov/pub/special.requests/cpi/cpiai.txt (last visited Aug. 18, 2005).
the political momentum to enact the federal securities laws. In fact, twice during 1933 the Senate authorized its Committee on Banking and Currency to expand its investigation beyond the original mandate of stock exchange practices to include broad areas of banking and business. During the course of the investigation, prominent members of the financial community testified before the Committee, including the president of the New York Stock Exchange and J.P. Morgan, who at the time was head of the largest private bank in the world. In addition, numerous traders and investment bankers from Wall Street’s most prominent firms described the details of manipulative trading devices such as stock pools and other deceptive practices in commercial and investment banking.

The stated purpose of the investigation was to “lay the foundation for remedial legislation.” In doing so, the Pecora Hearings sought to determine the reasons for the “staggering decreases” in the values of securities and to propose legislation that would prevent another stock market crash. The Hearings had another obvious, yet unstated, purpose as well – to diminish the public’s faith in the nation’s financial institutions. In order to enact effective securities regulation

---

31 JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 3 (4th ed. 2004) (“[I]t was the Great Depression and the market collapse in October 1929 that provided the political momentum for congressional action that would over the course of a decade produce a collection of acts known as the federal securities laws.”).  
32 S. REP. NO. 73-1455, supra note 24, at 2-4 (“The subcommittee has endeavored to investigate thoroughly and impartially some of the complex and manifold ramifications of the business of issuing, offering, and selling securities and the business of banking and extending credit. It has endeavored to expose banking operations and practices deemed detrimental to the public welfare; to reveal unsavory and unethicall methods employed in the floatation and sale of securities; and to disclose devices whereby income-tax liability is avoided or evaded.”).  
33 Id. at 19-29 (excerpted testimony of Richard Whitney).  
34 Id. at 84 (excerpted testimony of J.P. Morgan).  
35 Id. at 5-154. Investment bankers and traders from firms such as Chase Securities Corp, Dillon, Read, & Co., and National City Bank testified before the Committee. See id. at 13, 40, 86. See also SELIGMAN, supra note 2, at 24-38.  
36 S. REP. NO. 73-1455, supra note 24, at 30-31. A stock pool is an agreement between several people to actively trade a stock in order to raise its price so that a profit can be made later by selling their shares at the artificially inflated price to the unsuspecting public. Id. at 31.  
37 Id. at 83-153.  
38 Id. at 4.  
39 SELIGMAN, supra note 2, at 2.  
40 Id.; Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 YALE L.J. 1521, 1592-93 (2005) (stating that the Pecora hearings “were orchestrated to develop an explanation of the market crash as having
on the federal level, the Pecora Hearings sought to “galvanize[]

broad public support for direct federal regulation of the stock

markets.”41 In its reports on the Pecora Hearings, the Senate

Committee indicted the system as a whole by demonstrating

that the system had failed to impose essential fiduciary

standards on persons whose responsibility it was to handle

other people's money.42

Broad public support and political momentum for

sweeping reform resulted in the passage of the Securities Act

in 1933 and the Exchange Act one year later.43 The Securities

Act focuses on disclosure44 and requires corporations to disclose

information about their financial conditions and future

prospects in order to inform investors and allow them to make

educated decisions.45 The Securities Act also requires

registration for securities that are sold to the public in order to

record transactions and facilitate other corporate operations,

such as dividend payments and elections.46 The Exchange Act

established the SEC, regulates broker-dealers and securities

markets, and imposes disclosure requirements on publicly held

companies and proxy solicitations.47 More than any other

securities law, it defines the industry’s regulatory system and

governs how securities are traded.48

Congress gave the SEC the power to create rules and

regulations as the principal securities regulator in the United


41 SELIGMAN, supra note 2, at 2.
42 James M. Landis, The Legislative History of the Securities Act of 1933, 28

43 SELIGMAN, supra note 2, at 54, 75.
44 Choi & Pritchard, supra note 7, at 5 (noting that disclosure is the

"prevailing regulatory strategy in securities markets").
45 DAVID P. McCAFFREY & DAVID W. HART, WALL STREET POLICES ITSELF:

How Securities Firms Manage the Legal Hazards of Competitive Pressures 47
(1998). See also THE SECURITIES AND EXCHANGE COMMISSION (SEC): BACKGROUND,

ISSUES, BIBLIOGRAPHY, at xxv-xxx (Brian J. Wilder ed., 2003) [hereinafter Wilder].
46 McCAFFREY & HART, supra note 45, at 47.
47 See NORMAN POSER, BROKER-DEALER LAW & REGULATION, § 13.01 (2d ed.

2001); McCAFFREY & HART, supra note 45, at 47; Wilder, supra note 45, at xxvii.
48 McCAFFREY & HART, supra note 45, at 47. See also Wilder, supra note 45,
at xxv-xxx.
States, but also placed restrictions on that power. In Section 2 of the Securities Act, Congress dictated that the Commission’s rules must protect investors and promote efficiency, competition, and capital formation. In fulfilling that mandate, the SEC has regularly recognized the importance of small businesses and carved out special provisions designed to address the unique problems they face.

III. THE PRECEDENT FOR SMALL BUSINESS EXEMPTIONS

A. Importance of Small Businesses

Small businesses are the lifeblood of the American economy and the source of most of the economy’s innovation and opportunity. According to the U.S. Census, in 2000 there were approximately 5.6 million small businesses in the United States. During 2000 and 2001, small businesses with fewer

---


51 Id.

52 See infra Part III.


54 Verkuil, supra note 13, at 220 (“Many of our most innovative high technology companies such as those in the microprocessor industry began as small businesses.”). See also William J. Casey, SEC Rules 144 and 146 Revisited, 43 BROOK. L. REV. 571, 572 (1977) (“Almost every new technology that has given a lift to the American economy has come from a new company, struggling in a garage or venturing out to obtain needed capital from the public.”).

than five hundred employees also created virtually all of the net new jobs in the United States.\textsuperscript{56} Overall, the small business sector accounts for more than 50\% of the gross domestic product in the United States.\textsuperscript{57}

Despite their importance, however, small businesses face unique challenges in conforming to federal laws because of their size.\textsuperscript{58} The Small Business Administration has exhaustively documented the unique burdens faced by small businesses in complying with all types of federal regulations.\textsuperscript{59} In response, Congress has passed laws such as the Regulatory Flexibility Act\textsuperscript{60} that recognize the impact that federal regulation has on small business entities\textsuperscript{61} and require regulatory agencies to consider types of exemptions and reduced standards for them.\textsuperscript{62} Regardless of how “small business” is defined,\textsuperscript{63} the exemptions are all based on the common belief that a business’s small size justifies exemption
This belief is not only reflected in laws passed by Congress – there is broad public support for reduced regulation of small businesses as well. 65

In light of the Congressional mandate for regulatory relief for small businesses and in recognition of their importance to the economy, federal securities laws and regulations have traditionally contained special provisions for small businesses as well. 66 In fact, when the Securities Act was originally enacted, it contained an exemption from registration for offerings of $100,000 or less. 67 Congress has also added other exemptions to the Securities Act designed to help small businesses. 68 One specific concern addressed by these and other exemptions is the ability of small businesses to grow by allowing them access to financing and capital. 69 Raising money in the public capital markets can be problematic for small companies in part because of the high relative costs of complying with the federal securities laws. 70 In this context, the SEC has devoted its Office of Small Business to “the analysis of the securities laws’ impact upon small-business capital development.” 71 As a result, the SEC has adopted rules and regulations, including Regulation D, which provide for

---

64 Bradford, Size, supra note 62, at 3.
65 See, e.g., Robert A. Peterson et al., Opinions About Government Regulation of Small Business, 22 J. SMALL BUS. MGMT. 56, 59 (1984) (citing results of a survey which found that a majority of the general public surveyed favored less governmental regulation for small business).
66 Perry E. Wallace, Jr., Integration of Securities Offerings: Obstacles to Capital Formation Remain for Small Businesses, 45 WASH. & LEE L. REV. 935, 935-36 (1988) (stating that small issuers are particularly deserving of relief from unnecessary legal strictures because of the significant economic benefits they confer on American society).
67 Securities Act § 3(b) (codified in Securities Act of 1933, ch. 38, § 3b, 48 Stat. 75 (1933) (current version at 15 U.S.C. §77c (2005))). The threshold for this exemption is currently $5 million.
69 Johnson, supra note 53 (“[T]he Commission and small businesses share an interest in streamlining the capital formation process.”).
70 C. Steven Bradford, Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption, 5 J. SMALL & EMERGING BUS. L. 1, 3-4 (2001) [hereinafter Bradford, Securities] (“[B]ecause of economies of scale in registration, the cost of registering small offerings is disproportionately burdensome, consuming a greater percentage of the offering price than in larger offerings.”).
71 Stuart R. Cohn, The Impact of Securities Laws on Developing Companies: Would the Wright Brothers Have Gotten off the Ground?, 3 J. SMALL & EMERGING BUS. L. 315, 317 (1999). See also Verkuil, supra note 13, at 226 n.73 (stating that the SEC’s Office of Small Business seeks to minimize the negative impact of the Commission’s rules on small business).
certain exemptions to the registration requirements for transactions done by small businesses.\footnote{Cohn, supra note 71, at 317 n.2 (listing several recent rule changes, including reforms to Regulation D of the Securities Act of 1933).}

B. Regulation D

Almost 50 years after the Securities Act was passed,\footnote{Regulation D replaced three earlier exemptive rules. Release No. 33-6389, supra note 16 ("Regulation D replaces exemptions that currently exist under Rules 146, 240, and 242.").} the SEC adopted Regulation D in response to concerns about small businesses’ access to the capital markets.\footnote{Id. ("Regulation D is the product of the Commission’s evaluation of the impact of its rules and regulations on the ability of small businesses to raise capital. This study has revealed a particular concern that the registration requirements and the exemptive scheme of the Securities Act impose disproportionate restraints on small issuers."), See also Tom A. Alberg & Martin E. Lybecker, New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Securities, 74 Colum. L. Rev. 622, 622 (1974) (stating that most small businesses are precluded from raising capital by selling securities to the public due to the high cost of SEC registration); Roy L. Brooks, Small Business Financing Alternatives Under the Securities Act of 1933, 13 U.C. Davis L. Rev. 543, 546 (1980) (stating that the regulatory burden on small business issuers is a significant factor in the high cost of obtaining capital).} For years before Regulation D was enacted, many commentators criticized the regulations and requirements of the federal securities laws because of the comparatively disproportionate costs they imposed on small businesses that attempted to raise capital in the public securities markets.\footnote{Securities Act Release No. 33-5914, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,530 (Mar. 6, 1978) [hereinafter Release No. 33-5914] (acknowledging that calls for action had come from a variety of sources, including “the Small Business Administration, venture capital groups, and a substantial number of professional commentators.”), See Brooks, supra note 74, at 545-46 (stating that small business growth had been stagnant due to the “high cost of long term equity capital”); Lawrence A. Coles, Jr., Has Securities Law Regulation in the Private Capital Markets Become a Deterrent to Capital Growth: A Critical Review, 58 Marq. L. Rev. 395, 462-63 (1975) (arguing that the exemptive scheme was “less useful than intended”).} In response, the SEC held a series of public hearings to examine the special problems faced by small issuers under the federal securities laws,\footnote{Release No. 33-6389, supra note 16; Release No. 33-5914, supra note 75 (stating that the SEC began its evaluation in 1978 with 21 days of hearings in six different cities). See also Rutherford B. Campbell, Jr., The Plight of Small Issuers (And Others) Under Regulation D: Those Nagging Problems That Need Attention, 74 Ky. L.J. 127, 130 (1985) (“[T]he Commission . . . realized that it needed to take a hard look at the special problems of small issuers under the federal securities laws.”).} especially the effects of regulations on small businesses’ access...
to capital. As will be discussed in Part III.C of this note, the economic rationale for Regulation D – like all small offering exemptions – was the high relative cost to small businesses of registering securities.

Regulation D consists of eight rules enacted by the SEC which provide exemptions from the registration requirements for offerings made under the Securities Act of 1933. According to the SEC, Regulation D was designed to accomplish three goals: 1) to simplify and clarify the existing exemption scheme; 2) to eliminate unnecessary restrictions on issuers, and small businesses in particular; and 3) to achieve uniformity between state and federal exemptions “in order to facilitate capital formation consistent with the protection of investors.” Regulation D sets out three separate exemptions in Rules 504, 505, and 506. Rule 504 provides an offering exemption from registration for transactions totaling less than $1 million, provided the issuer meets certain other specified conditions. Rule 505 provides an exemption for offerings up

77 Release No. 33-6389, supra note 16 (“Regulation D is the product of the Commission’s evaluation of the impact of its rules and regulations on the ability of small businesses to raise capital.”); Release No. 33-5914, supra note 75.

78 Bradford, Securities, supra note 70, at 4. Many of the substantial fixed costs directly associated with registering an offering, which can range from $200,000 to $500,000, do not vary with the size of the offering. C. Steven Bradford, Transaction Exemptions in the Securities Act of 1933: An Economic Analysis, 45 EMORY L.J. 591, 603-14 (1996) [hereinafter Bradford, Exemptions] (stating that “for small offerings, the cost of registration is proportionately too great compared to the benefit”). See also notes 102-38 infra and accompanying text.

79 Congress had provided the SEC with specific exemptive authority in §§ 3(b), 4(2), and 4(6) of the Securities Act. See 15 U.S.C. § 77 c(b) (2005); 15 U.S.C. § 77d(2) (2005); 15 U.S.C. § 77d(6) (2005). See also Campbell, supra note 76, at 127 (“Regulation D traces its roots to section 4(2) and section 3(b) of the Securities Act of 1933 . . . .”)

80 Release No. 33-6389, supra note 16. See also Mark F. Donahue, Regulation D: A Primer for the Practitioner, 8 DEL. J. CORP. L. 495, 496 (1983) (“Regulation D is the latest in a series of legislative and administrative efforts to limit the burden otherwise imposed by the 1933 Act on small businesses seeking to raise capital.”).


85 17 C.F.R. § 230.504(b) (2005). In an offering made under Rule 504, general solicitation is permitted in limited circumstances. MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 49 (3d ed. 2001). In addition, the aggregate amount of securities offered under Rule 504 cannot exceed $1 million for any 12 month period. Id.
to $5 million, but imposes more restrictions on the characteristics of the offering than Rule 504. Most importantly, offerings made under Rule 505 are limited in the types and numbers of investors who may participate and, as a result, issuers are required to account for the number and nature of the purchasers of these securities. Rule 506 differs from the other two rules in that it does not set a limit on the size of the transaction. It instead focuses on the number and nature of the investors who participate in the offering to an even greater extent than does Rule 505.

Together, these three rules provide a comprehensive set of exemptions that, while technically available to companies of all sizes, were specifically designed to benefit small companies attempting to obtain financing through a public securities offering. According to the SEC, this design has been effective in practice as well as in theory. In a recent release, the Commission estimated that small businesses continue to be the principal beneficiaries of Regulation D. In

---

88 This restriction is based on the distinction between accredited and unaccredited investors. Accredited investors typically have more wealth at their disposal and are irrebuttably presumed to be sophisticated investors. As a result, they do not require registration-type disclosure from companies making exempt offerings. STEINBERG, supra note 85, at 41. Rule 501(a) lists eight types of accredited investors, among them any individual with a net worth of more than $1 million and any individual with an annual income of more than $200,000 (or, if married, a combined annual income of more than $300,000). While an offering made under Rule 505 cannot be purchased by more than thirty-five unaccredited investors, an unlimited number of accredited investors may participate. 17 C.F.R. § 230.501(a) (2005).
89 Sargent, supra note 17, at 233 (stating that the amount and type of purchasers dictates the type of disclosure that is required).
90 Compare 15 U.S.C. § 77d(2) (2005) (codifying § 4(2) of the Securities Act, which grants authority for exemptions (such as Rule 506) that are not limited by the size of the transaction), with 15 U.S.C. § 77c(b) (2005) (codifying § 3(b) of the Securities Act, which grants authority for exemptions (including Rules 504 and 505) that are restricted to offerings where the aggregate amount does not exceed $5 million).
91 Sargent, supra note 17, at 235. Like Rule 505, Rule 506 allows for a maximum of 35 unaccredited investors to participate in an offering. In addition, Rule 506 also requires that all unaccredited investors meet certain “sophistication standards.” Release No. 33-6389, supra note 16.
92 Sargent, supra note 17, at 236.
93 Donahue, supra note 80, at 496 (“T[he new rules were primarily adopted to facilitate capital growth by small businesses . . . .”)
94 Securities Act Release No. 33-7644, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,114, at 86,114 (Feb. 25, 1999) (“While it is not possible to know with certainty, it is believed that most of these [Regulation D] offerings were done by small businesses.”).
addition, the SEC has reported on the increasing popularity of the exemptions, with over 17,000 Form Ds – the required notice of the sale of unregistered securities under Regulation D – filed in fiscal year 2003.96

While Regulation D provides relief from the registration requirement, it does not allow for complete exemption from the federal securities laws. For example, as with all securities offerings, those made under Regulation D are subject to all the antifraud provisions of the Securities and Exchange Acts.97 Furthermore, there are additional restrictions imposed on offerings made under Regulation D that do not exist in registered offerings which are designed to protect investors.98 For example, Regulation D imposes a ban on general solicitation and advertising for offerings made under Rule 505 or 506.99 Regulation D also sets restrictions on the number and type of investors who may purchase securities in an exempt offering.100 As a result, the limited and specifically targeted exemptions of Regulation D provide their intended relief without undermining the purpose and objectives of the federal securities regulations.101 A similar exemptive scheme will be advocated in Part V.D of this note as an exemption to Sarbanes-Oxley Section 404.

C. Small Businesses and the Need for Regulatory Exemptions

Proponents of small business exemptions from regulation rely on the basic economic tenet that the benefit of a

97 These provisions include Section 17(a) of the Securities Act (15 U.S.C. § 77q (2005)) and Section 10(b) of the Exchange Act (15 U.S.C § 78j (2005)).
98 Bradford, Securities, supra note 70, at 31 (“The choice is not simply between full registration or nothing at all.”).
101 Sargent, supra note 17, at 292 (“Regulation D substantially reduces the costs of compliance for small business issuers without substantially increasing investors’ risk of fraud or overreaching.”). Congress gave the SEC an explicit mandate in Section 2 of the Securities Act, stating that when the Commission creates a rule pursuant to the Act, it must consider whether the rule protects investors and the public interest, as well as promotes efficiency, competition, and capital formation. 15 U.S.C. § 77b (2005). The SEC further acknowledged the need to strike this balance in its final release describing Regulation D, stating that the rules were designed “to facilitate capital formation consistent with the protection of investors.” Release No. 33-6389, supra note 16.
regulation must outweigh its cost. In fact, one commentator has said that any government regulation whose costs exceed its benefits is “senseless.” In the case of small businesses, the relative costs of compliance with federal regulations can be disproportionately high, both in terms of dollars and manpower. This is the result of economies of scale, the idea that the average costs per dollar of proceeds decrease as the size of the company or transaction increases because fixed costs can be spread out. As a result, only larger companies and larger transactions benefit from lower average costs.

Economies of scale are particularly prominent in securities regulations. For example, paperwork and record keeping requirements, such as the number of reports and the time required to complete them, often do not vary with the size of the business. In addition, the costs of interpreting a regulation are often extensive. In many small businesses, the owners or managers perform several different tasks in managing and operating the business. Since the personnel in many small businesses are not specialized, it often falls to

102 Bradford, Securities, supra note 70, at 5 (“[R]egulation is not justified if the cost of the regulation exceeds the benefits it produces.”).

103 Id. at 23 (“[G]overnment regulation is senseless if the cost of the regulation exceeds the benefit. We should not pay a million dollars to prevent a thousand dollar loss.”).

104 See Bradford, Size, supra note 62, at 7-11; Overregulation of Small Business: Hearing Before the Subcomm. on Gov’t Reg. of the S. Select Comm. on Small Bus., 94th Cong. 30 (1976) [hereinafter Hearing on Overregulation of Small Business] (statement of Donald S. Shoup, President, Winnipesaukee Aviation) (“In a small business it is often the owner-manager who must do it [compile and submit the required reports], at the expense of devoting his time and energies to making the business go.”).

105 Bradford, Exemptions, supra note 78, at 614 (“Due to these economies of scale, the total cost of registration increases as the dollar amount of the offering increases, but at a rate less than the rate of increase of the dollar amount.”).


107 “There are scale economies in regulatory compliance if the average cost of complying with regulation – measured by the total cost of complying with regulations divided by firm size . . . decreases with firm size.” William A. Brock & David S. Evans, The Economics of Small Businesses: Their Role and Regulation in the U.S. Economy 65 (1986).

108 Bradford, Size, supra note 62, at 9 (“[T]he cost to compile the necessary information and prepare the required reports . . . is fixed.”).

109 Id. at 8-9 (stating that small businesses are at a disadvantage in monitoring and interpreting complex federal laws and regulations because the costs of doing so can be substantial).

110 See Hearing on Overregulation of Small Business, supra note 104, at 30 (statement of Donald S. Shoup, President, Winnipesaukee Aviation).

111 See Federal Paperwork Requirements: Hearing Before the Subcomm. on Gov’t Reg. and Paperwork of the S. Select Comm. on Small Bus., 96th Cong. 12 (1979)
the owner or manager of the business to ensure compliance with federal regulations, which takes time and energy away from running the business itself. Further, complex regulations that require expert interpretation, such as Sarbanes-Oxley Section 404, must be outsourced to expensive professionals such as lawyers and accountants. On the other hand, large businesses have staff specifically dedicated to regulatory compliance, which allows management to devote its time and efforts to running the business.

In a securities offering, for example, the substantial cost of registering the offering with the SEC consumes a larger percentage of the offering proceeds in a smaller offering than in a larger offering. The costs of registration, which by one estimate can range from $200,000 to $500,000, include fees for legal and accounting work, filing fees paid to the SEC, and printing costs. In addition, this amount does not include the fee paid to the underwriters, which is taken out of the offering price in the form of a discount. Companies can use several types of forms to register offerings, depending on their size and characteristics. Form S-3 is used to register public securities offerings from most large, established companies. Forms SB-

---

113 See Thomas Watterson, Accountants Riding the Sarbanes-Oxley Wave, BOSTON GLOBE, Oct. 10, 2004, at G7 (stating that companies and external auditors need accountants with at least three to five years experience to handle the relatively challenging work related to Sarbanes-Oxley); Bradford, Size, supra note 62, at 8 ("Federal laws and regulations are often complex – as one congressional witness complained, ‘written . . . by lawyers for lawyers.’").
114 Hearing on Overregulation of Small Business, supra note 104, at 30 (statement of Donald S. Shoup, President, Winnipesaukee Aviation) ("In a large business the compiling and submission of required reports is the specific job of certain individuals.").
115 Bradford, Securities, supra note 70, at 24.
116 Bradford, Exemptions, supra note 78, at 603.
117 Bradford, Securities, supra note 70, at 24.
118 Id. at 24-25. The fee received by the underwriter is the difference between the public offering price and the proceeds received by the issuer company. In a hypothetical offering where the offering price is $10 per share, the underwriter would sell shares to the public at $10 share, but only pay the issuer company $9.50 per share, keeping the $0.50 per share difference as a fee.
119 STEINBERG, supra note 85, at 114-15.
120 Id. at 114. Form S-3 is available to companies which have been subject to the reporting requirements of the Exchange Act for 12 months and have a market value of $75 million or more. Form S-3 requires the least disclosure to be presented in
1 and SB-2 are special registration forms provided by the SEC for small business issuers. Small business issuers can use Form SB-1 to register up to $10 million of securities, while Form SB-2 can be used by small business issuers to sell any amount of securities. Finally, Form S-1 is used primarily by first-time issuers for initial public offerings.

The cost and preparation time required for each of these types of forms varies greatly. In a 1998 Securities Act Release, the SEC made its own estimate of the hours of work required by a company’s internal staff and external professionals to prepare a registration statement for a public offering. It found that only 398 hours were required to prepare Form S-3. In contrast, the special registration forms provided by the SEC for small or newly public companies required much more time to prepare. According to the SEC’s estimates, 710 hours were required for Form SB-1 and 876 hours were required to prepare Form SB-2. The most preparation time was required to complete Form S-1, consuming 1,267 hours of internal and external staff time.

the prospectus because it allows companies to incorporate information that has already been disclosed in previous SEC filings. Id. at 114-15.

A small business issuer is a U.S. or Canadian issuer that 1) has annual revenues of less than $25 million, 2) an aggregate market value of less than $25 million, and 3) is not an investment company. 17 C.F.R. § 240.12b-2 (2005). See also STEINBERG, supra note 85, at 115. Forms SB-1 and SB-2 are part of the framework of Regulation SB, which was adopted by the SEC in 1992 to facilitate small businesses’ access to the capital markets. Id.


Release No. 33-7606A, supra note 122, ¶ 81,584; STEINBERG, supra note 85, at 430.

STEINBERG, supra note 85, at 429. Form S-1 is the basic, long-form registration statement and requires full registrant and transaction information to be included in the prospectus. Id.

Release No. 33-7606A, supra note 122, ¶¶ 81,461-63 (proposing rules changes to allow more companies to use the small business forms, thereby reducing the costs of registered offerings for small issuers). The SEC estimated that 75% of the time required to prepare the forms would be used by external professionals, as opposed to internal corporate staff. Id. ¶¶ 81,584-85.

Id. ¶¶ 81,584-85.

Id. ¶ 81,584 (detailing the regulation of securities offerings). The forms used by less seasoned issuers require more disclosure than those used by larger, more established companies. Form S-3, for example, allows companies to incorporate much of the required information by reference to other disclosure documents filed with the SEC, such as quarterly and annual reports. Adoption of Integrated Disclosure System,
Further, in a separate study the SEC’s Advisory Committee on Capital Formation and Regulatory Processes found that the costs per dollar raised were highest in offerings made by companies using Form SB-2 for small business issuers. On a percentage basis, though, the costs were lowest for companies using Form S-3. The Committee concluded that the costs of a registered public offering for small companies and new entrants to the capital markets equal a larger percentage of offering proceeds than for larger and more seasoned issuers. Due to economies of scale, therefore, regulations that impose high fixed costs can be a substantial impediment to the growth and flexibility of small businesses.

Economies of scale do not only apply to the costs of securities transactions, however. The SEC has also recognized that they exist in regulatory and compliance costs as well. During the course of its investigation leading up to the adoption of Regulation D, the SEC acknowledged that “the cost of compliance with Exchange Act reporting requirements is not only substantial in absolute amounts but is relatively greater for smaller companies than for larger issuers.” In adopting Regulation D, the SEC intended it to substantially reduce costs to small business issuers of securities. Additionally, there is significant anecdotal evidence, much of it collected by the SEC itself, regarding the extent of the negative effect of


130 Id.

131 Id. app. A, at 2.

132 Verkuil, supra note 13, at 221 (“Laws and regulations, intended for both large and small firms, are having an increasingly negative effect on the growth of small business. This negative effect occurs in two ways: because small businesses have fewer units of output over which to spread regulatory costs, regulatory costs are higher per unit of output; and small businesses lack requisite size to take advantage of economies of scale in regulatory-compliance, personnel, and data systems.”).


134 Id.

135 Sargent, supra note 17, at 239 (describing the SEC’s intent that “the substantive provisions of the Regulation” would “relieve issuers of substantial costs”).
In recognizing these small business concerns, the SEC has carved out numerous exceptions to its rules and requirements in addition to Regulation D, including exemptions based on the size of the company and those based on the size of the transaction. As will be discussed in Part V of this note, the company size threshold used by other SEC exemptions serves as an appropriate model for an exemption to Sarbanes-Oxley Section 404 that would alleviate the comparatively disproportionate impact which it has on small businesses.

IV. HISTORY OF SARBANES-OXLEY

A. Background

The Sarbanes-Oxley Act instituted the most comprehensive changes to the federal securities laws since they were enacted in the 1930s. The Act strengthened and modernized the laws in response to the financial and accounting scandals of the early twenty-first century, including the financial collapses and bankruptcies of major companies such as Enron and WorldCom, and sought to “enhance the

---

136 Cohn, supra note 71, at 365, 366 n.6 (stating that a common theme revolves around the difficulties faced by small businesses as the result of overregulation and excessive technicalities).


138 See Regulation D, supra note 16.

139 Bush, supra note 3, at 1284 (stating that the Sarbanes-Oxley Act represents “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt”); Manz, supra note 3, at v (describing Sarbanes-Oxley as “the most far-reaching reform of American business practices since the Great Depression”).


141 COX, supra note 31, at 9-10; HAMILTON & RASMUSSEN, supra note 15, at 11 (“Market events evidenced a need to provide investors with a clearer understanding of the processes that surround the preparation and presentation of financial information.”).
quality of reporting and increase investor confidence in the financial markets.”

Enron’s free-fall from grace began with its quarterly earnings announcement in mid-October 2001, in which the company disclosed a large decrease in shareholder equity. In the less than two months that followed, a torrent of bad news, including an earnings restatement, cash shortages, credit downgrades, an SEC investigation and an aborted merger, drove the seventh largest corporation in the United States to file for bankruptcy in December 2001.

In late 2001 and early 2002, Congress held numerous hearings on the collapse of Enron, which at the time was the largest bankruptcy in U.S. history. Various committees in both the Senate and the House of Representatives examined the impact of the Enron scandal on the financial and energy markets, accounting practices, and retirement accounts and pension plans. The House Committee on Financial Services

---

142 Hamilton & Rasmus sen, supra note 15, at 11.


144 Floyd Norris, Does Enron Trust Its New Numbers? It Doesn’t Act Like It, N.Y. TIMES, Nov. 9, 2001, at C1.


146 See William W. Bratton, Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?: Enron and the Dark Side of Shareholder Value, 76 TUL. L. REV. 1275, 1276 (2002) (stating that before Enron filed for bankruptcy protection on December 2, 2001, it had been the seventh largest American firm by market capitalization); Oppel & Atlas, supra note 9. For a description of the complex financial maneuvers used by Enron to disguise its true financial condition, see Smith & Emshwiller, supra note 9.

147 Bankruptcies are measured by pre-bankruptcy total assets. Enron’s pre-bankruptcy total assets of $63.4 billion currently ranks it the second-largest bankruptcy in U.S. history. Enron’s bankruptcy was eclipsed by WorldCom’s $103.9 billion bankruptcy, which was filed on July 21, 2002. Figures from New Generation Research, Inc., at http://www.bankruptcydata.com/Research/15_Largest.htm (last visited Aug. 29, 2005).


introduced the bill that would become Sarbanes-Oxley on February 14, 2002, 152 less than five months after the first hint of trouble at Enron. The Committee approved it after less than two months of hearings. 153 Some of those who testified at the hearings, including the presidents of the Securities Industry Association and the American Institute of Certified Public Accountants, cautioned against legislative overreaction to the Enron scandal that could have unintended negative side effects. 154 Outside of the hearings, other policymakers, including Federal Reserve Board Chairman Alan Greenspan, also recommended legislative restraint for similar reasons. 155 At the time, neither the extent of the financial malfeasance nor the number of companies that would reveal these types of accounting problems was known. 156 The pitfalls of this expedited process were apparent even to the members of the committee, some of whom openly worried that the negative

---

152 See Manz, supra note 3, at ix.
153 Id.
154 See H.R. 3763 – The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002: Hearings Before the House Comm. on Financial Services, 107th Cong. 8-9 (2002) [hereinafter H.R. 3763 Hearings] (statement of Marc E. Lackritz, President, Securities Industry Association) (advocating a “measured response” to the Enron scandal and favoring SEC action over congressional legislation); id. at 14 (statement of James K. Glassman, Resident Fellow, American Enterprise Institute) (“[I]n times of scandal, emotions run high. And the urge to rush in with legislative remedies is understandable, but it should be resisted. Parts of H.R. 3763 [CARTA – Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002] are admirable, but market discipline and current criminal and civil laws provide powerful remedies and protections against another Enron already.”); id. at 17 (statement of Barry C. Melancon, President and CEO, American Institute of Certified Public Accountants) (“[O]ur economy would be better served [by a] more restrained approach because the unintended consequences could be extraordinarily negative.”).


156 WorldCom first restated its earnings on June 25, 2002, almost two months after the first version of the bill had been passed by the House of Representatives and exactly one month before the final version of Sarbanes-Oxley was passed by both houses of Congress. See Richard W. Stevenson, Fed Leaves Interest Rates Unchanged, N.Y. TIMES, June 27, 2002, at C11. WorldCom did not file for bankruptcy until July 21, 2002, only nine days before President Bush signed the bill into law. Jonathan D. Glater, Worldcom Selects 2 For Reorganization Posts, N.Y. TIMES, July 30, 2002, at C12.
consequences of adopting a hasty response could far outweigh any potential benefits.\textsuperscript{157}

Current events, however, pressured Congress to act quickly and decisively. New revelations following just a few months after Enron's bankruptcy about accounting abuses at WorldCom and elsewhere fueled public support for prompt action.\textsuperscript{158} In an election year, no one wanted to appear soft on the issue of corporate fraud.\textsuperscript{159} As a result, the bill passed by a nearly unanimous vote in both the House of Representatives\textsuperscript{160} and the Senate\textsuperscript{161} only seven months after Enron declared bankruptcy.\textsuperscript{162} In the same month it was introduced in both chambers of Congress,\textsuperscript{163} President Bush signed Sarbanes-Oxley into law,\textsuperscript{164} declaring that “[t]he era of low standards and false profits is over. No boardroom in America is above or beyond the law...... No more easy money for corporate criminals, just hard time.”\textsuperscript{165}

Sarbanes-Oxley is a wide-ranging law that contains numerous provisions setting out, for example, the

\begin{flushright}
\textsuperscript{157} H.R. 3763 Hearings, supra note 154, at 30 (statement by Rep. Paul E. Kanjorski, Member, House Comm. on Financial Services) (“[W]e run the risk of passing legislation very quickly, and then getting the unintended response. I understand we are hell-bent on getting this legislation passed by Memorial Day, which is shocking to me, because I do not think we know the extent of the problem here.”). Time would prove Rep. Kanjorski correct. Two of the 10 largest bankruptcies in history were filed after Sarbanes-Oxley was passed. Bankruptcy statistics from New Generation Research, Inc., http://www.bankruptcydata.com/Research/15_Largest.htm (last visited Aug. 29, 2005).

\textsuperscript{158} See Larry E. Ribstein, Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 J. CORP. L. 1, 46 (2002) (“[P]ublic perceptions contribute to this political environment. Revelations of corporate fraud coincided with public anxiety over the economy and populist sentiments condemning the insiders who took great wealth out of now-fallen companies.”); Alex Novarese et al., Under the Long Shadow of Enron, LEGAL WK., Dec. 12, 2002 (reporting that the news of WorldCom’s accounting irregularities in July 2002 weakened Sarbanes-Oxley’s opponents in Congress).

\textsuperscript{159} See Ben Worthen, A Funny Thing Happened on the Way to Compliance (It Got Easier), CIO MAG., Dec. 1, 2003 (“Congress responds to public outrage by passing legislation.”). See also David S. Hilzenrath et al., How Congress Rode a ‘Storm’ to Corporate Reform, WASH. POST, July 28, 2002, at A1. In the House-Senate conference committee, Senator Phil Gramm was the only dissenting voice, stating that “[i]n the environment we’re in, virtually anything could have passed the Congress.” Id.

\textsuperscript{160} The House passed the bill by a vote of 423-3. 148 CONG. REC. H5480 (daily ed. July 25, 2002).


\textsuperscript{163} Id.

\textsuperscript{164} Bush, supra note 3, at 1285.

\textsuperscript{165} Id. at 1284-85.
responsibilities and obligations of a company’s audit committee\textsuperscript{166} and its management,\textsuperscript{167} as well as the structure of the audit committee.\textsuperscript{168} Sarbanes-Oxley also established the Public Company Accounting Oversight Board (“PCAOB”),\textsuperscript{169} which along with the SEC, has prescribed rules for complying with Sarbanes-Oxley.\textsuperscript{170} These other provisions, however, are beyond the scope of this note. The focus of this note is Section 404 and how in its haste to adopt Sarbanes-Oxley, Congress ignored its potentially disproportionate impact on small businesses.\textsuperscript{171} The small business exemption proposed in this note addresses some of the unintended, yet serious consequences of Sarbanes-Oxley Section 404 for small businesses.

\textsuperscript{166} Sarbanes-Oxley § 301 (codified in 15 U.S.C. § 78j-1 (2005)). An audit committee is “a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.” Sarbanes-Oxley § 2(a)(3)(A) (codified in 15 U.S.C. § 7201 (2005)).

\textsuperscript{167} Sarbanes-Oxley § 302 (codified in 15 U.S.C. § 7241 (2005)).

\textsuperscript{168} Sarbanes-Oxley § 407 (codified in 15 U.S.C. § 7265 (2005)). See also Charles Hecht, \textit{The Audit Committee Financial Expert} (July 2003), http://accounting.smartpros.com/x38835.xml (explaining that although section 407 is framed as a disclosure rule, it is a de facto requirement for most boards of directors to have a financial expert on their audit committees).

\textsuperscript{169} Sarbanes-Oxley § 101 (codified in 15 U.S.C. § 7211 (2005)).


\textsuperscript{171} \textit{See infra} Part IV.D.
B. Sarbanes-Oxley Section 404\textsuperscript{172}

Of the many provisions of Sarbanes-Oxley,\textsuperscript{173} Section 404 has proven to be one of the most complicated and expensive for companies to implement.\textsuperscript{174} This relatively short section\textsuperscript{175} is one of the most significant new obligations for companies under Sarbanes-Oxley,\textsuperscript{176} and as will be shown, one of the most problematic as well.\textsuperscript{177}

Specifically, Section 404 requires a company’s annual report\textsuperscript{178} to include an assessment by the management of the effectiveness of the company’s internal control structure and

\begin{flushleft}
\textsuperscript{172} Sarbanes-Oxley Section 404: Management Assessment of Internal Controls:
\begin{flushleft}
(a) Rules Required: The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. § 78m or § 78o(d)) to contain an internal control report, which shall:
\begin{itemize}
  \item[(1)] state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
  \item[(2)] contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
\end{itemize}
\end{flushleft}
\begin{flushleft}
(b) Internal Control and Evaluation: With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.
\end{flushleft}
\end{flushleft}

\textsuperscript{173} See supra notes 166-70 and accompanying text.

\textsuperscript{174} See, e.g., Lyman P.Q. Johnson & Mark A. Sides, The Sarbanes-Oxley Act and Fiduciary Duties, 30 WM. MITCHELL L. REV. 1149, 1184 (2004) (“Section 404’s requirements, particularly the auditor certification requirement, have been and will continue to be very challenging for public companies.”); Andrew Parker, SEC To Consider Rules for Small Companies, FIN. TIMES (LONDON), Dec. 17, 2004, at 27 (“The most expensive provision is Section 404 of the legislation and its stipulation that companies document and test their internal controls against fraud.”).

\textsuperscript{175} Andrew Countryman, Law’s Effects Pile Up on Firms; Sarbanes-Oxley’s Internal-Controls Rules Prove Costly, CHI. TRIB., July 20, 2003, at C1 (“[Section 404 is] a mere 181 words, compared with more than 2,200 on insider trades during blackout periods.”).

\textsuperscript{176} Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002: Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs (Sept. 9, 2003), available at http://www.senate.gov/~banking/files/donaldson.pdf (statement of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission) (“For many companies, the new rules on internal control reports will represent the most significant single requirement associated with the Sarbanes-Oxley Act.”).

\textsuperscript{177} See infra Part IV.C.

\textsuperscript{178} As required by section 13(a) or 15(d) of the Exchange Act (15 U.S.C. § 78m(a)(2) or § 78o(d)(2)(2005)).
procedures. Section 404 also requires the company’s auditor to report on and attest to the management’s assessment of the company’s internal controls. The goal of these two required reports is to provide investors with information to better evaluate the management and financial health of the company and the SEC has adopted rules in order to achieve this purpose.

Internal control is a broad concept that goes beyond the accounting operations of a company and includes procedures and processes in every part of a business. Therefore, a company’s report on its internal controls will not only contain an appraisal of its financial condition, but will include an evaluation of things such as the company’s risk assessment policies and its information and communications systems. In addition, both of the Section 404 reports are very detailed and labor-intensive to prepare. For example, preparation of the report by management on internal controls alone will likely require contributions from multiple parties, including senior management, internal auditors, in-house counsel, outside counsel and audit committee members from the board of directors. These contributions are needed for management to

---


180 Section 404(b), supra note 15. See also 17 C.F.R. § 229.308 (2005); HAMILTON & RASMUSSEN, supra note 15, at 12.

181 HAMILTON & RASMUSSEN, supra note 15, at 12. See also Gorman & Stewart, supra note 140, at 156-57 (2004) (stating that the purpose of this section is to impose a new ethical standard on the securities markets by requiring corporate executives to take responsibility for the financial information published by their companies).


183 HAMILTON & RASMUSSEN, supra note 15, at 17-19. “[T]he scope of internal control extends to policies, plans, procedures, processes, systems, activities, functions, projects, initiatives, and endeavors of all types at all levels of a company.” Id. at 19.

184 Id. at 19.

185 Release No. 33-8238, supra note 179, ¶ 87,706 (“The preparation of the management report on internal control over financial reporting will likely involve multiple parties, including senior management, internal auditors, in-house counsel, outside counsel and audit committee members.”). See also HAMILTON & RASMUSSEN, supra note 15, at 13.
report on such things as the company's framework for internal control and the system used to evaluate it.\textsuperscript{186}

The auditor's report is even more complex because it requires the auditor to render two different opinions.\textsuperscript{187} In order to fulfill its obligation under Section 404, “the auditor must evaluate both management’s process for making its assessment and the effectiveness of internal control over financial reporting.”\textsuperscript{188} Therefore, the in-depth and intricate process of evaluating management must be repeated twice. In addition, Section 404 requires the company to retain two different auditors – one to prepare the internal controls report and another one to prepare the audited financial statements that are required for the company’s annual report.\textsuperscript{189} In order to complete an evaluation of a company’s internal controls, the auditor must examine the company’s financial statements.\textsuperscript{190} Since an auditor is prohibited from auditing its own work in order to maintain its independence, separate auditors must be retained.\textsuperscript{191}

Simply put, preparing an internal control report to comply with Section 404 requires a significant amount of time and labor from many different people in different capacities throughout a business. As a result, it is not surprising that the costs of compliance can be substantial\textsuperscript{192} and due to economies

\textsuperscript{186} According to the SEC, the internal control report must include:
a statement of management’s responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
management’s assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year; a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting; and
a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management’s assessment of the company’s internal control over financial reporting.
Release No. 33-8238, \textit{supra} note 179, ¶ 87,676.
\textsuperscript{187} \textit{HAMILTON & RASMUSSEN, supra} note 15, at 25.
\textsuperscript{188} \textit{Id.} at 20.
\textsuperscript{189} \textit{Id.} at 67 (“Auditors must not audit their own work.”).
\textsuperscript{190} \textit{Id.} at 81 (“Because of the potential significance of the information obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control over financial reporting, the auditor cannot audit internal control over financial reporting without also auditing the financial statements.”).
\textsuperscript{191} \textit{Id.} at 67 (“This prohibition [on auditors auditing their own work] is in keeping with the auditor independence principles of the Sarbanes-Oxley Act and the SEC rules under which auditors impair their independence if they audit their own work . . . .”).
\textsuperscript{192} \textit{See infra} Part IV.C.
of scale, these compliance costs disproportionately impact small businesses. These high relative costs to small businesses are the most serious problem with Section 404 and the most compelling reason for a small business exemption to its requirements.

C. Cost Problems with Sarbanes-Oxley and Section 404

It has been widely acknowledged that Section 404 is the most expensive and challenging aspect of Sarbanes-Oxley. While neither Congress nor the SEC expected that the new law would not cost anything to implement, the tremendous increases in costs that have been seen beg the question of whether the benefits of these regulations justify their costs. Due to economies of scale, the costs of these regulations are especially burdensome for small businesses.

A report on a company’s internal controls under Section 404 amounts to a complete evaluation of a company’s business by both management and the company’s auditors. As many firms have seen, the costs of audit fees as well as the costs of producing information to auditors have increased dramatically. Since the reporting requirements are the same

---

193 See supra Part III.C.
195 HAMILTON & RASMUSSEN, supra note 15, at 12 (stating that Congress originally did not intend the auditor attestation requirements in Section 404(b) to be “the basis for increased charges or fees”); Release No. 33-8238, supra note 179, ¶ 87,706 (“The final rules will increase costs for all reporting companies.”).
196 See, e.g., Cait Murphy, Keeping Small Business off the Street, FORTUNE, Nov. 7, 2003, available at http://www.fortune.com/fortune/print/0,15935,538294,00.html (documenting the burdensome costs of compliance for small businesses).
197 See supra Part III.C.
198 See supra Part IV.B.
199 Ribstein, supra note 158, at 40 (“Post-Enron...regulation directly increases firms’ costs in part by requiring them to spend more to get information. In particular, new auditor regulation significantly increases firms’ audit fees as well as their costs of dealing with and producing information for auditors.”). See also Deborah Solomon & Cassell Bryan-Low, Companies Complain About Cost of Corporate-Governance Rules, WALL ST. J., Feb. 10, 2004, at A1 (describing the costs of Sarbanes-
regardless of size, all companies have to devote significant resources to the effort to conform to Sarbanes-Oxley’s requirements.\textsuperscript{200} Costs incurred by companies to rearrange and disclose their corporate structure can be extremely oppressive, and potentially devastating, for new and smaller companies,\textsuperscript{201} since they often do not have an extensive infrastructure or extra staff to absorb these new and more complex requirements.\textsuperscript{202} Large, established issuers, however, have found it easier to comply with new regulations than smaller or newer firms.\textsuperscript{203}

There have been numerous attempts to document the increased costs of Sarbanes-Oxley compliance to small businesses. One survey, which defined “small business” as companies with less than $100 million in revenue, focused exclusively on Section 404 compliance costs.\textsuperscript{204} This survey found that small companies expected to pay an average of $259,500 in additional audit fees simply for the auditor attestation report required by Section 404(b).\textsuperscript{205} The same study also examined increases in “vendor costs” for small businesses, which include external consulting fees and software charges but do not include the costs of the auditor attestation report.\textsuperscript{206} Small businesses in this survey expected to pay an average of $192,000 for these vendor costs.\textsuperscript{207} In total, this survey found that small companies expected to pay an average of $451,500 in additional compliance costs solely as a result of Section 404.

In addition, the considerable costs incurred by these new regulations are not limited to resources devoted to

\begin{thebibliography}{9}


\bibitem{202} Cook, \textit{supra} note 200, at 1148; Kristina Shevory, \textit{Compliance Efforts Come with Big Accounting Bills}, SEATTLE TIMES, Oct. 3, 2004, at E10 (“Sarbanes-related expenses are rising for smaller companies . . . because they often have tiny accounting staffs that don’t have the time or expertise to deal with the new rules.”).

\bibitem{203} Ribstein, \textit{supra} note 158, at 46.


\bibitem{205} Id.

\bibitem{206} Id.

\bibitem{207} Id.

\end{thebibliography}
compliance.208 While direct costs such as employee and consultant time, expenditures for new technology, and increased auditor fees for internal control testing may be more obvious, indirect costs such as reassigning people and resources away from other, business-specific roles can also weigh on a company with limited resources.209 Furthermore, the rates for directors and officers (“D&O”) insurance210 have skyrocketed due to the increased responsibilities and heightened scrutiny of directors.211 These premiums were estimated by one attorney to have increased “by 100% to 400%, depending on the size of the company.”212 As a result of these drastic increases, it has become more difficult and more expensive to get qualified individuals to serve as directors.213

Overall, one survey of midsize companies found that the average price of being a public company has almost doubled.214 And since these costs are borne by the company itself, these significant additional expenses are passed along to the shareholders in the form of decreased value of their ownership stake in the company.215 Some of these costs, such as setting up a technology infrastructure, will be higher at the beginning of the process and taper off once systems are in place. There are

208 Cook, supra note 200, at 1148.
209 Id.
210 Directors and officers (D&O) insurance provides protection to individual directors and officers from personal liability and financial loss arising out of their capacity as corporate officers and/or directors. See Aon Corp., Directors and Officers Liability Insurance, http://www.aon.com/risk_management/d_and_o.jsp (last visited Aug. 29, 2005).
211 Richard A. Epstein, Sarbanes Overdose, NAT’L L. J., Jan. 27, 2003, at A17 (stating that independence requirements for boards and new heightened disclosure standards have made directors’ duties much more onerous).
212 Greg Farrell, Accounting Costs Rising as Wary Companies Play It Safe, USA TODAY, July 31, 2003, at 2B (citing George Davitt, an attorney with Testa, Hurwitz & Thibeault in Boston). See also Robert Max Crane, Going Private Transactions: A Serious Alternative for Small and Midsized Public Companies, 177 N.J.L.J. 406 (2004) (“Bly all accounts, the costs of directors’ and officers’ insurance has tripled or even quadrupled over the last year.”).
213 Epstein, supra note 211 (“As the duties become more onerous, the willingness of individuals to serve as independent directors decreases . . . . Insurance coverage supplied to these directors now costs more and has higher deductibles and more exclusions.”).
214 Tamara Loomis, Costs of Compliance Soars [sic] After Sarbanes-Oxley, 229 N.Y.L.J. 1 (2003) (citing a Foley & Lardner study which found that the average annual costs of being a public company increased from $1.3 million to $2.5 million in the year after Sarbanes-Oxley became law).
215 Nielsen & Main, supra note 201, at 4.
some significant costs that recur annually, however, such as
the auditor evaluation and attestation.\footnote{See Shevory, supra note 202 ("The expenses won’t end when companies become compliant . . . . Businesses will have to monitor their internal controls every year and devote additional staff or consultant time."); Thomas Watterson, Accountants Riding the Sarbanes-Oxley Wave, BOSTON GLOBE, Oct. 10, 2004, at G7 ("[E]xternal auditors have to go in and test the operational effectiveness of the internal control procedures every year . . . . This work isn’t going to go away.").}

While the disproportionately high costs to small
businesses have been the most significant and well-
documented problem with Section 404, they are not the only
rationale that supports a small business exemption. The
legislative history of Sarbanes-Oxley demonstrates that
Congress did not adequately consider the effects of the new law
on small businesses. As a result, the law’s requirements must
be reconsidered in light of their impact on small businesses.

D. Legislative Problems with Sarbanes-Oxley and Section
404

In the words of one SEC Administrator, “[o]ut of anger,
haste and politics came Sarbanes-Oxley.”\footnote{Tom Fowler, Five Questions with Hal Degenhardt: SEC Regional Office Beefs Up to Fight Corporate ‘Betrayals’, HOUSTON CHRONICLE, Oct. 12, 2004 (Business), at 2 (quoting Hal Degenhardt).} That is not to say
that reform wasn’t necessary, however. While Enron and
WorldCom were the two biggest companies to be engulfed by
scandals, scores of others were forced to restate earnings,
which led to falling stock prices and a crisis of confidence in the
markets.\footnote{Ribstein, supra note 158, at 7 ("Other accounting shenanigans in public corporations include Xerox’s accelerating revenues from long-term equipment leases, Qwest’s and Global Crossing’s manipulation of revenues and expenses on sales and swaps of fiber optic capacity, and apparently rampant looting by the family controlling Adelphia.”).} Making matters worse was the fact that the events
in the financial markets that led up to the summer of 2002
were not unprecedented.\footnote{See supra Part II.} In fact, many of the fraudulent
devices seen during the frenetic bull market of the late 1990s
were simply old schemes labeled with new names. These
collusions included variations on the classic “pump-and-dump” scheme,\footnote{In a “pump-and-dump” scheme, several investors buy shares in thinly
traded companies, fraudulently inflate their price (the “pump”) in order to sell to
the public at an artificial profit (the “dump”). For an example of a modern pump-and-dump
conspiracy, see U.S. v. Benussi, 216 F.Supp. 2d 299, 302 (S.D.N.Y. 2002), aff’d sub nom.} which was reminiscent of the stock pool
schemes of the late 1920s. Furthermore, the seemingly innovative use of special purpose entities ("SPEs") and other off-balance sheet devices by Enron and others bore close resemblance to similar practices during the late 1920s.

While rampant market speculation was not a new phenomenon, the fact that history had repeated itself with such massive and widespread financial fraud at the highest levels of business indicated that some changes needed to be made.

It is widely acknowledged, however, that Sarbanes-Oxley was created, passed and signed at a speed almost unheard of in Washington. In contrast, the Exchange Act

U.S. v. Salmonese, 352 F.3d 608 (2d Cir. 2003) (affirming conviction for conspiracy to commit securities fraud).

S. REP. NO. 73-1455, at 44-45 (1934) (stating that in both cases, manipulation of the trading volume by a small group of active traders was accompanied by dissemination of false and overly optimistic information about the stocks).

A Special Purpose Entity ("SPE") is a "business interest formed solely in order to accomplish some specific task or tasks. A business may utilize a special purpose entity for accounting purposes, but these transactions must still adhere to certain regulations." Investorwords.com, Special Purpose Entity Definition, http://www.investorwords.com/5799/special_purpose_entity.html (last visited Aug. 30, 2005).

See supra note 9.

Ribstein, supra note 158, at 19 ("This is not the first time that widespread financial chicanery has occurred in the context of rampant market speculation. For example, some of the speculation preceding the 1929 Crash has a familiar ring. J.K. Galbraith recounts Goldman Sachs’ launching of a series of ‘exiguous’ trading companies whose assets consisted largely of their own stock, rose sharply with their own value, and fell just as fast.").

See CHARLES MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS (Wordsworth Editions Ltd. 1995) (1841) (describing the rampant speculation that has seized markets specializing in everything from land to tulips throughout history). See also Lerach, supra note 23, at 73 n.8 ("This was not the first speculative bubble. The broadband boom has its match in the railway boom of the late 19th century. The Internet boom resembled the radio boom of the 1920s, when one of the favorite stocks, RCA, went from $1 a share to almost $600 a share in just a few years.").


See supra notes 152-65 and accompanying text. See also H.R. Con. Res. 139, 108th Cong. § 3 (2003), available at http://thomas.loc.gov/home/lawsmade.bysec/lawsnew.txt (explaining that bills are drafted by congressional committees and based on studies and hearings that often last a year or more). Commentators have also noted the unusual speed at which Sarbanes-Oxley became law. See, e.g., Hilzenrath, supra note 159 (stating that the convergence of concerns over the drastic decline in the stock market and the series of admissions of corporate malfeasance by some of the nation’s largest corporations harnessed a “perfect storm” which enabled Sarbanes-Oxley to be ratified by both chambers of Congress in a
was passed two years after the Pecora Hearings had begun to illuminate the fraud and manipulation it sought to remedy.\textsuperscript{228} Since Sarbanes-Oxley’s passage, critics have remarked that because Congress hurried to pass the Act, it was unable to achieve the necessary but delicate balance between the costs and benefits of these reforms.\textsuperscript{229} Specifically, the unique needs and concerns of small businesses were ignored during the abbreviated legislative process.\textsuperscript{230} According to one Congressman, “[s]mall business is one of the areas we could have focused on if we hadn’t been rushed to pass this law.”\textsuperscript{231}

Furthermore, there was an almost complete absence of small business representation during the deliberations on Sarbanes-Oxley. The hearings held by the House Committee on Financial Services and its Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities to solicit testimony on the bill did not include representatives from small business advocacy groups.\textsuperscript{232} This is contrary to hearings held for other significant securities rule proposals by the SEC.\textsuperscript{233} Further, both the prepared testimony of the witnesses and the questions posed to them by the members of the Committee focused on reactions to scandals and ignored the potential undesirable consequences of Sarbanes-Oxley, the most serious of which have been the tremendous relative costs that Section 404 has imposed on small businesses.\textsuperscript{234}

Together, the well-documented and tremendously burdensome costs that Section 404 has imposed on small businesses and the legislative apathy displayed by Congress

\textsuperscript{228} Ribstein, supra note 158, at 47 (“[T]he law Sarbanes-Oxley amends, the Securities and Exchange Act of 1934, was enacted years after the 1929 Crash, following extensive hearings.”).

\textsuperscript{229} Id. (“[T]he hasty adoption of the Sarbanes-Oxley Act in the midst of a stock market crash was even less conducive to careful weighing of costs and benefits than the circumstances surrounding typical legislation . . . . The Sarbanes-Oxley Act, among other things, reversed decisions made in more deliberative settings on such important issues as auditor independence and attorney reporting of fraud.”).

\textsuperscript{230} See Berlau, supra note 8.

\textsuperscript{231} Id. (quoting Rep. Jeff Flake (R-Ariz.)).

\textsuperscript{232} See supra notes 154-57 for examples of committee hearings which did not include representatives from small business.

\textsuperscript{233} The SEC will typically propose a rule in a preliminary release and solicit comments on its proposals before a final rule is adopted. See, e.g., Release No. 33-5914, supra note 75 (proposing rules changes that would become Regulation D); Release No. 33-6389, supra note 16 (adopting final rules for Regulation D).

\textsuperscript{234} See supra Part IV.C.
towards small business in creating Sarbanes-Oxley demonstrate that a targeted small business exemption is necessary for the continued growth and prosperity of small businesses.

V. THE CASE FOR A SMALL BUSINESS EXEMPTION TO SARBANES-OXLEY SECTION 404

Recently, the SEC has publicly acknowledged the serious burdens faced by small businesses in complying with some of Sarbanes-Oxley's requirements and taken preliminary steps to alleviate these burdens. In December 2004, the SEC created a taskforce to examine the effects of Sarbanes-Oxley on smaller public companies. The Securities and Exchange Commission Advisory Committee on Smaller Public Companies (“Advisory Committee”), as the taskforce is known, will also make recommendations on where and how to scale back regulations for companies based on size. In announcing the creation of the Advisory Committee, then-SEC Chairman William Donaldson stated that he wanted to examine Section 404 in particular to see if compliance costs can be reduced for small companies.

Even though the Advisory Committee is not scheduled to make its final report until April 2006, it has already influenced the SEC’s policy regarding Section 404 and small business. In August 2005, the Advisory Committee recommended that the SEC further extend the Section 404 compliance dates for small companies known as “non-accelerated filers,” and the SEC adopted the Advisory Committee’s recommendation without alteration one month...
later. This followed two other similar postponements by the SEC since 2004. The Advisory Committee based its recommendation on hearings, testimony, and comments it had received over the course of its investigation up to that point. In its resolution, the Advisory Committee expressly acknowledged that “[t]he costs of implementing Section 404 have been far more expensive than originally forecasted and these costs are disproportionately larger for small companies.” The Advisory Committee chose not to wait for its final report to advocate this change because “the advisability of implementing these recommendations seemed apparent to the Committee; further study did not seem justified.” As of October 2005, the compliance date for non-accelerated filers stands at July 15, 2007, over two years later than the original deadline set by the SEC for Section 404 compliance.

While the SEC has already created a de facto exemption with its series of postponements, there are several sound reasons for implementing an explicit and permanent small business exemption to Section 404 that the Advisory Committee should examine. First, imposing the same corporate governance restrictions on all public companies, regardless of their size, is illogical and impossible to justify under a cost-benefit analysis. Not only is there a precedent for


243 Id.


245 Release No. 33-8618, supra note 240.

246 Release No. 33-8238, supra note 179, ¶ 86,023 (establishing the original compliance date for non-accelerated filers as April 15, 2005).
creating these types of exemptions, there are provisions currently in Sarbanes-Oxley, such as the accelerated filer provision, which specifically address other small business issues in the federal securities laws. Unfortunately, Congress and the SEC have failed to address the most troublesome requirement of the Act – Section 404 – and the creation of the Advisory Committee is recognition that they have not gone far enough to alleviate the regulatory burden on small businesses.

Second, the immense and disproportionate burden that Section 404 imposes on small companies has restricted their access to capital for growth. This result directly contradicts the statutory mandate of the SEC, which is required to consider the effects of its rules on capital formation. In many cases, Section 404 offers small companies a Hobson’s Choice of accepting the crushing burden of federal securities regulations that could lead to bankruptcy in order to stay public, or a slow, suffocating existence without access to capital for growth. In some cases there is no choice at all because Section 404 reaches beyond the realm of publicly traded companies to influence companies that otherwise would not be affected by the federal securities laws.

Finally, any company that would qualify for the proposed exemption from Section 404 would still be subject to the other provisions of the Sarbanes-Oxley Act, as well as antifraud regulations such as Rule 10b-5. As a result, this proposed exemption would not weaken or have any detrimental effect on the federal securities laws. In fact, this proposed exemption draws on the provisions and policies of several existing exemptions, making it both a pragmatic and effective solution to Section 404’s shortcomings.

---

247 See supra notes 137-38 and accompanying text.
248 See infra Part V.A.
249 Id.
251 See infra Part V.B.
252 17 C.F.R. § 240.10b-5 (2005) (prohibiting the use of manipulative or deceptive devices to defraud by any means of interstate commerce or on any national securities exchange).
A. Precedent for Small Business Exemptions in Sarbanes-Oxley

Even in the current environment of heightened sensitivity to corporate governance issues, the SEC has already adopted rules pursuant to Sarbanes-Oxley that explicitly address the concerns and problems faced by small businesses and provide targeted exemptions to alleviate those burdens. For example, in the wake of Sarbanes-Oxley, the SEC shortened the amount of time that some companies have to file their quarterly and annual reports in order to increase the relevance and timeliness of the information in these reports.253 These companies, which are generally larger and more established, are called “accelerated filers.” In creating this new requirement, the SEC has also created a corresponding exemption for companies with an aggregate market value of less than $75 million.255 These companies still have to file disclosure documents such as quarterly and annual reports, but they do not have to meet the new accelerated deadlines.256 In a release describing these accelerated filing deadlines, the SEC acknowledged that costs would likely increase for companies to comply with the accelerated filer requirements, and as a result, the Commission only imposed the new requirement on more seasoned public companies.257 The facts surrounding the accelerated filer provision support an exemption from Section 404 for small businesses for

253 Release No. 33-8128, supra note 137.
254 17 C.F.R. § 240.12b-2 (2005) (defining “accelerated filer” as “an issuer after it first meets the following conditions as of the end of its fiscal year: (i) The aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer is $75 million or more; (ii) The issuer has been subject to the requirements of Section 13(a) or 15(d) of the Act for a period of at least twelve calendar months; (iii) The issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Act; and (iv) The issuer is not eligible to use Forms 10-KSB and 10-QSB for its annual and quarterly reports.”) (citations omitted).
256 See Release No. 33-8238, supra note 179.
257 Release No. 33-8128, supra note 137 ("Although we believe investors in less large or unseasoned companies may want and benefit from more timely disclosures just as much as investors in larger, listed companies, we are concerned that this may impose undue burden and expense on these companies. Smaller companies are likely to be more sensitive to any increased costs in preparing their reports. These entities may not have the infrastructure and resources available or necessary to prepare their reports on a shorter timeframe. Accordingly, we are only shortening the filing deadlines for companies with a minimum public float or reporting history as proposed.").
two reasons. First, they demonstrate the importance of cost-benefit analysis in the SEC rulemaking process. The Exchange Act explicitly prohibits the SEC from adopting any rule that places an undue burden on competition and requires the SEC to state its cost-benefit justification for its rules. To that end, in its release announcing the accelerated filer rule, the SEC included an extensive section describing the cost-benefit analysis it undertook in creating the rule. The SEC explained that the benefits of the rule, such as more meaningful disclosure to investors, would outweigh the costs of getting information to investors faster. To be consistent, the SEC should also apply this measure of efficiency in evaluating the application of Section 404 to small businesses. As described in Part III.C and IV.C, imposing Section 404 on all companies universally, regardless of their size, fails a cost-benefit test because of economies of scale in the costs of compliance.

Second, the accelerated filer exemption implicitly acknowledges that Sarbanes-Oxley will need to be adjusted for the unique concerns of small businesses. As described in Part IV.D, in Congress’s zeal to combat fraud and provide investors with the best information possible, it largely ignored the disproportionate impact its proposals would have on small businesses. This acknowledgement has been explicitly reinforced by the SEC’s recent formation of the Advisory Committee on Smaller Public Companies.

B. Less Participation by Small Business in the Public Capital Markets

As foreshadowed by one commentator, another side effect of Sarbanes-Oxley has been a trend of small, public companies going private or deregistering to avoid some of

---

259 Release No. 33-8128, supra note 137.
260 See supra Part IV.
261 See supra Part IV.D.
262 See supra Part V; see also Parker, supra note 174; Advisory Committee Release, supra note 235.
263 Ribstein, supra note 158, at 39 (“Moreover, a trend toward going-private transactions could reduce the available investment options. The effect might be exacerbated if going-private transactions were concentrated in particular industries that will have particularly high liability and auditing costs under Sarbanes-Oxley.”).
264 When a company “goes private,” it or a controlling group eliminates all or substantially all of the company’s publicly held shares. This is usually done through a tender offer, exchange offer, reverse stock split or merger. Going private transactions
the more costly requirements of the law.\textsuperscript{266} In the first full year after Sarbanes-Oxley was passed, 198 companies deregistered, while the following year in 2004, another 134 followed suit.\textsuperscript{267} This was a sharp increase over the 67 companies in 2002 and 43 companies in 2001 that deregistered.\textsuperscript{268} Given the law’s intent to restore investors’ confidence in the market and encourage their continued investment, this effect has been ironic.\textsuperscript{269} This trend is important and disturbing because of the importance of the public securities markets to small business growth.\textsuperscript{270}

Being publicly traded enables businesses to grow in two ways.\textsuperscript{271} It not only allows companies to raise capital by selling securities, but also enables them to use their stock as currency to merge with and acquire other companies.\textsuperscript{272} In the past, these substantial benefits outweighed the burden and costs of being a public company. Since the costs of being public have increased so drastically, many businesses have decided that it is not worth the trouble.\textsuperscript{273} As a result, more companies are

\footnotesize
\textsuperscript{265} When a company deregisters or delists, it is no longer required to file various disclosure reports with the SEC or to comply with the SEC rules implementing Sarbanes-Oxley. \textit{Id.}

\textsuperscript{266} See Farrell, \textit{supra} note 212 (citing a Grant Thornton report that found there had been a 26% increase between 2002 and 2003 in companies going private); Peter Loftus, \textit{Delistings Surge After Sarbanes-Oxley, Study Finds}, \textit{WALL ST. J.}, Dec. 16, 2004, at B3 (describing a study of firms that deregistered in 2003 that found “most of the companies that deregistered their shares say they did so to escape the steep costs associated with regulatory filings”).

\textsuperscript{267} Amy Feldman, \textit{What Does Sarbanes-Oxley Mean for Companies That Want to Go Public?}, \textit{INC. MAGAZINE}, Sept. 2005, at 138 (describing a study conducted by the Wharton School at the University of Pennsylvania).

\textsuperscript{268} \textit{Id.}

\textsuperscript{269} Claudia H. Deutsche, \textit{The Higher Price of Staying Public}, \textit{N.Y. TIMES}, Jan. 23, 2005, \S 3 at 5 (stating that while being intended to promote additional corporate transparency, Sarbanes-Oxley is inducing some companies to become less transparent); William D. Holyoak, \textit{Corporate Reform: Can Utah’s Small Public Companies Survive Sarbanes-Oxley?}, \textit{UTAH BUS.}, June 1, 2003, at 42 (“[I]t certainly is ironic that a law born of corruption at some of the country’s largest public companies may end up incapacitating many small-cap companies.”); Ribstein, \textit{supra} note 158, at 39 (stating that a trend toward companies going private “would be ironic in light of the law’s [Sarbanes-Oxley’s] intent to lure investors back into the market”).

\textsuperscript{270} Romano, \textit{supra} note 40, at 1589 (stating that although difficult to quantify, the costs associated with the decrease in financing opportunities for small businesses could be substantial).

\textsuperscript{271} See Crane, \textit{supra} note 212, at 406.

\textsuperscript{272} \textit{Id.}

\textsuperscript{273} Deutsche, \textit{supra} note 269 (stating that some companies would rather use their time and money to grow their businesses than spend it on compliance).
removing themselves from the requirements of being public by deregistering or going private.

The recent trend in companies leaving the public markets has been largely attributed to the new Sarbanes-Oxley requirements, and specifically to Section 404. For example, another study examined the 198 firms that deregistered in 2003 and found that most of them did so because of the extreme costs associated with the regulations. In addition, numerous recent articles have documented anecdotal evidence that small public companies are fleeing the public markets in droves because of stifling compliance costs. As a result of these costs, more and more companies are trading some of their long-term growth potential for short-term solvency.

Furthermore, while Sarbanes-Oxley is the law for most public companies, small businesses do not have to be public companies for Sarbanes-Oxley to affect them. Companies only need to consider the prospect of becoming public for these overly burdensome requirements to chill their plans to seek public financing. While there are no statistics kept on the number of private companies that eschew public financing or why they do so, there has been increasing anecdotal evidence that fewer private companies are considering going public.

---

274 Loftus, supra note 266.


276 Loftus, supra note 266.


278 See Murphy, supra note 196 (documenting the burdensome costs of compliance for small businesses).

279 Amy Feldman, Surviving Sarbanes-Oxley, INC. MAGAZINE, Sept. 2005, at 132 (quoting Mark Jensen, national director of VC services for the San Jose, Calif., office of Deloitte & Touche: “Unless you are a 100% family-owned business and 100% self-financed, you’re going to be impacted by Sarbanes-Oxley.”).

280 See Peter H. Ehrenberg & Anthony O. Pergola, Why Private Companies Should Not Ignore the Sarbanes-Oxley Act, WALL STREET LAW., Dec. 2002, at 12 (stating that private companies that are considering accessing the public markets should consider the costs of complying with Sarbanes-Oxley); Greco, supra note 275 (stating that a company that is thinking about going public or being acquired by a public company may adopt Section 404-type controls).
because of Sarbanes-Oxley compliance costs.\textsuperscript{281} It is also noteworthy that some of the other hurdles that companies would have to overcome in order to sell securities to the public are relatively low. For example, notwithstanding several shareholder-specific requirements, a company need only have $1 million of annual income before taxes and a share price of five dollars in order to list on the NASDAQ National Market,\textsuperscript{282} and the threshold is even lower for the NASDAQ Small Cap Market.\textsuperscript{283}

C. Antifraud Provisions of the Securities Laws Still Apply

As important as what a small business exemption to Section 404 would do is what an exemption would not do. Any small business exemption to Section 404 would not compromise the goals of investor protection and fraud prevention, which are at the heart of Sarbanes-Oxley and all of the federal securities laws.\textsuperscript{284} All exemptions, including Regulation D, require that companies still comply with the antifraud provisions of the federal securities laws,\textsuperscript{285} including Section 17(a) of the Securities Act\textsuperscript{286} and Rule 10b-5,\textsuperscript{287} the chief anti-fraud provision promulgated under the Exchange Act.\textsuperscript{288}

In addition, Sarbanes-Oxley has already increased the deterrent component of the existing antifraud rules by significantly increasing the criminal penalties attached to them. For example, criminal penalties for violations of the Exchange Act, under which Rule 10b-5 is promulgated, have been increased to $5 million in fines and twenty years in prison.

\textsuperscript{281} See, e.g., Murphy, supra note 196.

\textsuperscript{282} NASDAQ Marketplace Rule 4420(a)(1).

\textsuperscript{283} In order to qualify for an initial listing on the NASDAQ Small Cap Market, a company must have net income from continuing operations of at least $750,000 in the latest fiscal year or two of the last three fiscal years. NASDAQ Listing Standards and Fees, March 2005, http://www.nasdaq.com/about/nasdaq_listing_req_fees.pdf.

\textsuperscript{284} STEINBERG, supra note 85, at 1.

\textsuperscript{285} Release No. 33-6389, supra note 16 (discussing Preliminary Note 1, which states that Regulation D does not exempt issuers from the antifraud or civil liability provisions of the federal securities laws); see also Bradford, Exemptions, supra note 78, at 609.


\textsuperscript{287} 17 C.F.R. § 240.10b-5 (2005).

\textsuperscript{288} J. Robert Brown, Jr., The Irrelevance of State Corporate Law in the Governance of Public Companies, 38 U. RICH. L. REV. 317, 318 n.6 (2004) (describing Rule 10b-5 as the “most significant antifraud provision” of the federal securities laws); Robert A. Prentice, The Future of Corporate Disclosure: The Internet, Securities Fraud, and Rule 10b-5, 47 EMORY L.J. 1, 4 (1998) (stating that Rule 10b-5 is the “most significant antifraud securities provision in the world”).
for individuals.\footnote{Sarbanes-Oxley § 1106(1) (codified in 18 U.S.C. § 1513 (2005)).} In addition, any person who knowingly alters or destroys documents in order to obstruct an investigation can be sentenced to up to twenty years in prison.\footnote{Sarbanes-Oxley § 802(a) (codified in 18 U.S.C. § 1519 (2005)).} Furthermore, each incidence of mail and wire fraud is now punishable by up to twenty years in prison as well.\footnote{Sarbanes-Oxley §§ 903(a)-(b) (codified in 18 U.S.C. §§ 1341, 1343 (2005)).} These severe penalties serve as powerful deterrents to securities fraud on their own and operate independently of the management reporting requirement of Section 404.

There is a common sense aspect to this argument as well. The corporate misconduct that was committed at companies like Enron and WorldCom was criminal before Sarbanes-Oxley.\footnote{Karmel, \textit{supra} note 12, at 133 ("The financial misreporting at Enron, Adelphia, WorldCom, and elsewhere was already illegal, indeed criminal.").} If a corporate officer or director had no qualms about violating existing rules against fraud and manipulation, then it is doubtful that simply adding another report to complete would have any more of an effect on his or her behavior.\footnote{Douglas M. Branson, \textit{Enron – When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?}, 48 \textit{Vill. L. Rev.} 989, 1008 (2003) ("Corporate codes of conduct have been around for approximately twenty years. Enron had a code. Codes can serve to raise the level of ethical behavior within an organization, but only if they are taken seriously and enforced.").} On the other hand, the threat of twenty years in prison and a $5 million fine for each incident of securities fraud will serve as a much more powerful deterrent for wrongdoing than the additional reporting requirements of Section 404.\footnote{Andrew Hill, \textit{Scandals Are Nothing New To Wall Street}, \textit{Fin. Times} (LONDON), Aug. 12, 2002, at 32 ("[I]t has taken the threat of criminal litigation to persuade the firms they need to take more radical action than they originally suggested was necessary.").}

\textbf{D. The Proposed Exemption}

For the reasons stated above, a small business exemption to Section 404 must be created in order to protect the continued growth and prosperity of the nation's small businesses. While the Advisory Committee could recommend action by either Congress or the SEC,\footnote{It is not clear if such an exemption can be created by the SEC or if Congress would have to amend the statute. While Section 404 gives the SEC explicit power to make rules regarding the internal control reports that a company must file as part of its annual report, Section 404 does not give the SEC explicit exemptive authority. This is in contrast to other exemptions that are based on explicit statutory} the language of the
release that announced the creation of the Advisory Committee indicates that the SEC presumes to have the power to make these rule changes.\(^{296}\) A complete analysis of the SEC's rulemaking and exemptive authority, however, is beyond the scope of this note.

The main provision of this proposed exemption would allow a company to file its management report on internal controls without the independent auditor's attestation report that is required by Section 404(b). In addition, officers and directors of companies eligible for the exemption would not be subject to the enhanced criminal penalties for filing a false or misleading certification under Section 404.

In order to be eligible for this proposed small business exemption, a company would have to have a public float\(^{297}\) of less than $75 million, as measured on the last day of the company's most recent fiscal year. This size threshold is the same as in the accelerated filer exemption as well as other

---

\(^{296}\) Advisory Committee Release, supra note 235 ("[T]he Commission expects the committee to provide recommendations as to where and how the Commission should draw lines to scale regulatory treatments for companies based on size.") (emphasis added).

\(^{297}\) A company's float is the market value of the company's equity shares outstanding. This number is calculated by multiplying the number of shares outstanding by the market price of the shares. Investorwords.com, Public Float Definition, at http://www.investorwords.com/3936/public_float.html (last visited Aug. 30, 2005).
significant securities regulations, and this consistency will
simplify one aspect of the notoriously complex federal securities
laws. By measuring the company’s float at the end of the
fiscal year, this proposal is also consistent with the standard
established in the accelerated filer provision. In addition, the
SEC has already explained that the public float test serves as a
“reasonable measure of company size and market interest.”
The SEC also established that this threshold, which excludes
nearly half of all publicly traded companies and all the
companies eligible for the SEC’s small business reporting
system from the accelerated filer provision, forms a group of
companies worthy of an exemption based on their size. It is
therefore likely that the SEC would consider this group
deserving of an exemption from the high relative costs of
Section 404 as well.

This proposed exemption would be effective because it
addresses several of the key issues that have plagued small
businesses while continuing to protect investors. First, it
eliminates several significant costs associated with Section 404
compliance. An eligible small company would be able to forego
an additional costly review of its entire business every year by
an independent auditor. Furthermore, by exempting directors
and officers at eligible companies from the harsh penalties
associated with Section 404, D&O insurance providers could
lower premiums on policies for directors and officers of small
companies. As described in Part IV.C, D&O insurance costs
have skyrocketed in response to the new requirements of
Section 404. As a result of this exemption, directors and
officers could obtain the insurance coverage they need without
sacrificing protection or incurring exorbitant premiums.

Second, since many of the federal securities laws would
still apply to these companies, the actual terms of the proposed
provision would more accurately be described as a “partial

Nos. 33-6383 & 33-6964, supra note 128 (describing Form S-3 for registration
statements).

299 This rationale was also cited by the SEC in its adoption of the $75 million
float threshold for the accelerated filer provision. Release No. 33-8128, supra note 137
(“In identifying companies that will be subject to this new requirement, we also
thought it would be appropriate to use a pre-existing threshold to reduce regulatory
complexity.”).

300 Release No. 33-8128, supra note 137, ¶ 86,185.

301 Id. (adopting amendments to the SEC’s rules and forms to accelerate the
filing of quarterly and annual reports under the Exchange Act).

302 Id.
exemption.” As in Regulation D, all the antifraud provisions of the federal securities laws would still apply to a company eligible for this exemption. As stated above, the current rules provide the SEC with powerful antifraud tools and newly enhanced criminal penalties for securities fraud, which are both effective deterrents and adequate punishment for wrongdoers. The proposed exemption would only exempt managers from the enhanced criminal penalties for violations of Section 404, not for securities fraud. Therefore, the SEC’s enforcement capability would not be weakened in any way by this proposal. In addition, under this proposal, companies that fall below the $75 million public float threshold would still be required to submit a management report on internal controls, but the report would not have to be certified by independent auditors. As a result, investors would still receive the standard types of disclosure information from the company’s management, such as audited financial statements.303

Finally, companies eligible for this proposed exemption would still have incentives to create sound, effective corporate governance practices. Doing so would give a company a solid corporate governance foundation and make it easier for that company to eventually comply with Section 404 if and when it outgrows the small business exemption. In addition, even though this proposed exemption would allow a company to remain public without fully complying with Section 404, there is no guarantee that investors will continue to commit capital to a company without proof of its solid financial standing and sound management practices. Since the goal of this proposed exemption is to allow small companies to continue to access the public capital markets, any eligible company that neglected to take its corporate governance responsibilities seriously would violate the spirit and purpose of the exemption, and probably induce a precipitous drop in that company’s stock price. Companies that did effectively use the exemption, however, would benefit by continuing to expand through access to the public capital markets without exorbitant compliance costs strangling their profits and their ability to grow.304

304 Neal L. Wolkoff, Chairman & CEO, American Stock Exchange, Sarbanes-Oxley Is a Curse for Small-Cap Companies, WALL ST. J., Aug. 15, 2005, at A13 (“We need to implement regulations that allow [small companies] to compete, not kill them off with red tape.”).
VI. CONCLUSION

The federal securities laws provide the essential regulatory framework for the financial markets and the economy as a whole. The recent scandals at Enron and elsewhere demonstrate that their protections are needed now as much as ever, and Sarbanes-Oxley has modernized and strengthened those protections for the twenty-first century. That need for protection, however, must be balanced with the objective of promoting economic growth.

Accordingly, the federal securities laws have evolved over the years to include exemptions such as Regulation D to fine-tune securities regulations and alleviate some of the high relative costs to small businesses which result from economies of scale. Currently, there is no provision in the federal securities laws that imposes a more disproportionate burden on small businesses than Sarbanes-Oxley Section 404.

By forming the Advisory Committee on Smaller Public Companies, the SEC has taken an important first step in a much-needed reevaluation of Sarbanes-Oxley and its effects on small businesses. While the Advisory Committee will have to examine the balance between the costs and benefits of the new regulations, it is clear that Section 404 does not strike an appropriate balance between these costs and benefits for small businesses. As a result, a small business exemption from Section 404 is both necessary and long overdue.
The small business exemption proposed in this note addresses some of the main problems with the current state of the law, most importantly the high relative costs to small businesses and their impact on businesses’ access to capital. The proposal is based on the reasoning and concepts behind two existing exemptions and incorporates aspects of both to create a practical and effective exemption that successfully balances the investor protection and capital formation goals of the federal securities laws. This proposal also draws on the effectiveness of other recent corporate governance reforms, including strengthened antifraud laws. These reforms provide an important safety net that would enable this exemption to function effectively while continuing to serve the important policy goals of Sarbanes-Oxley. The positive effects of such an exemption would extend beyond small businesses and have a beneficial impact on the economy as a whole.

Joseph A. Castelluccio III †

† B.A., Georgetown University; J.D. Candidate, 2006, Brooklyn Law School. I would like to thank the editors of the Brooklyn Law Review, especially Megan O’Keefe and Mason Barney, for all their hard work and helpful suggestions. I would also like to thank Prof. Norman Poser, whose advice and guidance were indispensable to my writing efforts. Finally, I want to thank my mother, father, and sister for their unconditional love and support.