BALANCING PUBLIC MARKET BENEFITS AND BURDENS FOR SMALLER COMPANIES POST SARBANES-OXLEY

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Accumulating evidence suggests that several recent regulations enacted by Congress and the SEC, including the Sarbanes-Oxley Act,[1] *have disproportionately burdened smaller public companies in a negative manner, such that many of these companies are exiting the public markets. This Article describes these regulations, reviews their effects, and proposes several options that the SEC might choose to address the imbalance of costs and benefits for small businesses. The simplest option would provide for a waiver or postponement of certain regulations imposed under the Sarbanes-Oxley Act. More significant possible measures include the expansion of the SEC's small business regulatory regime under Regulation S-B,*[2] *and the creation of a securities market for small-business issuers.*

INTRODUCTION

The Securities and Exchange Commission has generally recognized the need to tailor its regulations not only to satisfy investor expectations but also to reduce costs on securities issuers. Ideally, the costs of the SEC's regulatory regime are balanced by its benefits to investors and issuers. However, a series of recent regulations has created an imbalance between these costs and benefits, particularly for small businesses. A few scholars have argued that the Public Company Accounting Reform and Investor Protection Act of 2002[3] (more commonly known as the "Sarbanes-Oxley Act") imposes a dispropor-

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1. Public Company Accounting Reform and Investor Protection Act of 2002, 15 U.S.C. § 7201 (2002) (hereinafter Sarbanes-Oxley Act).

2. 17 C.F.R. §§ 228.10-.702 (2004) (pertaining specifically to small businesses).

3. 15 U.S.C. § 7201.

tionately heavy burden on small businesses.[4] However, two other fairly recent SEC regulations—the application of the Exchange Act to over-the-counter bulletin-board companies (OTCBB) in 1999[5] and the adoption of Regulation Fair Disclosure (Regulation FD) in 2000[6]—have also significantly affected the costs of access to the capital markets for many small companies.[7] As a result, some companies have abandoned the public markets by "going private," while others have "gone dark" by opting for lower-tier, less regulated markets such as the "Pink Sheets"[8] (a quotation service for small or troubled companies).

The OTCBB eligibility rule, Regulation FD, and Sarbanes-Oxley were designed to respond to abuses of investor confidence, whether by fraudsters' exploitation of the lightly regulated "bulletin boards," by preferential treatment of large investors and analysts, or by the fraudulent accounting and gatekeeper failures that characterized the

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4. *See, e.g.*, Ellen Engel et al., *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*, *available at* http://papers.ssrn.com/sol3/ papers.cfm?abstract_id=546626 (Oct. 29, 2004).

5. *See* Self-Regulatory Organizations, National Associations of Securities Dealers, Inc., Relating to Microcap Initiatives-Amendments to NASD Rules 6530 and 6540, Exchange Act Release No. 34-40878, 64 Fed. Reg. 1255 (Jan. 4, 1999) (order granting approval of proposed rule change).

6. Regulation F-D, 17 C.F.R. § 243.100 (2004); *see also* Selective Disclosure and Insider Trading, Exchange Act Release Nos. 33-7881, 34-43154, IC-24599, 17 CFR §§ 240, 243, 249 (Aug. 15, 2000).

7. For the SEC, a small business is a public company with less than $25 million in revenues and $25 million in market capitalization. The Small Business Administration (SBA) generally defines a small business as a company with less than 500 employees. Size definitions vary by industry and may be found at the SBA's Office of Size Standards website, www.sba.gov/size (last visited Feb. 1, 2005). In this Article, I do not use a single-size threshold to describe smaller companies, although I will note that the SEC's definition of a small company in terms of market capitalization is less than a tenth the size of what brokers would call the smallest of small-cap companies. *See* Investopedia.com, *Market Capitalization Defined*, *at* http://www.investopedia.com/articles/basics/03/031703.asp (last visited April 26, 2005).

8. *See* Pink Sheets LLC, *About the Pink Sheets: Revolutionizing the OTC Markets*, *at* http://www.pinksheets.com/about/index.jsp (last visited Mar. 13, 2005).

> The origins of the Pink Sheets go back to 1904, when the National Quotation Bureau began as a paper-based, inter-dealer quotation service linking competing market makers in OTC securities across the country. Since that time, the Pink Sheets and the Yellow Sheets have been the central resource for trading information in OTC stocks and bonds . . . . Today Pink Sheets provides broker/dealers, issuers and investors with electronic and print products and information services designed to improve the transparency of the OTC markets . . . . Pink Sheets is a source of competitive market maker quotations, historical prices and corporate information about OTC issues and issuers.

Id.

Enron and WorldCom debacles. Because the OTCBB eligibility rule imposed the burdens of Exchange Act disclosure on many smaller firms, the privatization of certain firms as a result of the imposition of the OTCBB eligibility rule was probably an expected (if not intended) consequence, since the SEC anticipated that firms with something to hide would prefer to go private rather than provide disclosure. Regulation FD and Sarbanes-Oxley, on the other hand, likely were not expected to have a disproportionate effect on any issuers.[9]

Accumulating evidence suggests that the regulations described herein have disproportionately impacted smaller companies. As a result, the SEC has recently created a panel to examine the effects of Sarbanes-Oxley on small businesses,[10] and the SEC is considering how its regulations might be tailored for companies of different sizes. I attempt here to consider several options that the SEC might choose to address the imbalance of costs and benefits for small businesses. Some of what I propose may properly be called "tailoring," while some options would require significant restructuring of the SEC's regulations and may require congressional action.

The Article proceeds in three parts. Part I describes the costs and benefits of being a public company under the SEC's regulatory regime. Part II describes the OTCBB eligibility rule, Regulation FD, and Sarbanes-Oxley and then discusses how they have added to the regulatory burden on small businesses, such that the costs of being a pubic company often outweigh the benefits. Part III offers several solutions that would provide a better balance between the costs and benefits of being a small public company. The simplest possibility would provide for a waiver or postponement of certain regulations imposed under Sarbanes-Oxley for small businesses.[11] A more sweeping (and likely more effective) measure would involve expanding the scope of the SEC's existing relief, set out in Regulation S-B,[12] to a more significant number of businesses. Finally, the SEC and existing exchanges could consider creating a securities market for small business issuers, comprised of a number of competitive exchanges. The incentive for such a securities market is that it would create a

9. The intent of the SEC is less relevant with respect to Sarbanes-Oxley since Congress dictated the content and scope of much of the SEC's Sarbanes-Oxley rulemaking.

10. *See* SEC Press Release 2004-174, SEC Establishes Advisory Committee to Examine Impact of Sarbanes-Oxley on Smaller Public Companies (Dec. 12, 2004).

11. As described below, the SEC has already done this with respect to some of the more costly regulations. *See infra* Part III.

12. 17 C.F.R. §§ 228.10-702 (2004).

more balanced regulatory structure, while still operating within the self-regulatory organization (SRO) framework through which the SEC oversees larger exchanges such as the NYSE and NASDAQ.

I. BENEFITS AND COSTS OF BEING A PUBLIC COMPANY

Public companies will differ in the costs incurred and benefits obtained as a result of public status because of differences in size, industry and/or other factors. With that qualification, the following are some general descriptions of the costs and benefits of public company status that will serve as a baseline for our consideration of the additional effects brought on by the OTCBB eligibility rule, Regulation FD, and the Sarbanes-Oxley Act.

A. Benefits

Companies obtain benefits both from going public and from *being* public. As discussed below, some of the benefits obtained by going public become less significant or disappear within a short time after the Initial Public Offering (IPO).

1. Liquidity

A primary justification for going public is the creation of liquidity—the ability of stockholders and the company issuing such stock to buy or sell stock easily and without significantly affecting its price.[13] Because many state blue sky and federal securities law restrictions will no longer apply to the sale of the company's securities, the company and its stockholders will be able to sell the securities to a broader array of potential investors. After a short period of time following the offering (the "lock-up" period, which is generally set by contract between the shareholder and the issuer[14]), executives and

13. For example, Google's registration statement indicated that creating investor and employee liquidity was a "significant factor" in its decision to go public. Registration Statement of Google, Inc., filed on Form S-1 with the SEC (Apr. 29, 2004). Of course, the most significant factor in Google's decision was almost surely the fact that they were going to have to file periodic reports under the Exchange Act, despite private company status. Rule 12g-4 of the Exchange Act requires periodic reporting by issuers with over 500 shareholders and $10,000,000 in assets on the last day of each of the issuer's 3 most recent fiscal years. Google stated that "[o]ur growth has reduced some of the advantages of private ownership. By law, certain private companies must report as if they were public companies. The deadline imposed by this requirement accelerated our decision." *Id.*

14. Standard lock-up agreements require shareholders to wait 180 days before disposing of their shares, although some call for a lock-up of a year or more. *See* U.S. Securities and

other employees may begin to sell the stock they have accumulated (subject to restrictions under the securities laws, including insider trading rules). This liquidity benefit will continue throughout the company's existence since directors, executives and employees likely will continue to receive equity compensation.

A public market not only benefits employee-shareholders by providing them an easier means of selling their shares, but it also benefits the company by allowing it to incentivize employees, directors and executives by basing equity compensation on the actual market value of the shares. A liquid public market for a company's shares will also help the company recruit and retain employees and managerial talent, since equity compensation is now regarded as a standard component of executive compensation. On the other hand, companies may find that they may not be able to offer the same upside potential that lured talented employees and executives to the company pre-IPO. Indeed, companies may lose employees and executives who decide to cash out entirely as soon as possible following the IPO.

Liquidity also rewards early investors, such as venture capital firms, which place bets on promising companies in the hope that as many as possible will go public or at least be acquired by other companies for a profit. Along with employees, investors may have many years and several rounds of financing invested in a company, and a public offering allows these investors to cash in on their investment. Note that with a company's executives and other employees, the liquidity benefit that a public market provides these investors may be delayed by contractual agreements restricting the sale of the shares during a lock-up period.

The extent of the liquidity benefit will vary across the market from company to company. While every public company stock enjoys some liquidity, the amount of trading of a company's stock, in terms of trading frequency and number of shares, will depend in large part on the company's market capitalization (the total value of the company's issued and outstanding stock). Thus, a shareholder of Microsoft will have no trouble finding someone to buy his stock, and because of the high liquidity of the stock, the spread between the bid and the ask (the price at which an investor is willing to purchase or sell, respectively) will be tighter, resulting in more efficient share

Exchange Commission, *Initial Public Offerings, Lock-up Agreements*, *at* http://www.sec.gov/answers/lockup.htm (last visited Mar. 13, 2005).

pricing.[15] If a stock is thinly or sporadically traded, or, in the case of a smaller company, there are simply fewer shares available on the market, a shareholder may have difficulty finding a buyer. Thus, the shareholder will generally find a wider bid-ask spread, resulting in less-efficient pricing.[16]

2. *Cash*

An IPO can raise from a few million to more than a billion dollars.[17] In 2004, the average amount raised through an IPO was approximately $190 million,[18] with seven IPOs bringing in over a billion dollars each.[19] The cash from an IPO may be used for any number of corporate priorities, which are generally described in the "Use of Proceeds" section of the issuer's stock prospectus. Such priorities often include acquisitions, expansion of research and development, or operating capital.

3. *Access to Markets*

Once public, the company has the ability to raise additional funds through follow-on stock offerings. A follow-on offering generally is completed on a much shorter timetable than an IPO, in part because through the IPO process, a company must develop relationships with underwriters and accountants who have become well-acquainted with the business.[20] Furthermore, after 12 months, and if the company meets certain requirements, the company may offer shares using an abbreviated registration form (Form S-3).[21] Much of the informa-

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15. *See, e.g.*, Yakov Amihud & Haim Mendelson, *Asset Pricing and the Bid-Ask Spread*, 17 J. FIN. ECON. 223, 246-47 (1986).

16. *Id.* at 240-45.

17. Because of the tremendous costs involved in becoming public and being public, one is more likely to see an IPO of a billion dollars than an IPO of only a few million dollars worth of stock. *See* The Red Herring, *IPO Watch: 2004 in Review: A big year, by the numbers: Google myths debunked, when and why the market recovered, the top IPOs, and the final scorecard*, *at* http://www.redherring.com/Article.aspx?a=11119&hed=IPO%20Watch:%202004%20in%20review (Jan. 6, 2005) (last visited Mar. 13, 2005).

18. *See id.*

19. *Id.* The seven companies that raised at least $1 billion were: Genworth Financial ($2.83 billion); Assurant ($1.76 billion); Semiconductor Mfg International ($1.71 billion); Google ($1.67 billion); Freescale Semiconductor ($1.58 billion); China Netcom Group ($1.03 billion); and Dex Media ($1.01 billion). *Id.*

20. *See* GAIL CLAYTON HUSICK & J. MICHAEL ARRINGTON, THE INITIAL PUBLIC OFFERING: A PRACTICAL GUIDE FOR EXECUTIVES 2 (Bowne & Co. 1998).

21. 17 C.F.R. § 239.13 (2004).

tion in the S-3 may be incorporated by reference to documents filed as exhibits to the Form S-1,[22] which is filed in connection with the IPO.

4. Raising the Profile of the Company

A company that goes public will raise its profile and enhance its credibility. The company will generally receive some publicity from the IPO and will often receive continuing analyst attention,[23] although, as discussed below, smaller companies generally receive less coverage. Furthermore, lenders and suppliers may believe public companies to be better credit risks, and thus may be inclined to offer better contract terms to those companies. Because public companies are often deemed to be more stable, potential customers may be more willing to contract with or purchase goods and services from public companies than private companies. The enhanced credibility and publicity achieved through becoming a public company is often more important than the cash obtained through the IPO.[24]

5. Creating Currency for Acquisitions

Public company stock is often used as merger consideration. Companies will choose to offer stock in lieu of cash since stock-for-stock acquisitions are generally eligible for more favorable tax treatment than cash-for-stock transactions.[25]

6. Disclosure Benefits

While mandatory disclosure undoubtedly imposes significant costs on public companies (as discussed in Part I.B.2 below), it also brings certain benefits. Investors benefit from the mandatory disclosure's role as a commitment device.[26] Without mandatory disclosure requirements, companies would have incentives to withhold or manipulate information, especially when the information reveals poor performance. Mandatory disclosure requires companies to reveal the

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22. *Id.* § 239.11 (2004).

23. Indeed, the more analysts that cover the company, the better for the company. *See* Daniel Bradley et al., *The Quiet Period Goes Out With a Bang*, 58 J. FIN. 1, 33-34 (2003).

24. *See* Elizabeth Demers & Katharina Lewellen, *The Marketing Role of IPOs: Evidence from Internet Stock*, 68 J. FIN. ECON. 413, 435 (2003).

25. *See* 26 U.S.C. § 368 (1999) (Internal Revenue Code provision defining different classes of reorganization by stock or otherwise).

26. *See* Edward B. Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675 (2002).

bad with the good, and is reinforced by penalties for companies providing incomplete, false or misleading information. The SEC's disclosure requirements and enforcement mechanisms act as an assurance to investors and encourage investment in the stock market, a systemic benefit to public companies and investors.

B. Costs/Burdens

Although companies obtain benefits both from going public and from being public, companies also incur costs through both the IPO process and the continuing obligations and expenses associated with maintaining public company status.

1. Preparing for an IPO

An IPO is a costly, time-consuming process, with the majority of direct fees attributable to costs such as printing expenses, investment banking fees, attorneys' fees and the like. Many expenses also result from a company's preparations for the IPO rather than the actual offering process. For example, a public company may need to hire additional personnel and may need to enhance its accounting and other information systems in order to comply with the regulatory burdens of public company status.

2. Regulatory Compliance Costs

Post-IPO, a public company will incur significant costs in complying with the securities laws. The company will have periodic reporting requirements, including the obligation to file quarterly 10-Q reports[27] and annual 10-K reports.[28] The company must also announce through Form 8-K[29] filings certain significant interim events, such as significant acquisitions, the loss of key employees, or even the termination of the company's relationship with a major customer. All of these filings will require significant employee effort (primarily the firm's inside counsel and accountants) and may require extensive and costly outside advice.[30]

Public company insiders and large stockholders will become

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27. 17 C.F.R. § 249.308a (2004).

28. *Id.* § 249.310 (2004).

29. *Id.* § 249.308 (2004).

30. *See, e.g.*, Thomas E. Hartman, *The Cost of Being Public in the Era of Sarbanes-Oxley*, Foley & Lardner LLP 2004, *at* http://www.foley.com/files/tbl_s31Publications/File Upload137/2017/Public%20Study%20Results%20FINAL.doc.pdf (last visited Mar. 13, 2005).

subject to Section 16 reporting requirements under the Exchange Act[31] (which include requirements to report stock trades by company insiders), and company personnel will spend significant time in monitoring compliance with Section 16. More generally, a company will incur costs in creating and managing an insider trading prevention program.[32]

3. *Management Focus*

An offering process requires significant management attention. The IPO process may take six months to two years, and the participation of the chief executive officer (CEO), chief financial officer (CFO) and chief legal officer (CLO) is mandatory throughout the process. Meanwhile, management must also continue to oversee the core business in order for the company to have something of value to sell by the time of the IPO. Even after the IPO, however, the responsibilities of public company status will often distract management focus from the business. Consider, for example, the mandatory annual shareholders' meeting. Management often begins preparing the story or vision it wishes to present at the meeting months in advance. Management will generally meet in planning sessions and drafting sessions, craft speeches, prepare and review financial presentations, and prepare for the customary question-and-answer session with activists and disgruntled shareholders. These activities, while a necessary function for public companies (and perhaps beneficial as an annual diligence exercise), require significant management attention that could be spent in developing the business.

4. *Difficulty in Finding and Retaining Qualified Directors and Officers*

Officers and directors of public companies generally demand and receive higher compensation than those of private companies because of the perceived higher risks of managing a public company as compared to a private one. Even with the allure of top compensation, however, many companies have had difficulty in finding and retaining managerial talent, and even more have reported difficulties in finding

31. 15 U.S.C. § 78(p) (2004).

32. These costs, usually incurred in the form of software purchase and support, can range from a few thousand dollars to over $100,000. *See, e.g.*, Executive Press, *Section 16 Filer Price Comparison Chart*, *at* http://www.section16.net/Filer/price-list.htm (last visited Mar. 13, 2005).

qualified directors.[33] Companies seeking to go public must often replace certain management and directors with candidates possessing public company expertise. Smaller companies seeking to go public may find it difficult to pay the higher risk premiums (in the form of higher cash and equity compensation) demanded by well-qualified officers and directors. In addition, even where a small company offers compensation equal to that of a larger company, the officer or director offered such an amount from a small company may seek the prestige associated with working for a large, well-known company.

5. *Loss of Flexibility in Managing the Affairs of the Company*

A private company may conduct business informally, yet at the same time, restrict the amount of information flowing within and from the company. A public company, on the other hand, must conduct its business formally (especially with respect to matters of corporate governance) and must provide a steady stream of operational information to the public, including its employees, shareholders, and competitors. While the SEC does not require a public company to disclose all sensitive, competitive information, the company will nevertheless be required to disclose (and receive shareholder approval for) many strategic decisions, such as certain significant acquisitions or equity compensation plans.[34]

II. REGULATIONS ADVERSELY AFFECTING SMALL BUSINESSES

As I detail below, Sarbanes-Oxley tipped the cost/benefit balance for many companies, pushing many smaller companies to exit the public markets. However, prior to Sarbanes-Oxley, the cumulative effect of other recent regulations, such as the OTCBB eligibility rule and Regulation FD, had already made public life more difficult for many small companies.

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33. Under new SEC, NYSE and National Association of Security Dealers (NASD) rules, at least one director must be a "financial expert," which, as a practical matter, means finding a director who is or was an accounting professional or a senior corporate officer, such as a CFO or CEO. *See* discussion *infra* Part II.C.6. A recent study of directors serving on publicly-traded companies found that nearly one in three respondents cited difficulty in finding directors for one or more boards on which they serve. *See Board Members Respond to Lasting Impact on Corporate Reforms: Exclusive Results from Survey by Houlihan Lokey and Corporate Board Member*, at http://www.boardmember.com/network/HoulihanCBMresearch.pdf (last visited April 25, 2005).

34. 17 C.F.R. §249.308 (2004).

A. The OTCBB Eligibility Rule

The Over-the-Counter Bulletin Board is an electronic quotation system for small companies not traded or listed on any of the national exchanges, such as the NYSE or the American Stock Exchange (AMEX). The OTCBB provides real-time quotes, last-sale prices, and volume information, and it operates under the aegis of the National Association of Securities Dealers (NASD).[35] The OTCBB currently lists over 3,000 public companies, with an average daily share volume of over $250,000,000.[36]

Prior to the enactment of the OTCBB eligibility rule in January 1999, issuers on the OTCBB did not have to file periodic reports under the Exchange Act if they (1) had never registered securities under the 1933 Act and (2) were below the thresholds specified in Section 12(g) of the 1934 Act.[37] Section 12(g) states that issuers with total assets exceeding $10 million *and* a class of security held by more than 500 owners of record on the last day of the fiscal year must register their securities under the Exchange Act.[38] Note that the ownership limit refers to "owners of record" and not the number of actual shareholders. The number of actual shareholders is typically much higher because many of the shares are often held in "street name" by a broker or clearinghouse (such as Cede & Co.), which, despite the number of shareholders for whom the shares are held, is counted as a single owner.

OTCBB companies are small and typically receive little publicity, and perhaps because of this, OTCBB companies have historically received relatively less attention from the SEC. In the late 1990s, however, the SEC noted a surge in OTCBB securities fraud. The SEC then determined that it should bring small OTCBB companies, including those falling below the size and shareholder limits set out in the Exchange Act, under the same reporting standards applicable to larger public companies. The enactment of the eligibility rule therefore required that all OTCBB companies comply with the periodic re-

35. The OTC Bulletin Board was created in June 1990, in part as a result of the Penny Stock Reform Act of 1990. Pub. L. No. 101-429, 102, 104 Stat. 931, 933-34 (1990). The Penny Stock Reform Act was designed to increase price transparency in the over-the-counter market through the creation of an electronic quotation system. *Id.*

36. *See* OTCBB, *Market Statistics, at* http://www.otcbb.com (last visited Mar. 13, 2005).

37. 15 U.S.C. §78-12(g) (1988).

38. *Id.*

porting requirements of the Exchange Act.[39] Essentially, this means that OTCBB companies must file quarterly reports on Form 10-Q, annual reports on Form 10-K, and current event reports on Form 8-K upon the occurrence of extraordinary corporate events.[40] Thus, these firms went from a requirement of very little disclosure to a requirement of the kind of full disclosure applicable to the largest public companies.

As was likely an anticipated consequence of the rulemaking (but probably not an intended consequence) a large percentage of firms determined that the costs of SEC compliance outweighed the benefits of continued listing on the OTCBB. Nearly 75 percent of OTCBB firms not previously filing with the SEC decided to move to the less regulated "Pink Sheets" market, where firms remain exempt from the Exchange Act requirements so long as they stay below the ownership and asset value thresholds.[41] While these firms were thus able to avoid the Exchange Act's disclosure burdens, a recent study from the Wharton School of Business at the University of Pennsylvania demonstrates that these companies also suffered permanent decreases in liquidity and related decreases in market value.[42] In effect, the OTCBB eligibility rule shut down a kind of incubation chamber for many smaller companies, and arguably did not effectively respond to the problem of OTC fraud since many small companies moved to the less-regulated Pink Sheets markets.

B. Regulation FD

The SEC designed Regulation FD to end the practice of companies providing material information to certain analysts and institutional investors before disclosing the information to the rest of the public.[43] Regulation FD requires that when an issuer intentionally discloses material information, it must do so publicly and not selectively.[44] An issuer must make the required disclosures by filing the information with the SEC or by another method (such as a web cast or

39. Pub. L. No. 101-429, 102, 104 Stat. 931, 933-34 (1990).

40. *Id.*

41. *Id.*

42. *See* Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board*, 39 J. OF ACCT. & ECON. (forthcoming 2005).

43. Release Nos. 33-7881, 34-43154, IC-24599, File No. S7-31-99.

44. 17 C.F.R. § 243.100 (2000).

press release) intended to reach the public on a broad, non-exclusionary basis.[45]

The preservation of investor confidence was a primary reason for the SEC's adoption of Regulation FD.[46] Implicitly, if small investors feel that institutional investors are receiving valuable information before it is publicly available and are thereby profiting at small investors' expense, small investors may be unwilling to invest in the markets. Despite its well-intentioned goal of providing equal access to material public company information, Regulation FD drew heavy criticism. Believing that companies might provide less disclosure because of fear of liability under Regulation FD, opponents argued that Regulation FD would have a chilling effect on company/investor communications and that "information transfer between companies and investors would deteriorate.[47]

A 2004 study by scholars at Wharton validates these concerns.[48] The study results suggest that Regulation FD raised costs for smaller firms by forcing a "significant reallocation of information–producing resources."[49] Many companies could no longer rely on disclosures to analysts as a means of getting important information to the public. The researchers found that "small firms on average lost 17% of their analyst following and big firms increased theirs by 7%, on average."[50] Analyst coverage is a significant benefit of public company status because it brings information about companies to current and potential investors. The study concluded that, as an overall economic effect, the decrease in analyst coverage of small companies has cost those businesses approximately 138 basis points annually.[51] Put in other terms, the difference in analyst coverage accounts for an approximately 1.38 percent difference in the returns on a portfolio of small company stocks versus a portfolio of large company stocks.

The study also found that while large companies are almost twice as likely to make voluntary earnings announcements, small

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45. *See* Selective Disclosure and Insider Trading, Exchange Act Release Nos. 33-7881 (Aug. 15, 2000).

46. *Id.*

47. Armando R. Gomes et al., *SEC Regulation Fair Disclosure, Information, and the Cost of Capital* (July 8, 2004), AFA 2005 Philadelphia Meetings; EFA 2004 Maastricht Meetings Paper No. 4339, *available at* http://ssrn.com/abstract=529162 (last visited Feb. 1, 2005).

48. *Id.*

49. *Id.*

50. *Id.* at 4.

51. *Id.*

companies did not increase their pre-announcements significantly.[52] Thus, although there is equal access to information, generally there is less information to be had from smaller companies.

C. *The Sarbanes-Oxley Act*

The third recent rulemaking that has affected small companies, and perhaps the most significant securities rulemaking since the Exchange Act of 1934, is the Sarbanes-Oxley Act.[53] Sarbanes-Oxley has generated many criticisms from businesses and their lawyers, and of these many complaints, the most frequently and consistently heard is that Sarbanes-Oxley is unduly costly and burdensome given its benefits to shareholders and the general public. As discussed below, many observers also worry that Sarbanes-Oxley restricts risk-taking. Before reviewing the effect of Sarbanes-Oxley, however, a brief description of the scope of its regulations is worthwhile.

Others have described the regulations in greater detail than is needed for our purposes here;[54] I will only sketch the contours of Sarbanes-Oxley, and where appropriate, discuss the underlying rationale for the regulations. I will then turn to Sarbanes-Oxley's effects, particularly as they relate to smaller companies. Many of the effects were anticipated and intended by the SEC, while others were unintended consequences. Unintended effects are only now becoming apparent as SEC regulations are beginning to be implemented, so the debate over the real value of the legislation is becoming focused on actual results rather than theoretical suspicions that commentators expressed prior to the enactment of the regulations.

Sarbanes-Oxley regulates various dimensions of corporate responsibility and accountability. Many of its provisions focus on the actions of certain "gatekeepers," such as a company's outside accountants and lawyers, while others relate to actions by the corporation itself.

1. *Gatekeeper Regulation*

An individual investor may have many reasons for investing in a

52. *Id.* at 12.

53. 15 U.S.C. §§ 7201-7266 (2002).

54. *See, e.g.*, Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. LAW 1 (2002); Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And it Might Just Work)*, 36 CONN. L. REV. 915 (2003).

particular company. Perhaps the investor wants to diversify by investing in a particular sector of the market, views a certain company's stock as undervalued, likes the company's products, or perhaps values the company's policies relating to the environment. Whatever motivation or combination of motivations compels investment, the most common desire among all shareholders is the accretion of share value. To this end, management, as agents of the shareholders, constantly, sometimes aggressively and occasionally recklessly, pursues value-creating opportunities. Gatekeepers such as audit committees, independent auditors, analysts and outside counsel provide a check on management activity, constraining activities that do not serve the basic goal of return on investment or that otherwise serve the interests of management at the expense of shareholders.

So why did gatekeepers fail to prevent frauds such as those orchestrated by the management of Enron, Adelphia, and others?[55] The failure is attributable in part to numerous conflicts of interest between management, shareholders, and the gatekeepers who often tried to serve both. Audit committees were often staffed (and sometimes chaired) by insider directors.[56] "Independent" directors were sometimes not truly independent.[57] Truly independent directors serving on audit committees often did not have the motivation or the institutional support necessary to actively monitor management activities.[58] Meanwhile, lawyers, auditors and analysts were often compromised by their firms' dependency on the fees generated by the services they

55. For a general discussion on the role of gatekeepers in the fall of Enron, *see* John C. Coffee Jr., *Understanding Enron: It's About the Gatekeepers, Stupid*, Columbia Law & Economics Working Paper No. 207, *at* http://ssrn.com/abstract=325240 (July 30, 2002).

56. This was the case at Adelphia, for example, where insider Timothy Rigas served on the audit committee. *See* Adelphia's annual report on Form 10-K, *at* http://sec.freeegar.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?SessionID=Y8GNI6pWOThJUmc&ID=3359737 (last visited Feb. 1, 2005).

57. For example, a number of Enron's directors were found to have not been independent. *See "The Role of the Board of Directors in Enron's Collapse,"* Permanent Subcommittee on Investigations of the Committee on Governmental Affairs of the United States Senate, *available at* http://news.findlaw.com/hdocs/docs/enron/senpsi70802rpt.pdf (July 8, 2002). Generally, a director may not be considered "independent" if he or she (or an immediate family member) has or recently had a material relationship with the company. For a discussion of the specific independence rules for the NYSE and NASDAQ, see *NASD and NYSE Rulemaking: Relating to Corporate Governance, Commission Rel. No. 34-48745 (November 4, 2003), available at* http://www.sec.gov/rules/sro/34-48745.htm (lat visited April 25, 2005).

58. *Id.*

performed for and on behalf of the company.[59] The possibility of erosion of the gatekeeper firms' reputation is no longer a sure deterrent to a firm partner's casual audit or disingenuous opinion letter; the interests of the firm and its employees, partners or members are not always aligned, especially where a particular company is one of only two or three big clients of a given firm employee.

Sarbanes-Oxley attempts to address the problem of gatekeeper failure by limiting or eliminating conflicts of interest and by increasing penalties for ignoring or facilitating illegal activities. The gatekeeper regulations include:

a. Directors and Audit Committees of the Board of Directors.

Audit committees must be composed of independent directors only.[60] The audit committee has discretion over the hiring and oversight of the firm's outside auditors, and it must be provided sufficient funding to compensate such outside auditors.[61] Audit committees also must have at least one member qualified as a "financial expert,"[62] which essentially means that the member must possess the ability to understand the minutiae of financial reporting.

b. Accountants.

A central component of Sarbanes-Oxley was the creation of the Public Company Accounting Oversight Board (PCAOB),[63] which replaced the accounting industry's self-regulatory scheme. The PCAOB operates independently of the industry and falls under the supervision of the SEC.[64] Among other responsibilities, the PCAOB registers, monitors, investigates, and disciplines the activities of public accounting firms.[65]

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59. *See* Coffee, *supra* note 55.

60. 15 U.S.C. § 78j-1(m)(3)(A) (2002). *See also* Disclosure Required by Sections 406 and 407 of Sarbanes-Oxley Act of 2002, Exchange Act Release No. 34,47235 (Jan. 23, 2003).

61. 15 U.S.C. § 78j-1(m)(6) (2002).

62. Management and Certain Security Holders, 17 C.F.R. § 229.401(h)(1)(i)(A) (2004). *See also* Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release, No. 34,47276 (Jan. 29, 2003).

63. 15 U.S.C. § 7211(a).

64. 15 U.S.C. § 7217(a).

65. 15 U.S.C. § 7211(c).

c. Attorneys.

The SEC's rulemaking enlists attorneys (both in-house and outside counsel) in policing issuers.[66] The new SEC rules require attorneys to report evidence of a material violation of securities laws or a breach of fiduciary duty or similar violation by a company "up-the-ladder" within the company, e.g., to the issuer's chief legal officer or to both its chief legal officer and its chief executive officer.[67] If the company's management does not respond appropriately[68] to the evidence, the attorney must report the evidence to the audit committee, another committee of independent directors, or the full board of directors.[69]

66. Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Presentation of an Issuer, 17 C.F.R § 205.1 (2004); *see also* Stephen M. Bainbridge & Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes-Oxley § 307*, MICH. ST. L. REV. (forthcoming), *available at* http://ssrn.com/abstract=434721 (last visited Feb. 1, 2005).

67. Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.3(b) (2004).

68. "Appropriate response" is defined as follows:

[A] response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

(1) That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;

(2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

(3) That the issuer, with the consent of the issuer's board of directors, a committee thereof to whom a report could be made pursuant to §205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

(i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or

(ii) Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.2(b); *see also* Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34,47276 (Jan. 29, 2003).

69. Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.3 (2004).

d. Analysts.

New SEC Regulation Analyst Certification (Regulation AC) requires an analyst to certify in his or her research reports that the views expressed in the research report accurately reflect such research analyst's personal views about the subject securities and issuers.[70] The analyst must also disclose whether part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.[71] If such a connection exists, the statement must include the source, amount, and purpose of such compensation, and further disclose that such compensation may influence the recommendation in the research report.[72]

2. Corporate Governance

Numerous commentators pointed out long before Enron the one-sidedness of the management-director relationship at many companies[73]—in certain egregious cases, directorships appeared to be little more than rubber-stamp positions enjoyed by close associates of management.[74] Sarbanes-Oxley, therefore, imposed numerous restrictions on governance practices which have historically been the province of states,[75] and, to some degree, the stock exchanges.

Some of these governance restrictions are packaged as disclosure rules.[76] For instance, a company must disclose the name of its audit committee financial expert, and if the company does not have an audit committee financial expert, it must explain why it does not.[77] Since almost all companies have disclosed or will disclose that they have an audit committee financial expert,[78] meeting this governance standard

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70. Regulation AC—Analyst Certification, 17 C.F.R. § 242.501(a)(5) (2004); *see also* 15 U.S.C. § 78d-3-78j-1 (2002).

71. 17 C.F.R. § 242.501(a)(2)(ii)(A).

72. 17 C.F.R. § 242.501(a)(2)(ii)(B)-(C).

73. *See, e.g.*, MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 10 (Princeton University Press 1994).

74. *See, e.g.*, Robert Frank & Elena Cherney, *Lord Black's Board: A-List Cast Played Acquiescent Role*, WALL ST. J., Sept. 27, 2004, at A1 (giving a recent example of this sort of governance failure).

75. *See* Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26 REGULATION 1, 26-31 (2003) (critiquing federal encroachment on corporate governance matters).

76. 17 C.F.R. 229.401.

77. *Id.*

78. See, e.g., Deloitte & Touche, Audit Committee Financial Expert Designation and Disclosure Practices Survey, available at http://www.deloitte.com/dtt/article/0,2297,sid%

will likely not positively affect the company's stock price. On the other hand, the failure to meet this standard is likely to negatively affect a company's stock price, since the failure to recruit an audit committee financial expert may signal that management has something to hide. Such a disclosure requirement is functionally a stealth governance regulation, although, in form, the SEC stays within its traditional bounds of disclosure regulation. A similar stealth governance regulation is found in the requirement that a firm disclose its code of ethics for financial officers.[79] If a company does not have a code of ethics in place, it must disclose why it does not;[80] the threat of punishment by the market if a code of ethics is not in place will presumably compel every company to create such a code.

Sarbanes-Oxley provides for other direct governance regulations. Section 13(k) of the Exchange Act (enacted by Section 402 of Sarbanes-Oxley) makes it unlawful for a public company to loan funds or extend credit to directors or executive officers.[81] Under Section 304 of Sarbanes-Oxley, if a public company is required to restate earnings as a result of noncompliance with any of the securities laws because of misconduct, the CEO and CFO must reimburse the company for (1) any bonus or equity-based compensation received or (2) any profits from a sale of company securities, during the 12 months following the filing of the restated financial statements.[82] Sarbanes-Oxley also prohibits trades by insiders during pension plan "black-out" periods.[83]

3. *Disclosure Regulation*

Sarbanes-Oxley requires disclosure of off-balance sheet transactions[84] and requires issuers to disclose on a "rapid and current basis"

253D5601%2526cid%253D29064,00.html (Nov. 2003).

79. Item 406 of Regulation S-K.

80. *Id.*

81. § 78m(k).

82. § 7243(a)(1)-(2).

83. More specifically, Sarbanes-Oxley prohibits directors and executive officers of a public company from selling or transferring company stock (if it was acquired through their service with the company) during a "black-out period." General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240 (2004). A black-out period is defined as a period of more than three consecutive business days in which at least 50% of the participants in the company's participant-directed defined contribution plans cannot sell or otherwise transfer their company stock held under the plans. Regulation Blackout Trading Restriction, 17 C.F.R. § 245 (2004). *See also* Insider Trades During Pension Fund Blackout Periods, Exchange Act Release No. 34,47225 (Jan. 22, 2003).

84. § 7261(c)(1)(A); *see also* Exchange Act Release No. 34-47264 (Jan. 27, 2003). The

material changes in their financial condition or operations.[85] This latter requirement is largely accomplished through the expanded Form 8-K disclosure requirements.[86] Almost all companies must also disclose their contractual obligations in a tabular form, including all leases, debt and many purchase obligations.[87]

4. *Enhanced Enforcement*

Finally, Sarbanes-Oxley enhances the SEC's enforcement powers. As noted above, the SEC may require forfeiture of certain equity profits and compensation in the event of a restatement of the company's financial results.[88] Professionals appearing before the SEC are subject to SEC discipline in the event of "improper conduct."[89] Criminal sanctions await CEOs and CFOs who violate the certifica-

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definition of "off-balance sheet arrangement" includes any contractual arrangement to which an unconsolidated entity is a party, under which the registrant has any obligation under certain guarantee contracts; a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets; any obligation under certain derivative instruments; or any obligation under a material variable interest held by the registrant in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the registrant, or engages in leasing, hedging or research and development services with the registrant. *Id.*

85. 15 U.S.C. § 7261(c)(1)(A).

86. Among the new requirements on Form 8-K, issuers must disclose the following: the entry into a material agreement not made in the ordinary course of business; termination of a material agreement not made in the ordinary course of business; termination or reduction of a business relationship with a customer that constitutes a specified amount of the company's revenues; creation of a direct or contingent financial obligation that is material to the company; events triggering a direct or contingent financial obligation that is material to the company, including any default or acceleration of an obligation; exit activities including material write-offs and restructuring charges; any material impairment; a change in a rating agency decision, issuance of a credit watch or change in a company outlook; movement of the company's securities from one exchange or quotation system to another, delisting of the company's securities from an exchange or quotation system, or a notice that a company does not comply with a listing standard; conclusion or notice that security holders no longer should rely on the company's previously issued financial statements or a related audit report; and any material limitation, restriction or prohibition, including the beginning and end of lock-out periods, regarding the company's employee benefit, retirement and stock ownership plans. *See generally* 17 C.F.R. §§ 228, 229, 240, 249; Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Exchange Act Release No. 34-46084 (June 17, 2002).

87. Disclosure In Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Release No. 33-8182 (Jan. 28, 2003). The contractual obligations table is intended to enhance the ability of investors to evaluate cash-flow requirements arising out of the issuer's outstanding contracts, including debt, leases, and purchase obligations.

88. 15 U.S.C. § 7243.

89. 15 U.S.C. § 78d-3(a)(2).

tion requirements with respect to financial reporting. [90] As a response to the actions of Enron and Arthur Anderson, Sarbanes-Oxley also imposes criminal penalties of up to 20 years imprisonment and fines of up to $10 million for anyone who "knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States."[91]

5. *Direct Costs Imposed by Sarbanes-Oxley*

As expected, most of the regulations described above resulted in additional costs to public companies. Some regulations, however, have proven to be much more costly, in both time and money, than the SEC originally anticipated.[92] The following discussion provides examples of such costs.

a. *Additional Burdens on Directors*

One of the primary results of Sarbanes-Oxley is an increase in the supervisory responsibilities of directors, and especially independent directors. The standard rationale justifying this increase, which a number of scholars question,[93] is that independent directors are more reliable stewards than management or "interested" directors.[94] Following from this rationale is the decision to tighten the rules on director independence, which was primarily accomplished through revised NYSE[95] and NASDAQ[96] listing standards. The new listing standards for both markets provide a requirement that a majority of directors be independent, enhance independence standards for directors (height-

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90. 15 U.S.C. § 1350 (c).

91. 15 U.S.C. § 802.

92. The SEC originally believed that the internal controls requirement would take only five additional hours of company time. *See* Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 34-46701 (Oct. 22, 2002).

93. *See*, Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, UCLA School of Law, Research Paper No. 02-15 (June 2002), *available at* http://ssrn.com/abstract=317121 (last visited Mar. 10, 2005); *see also* April Klein, *Firm Performance and Board Committee Structure*, 41 J. L. & ECON. 275 (1998).

94. *Id.*

95. *NYSE Listed Company Manual*, § 303A.00, *available at* http://www.nyse.com/Frameset.html?displayPage=/listed/1022221393251.html (last modified Nov. 3, 2004).

96. NASDAQ standards are codified in NASD Rules 4200 and 4350, *available at* http://nasd.complinet.com/nasd/display/index.html (last visited Mar. 10, 2005).

ened even further for independent directors serving on audit committees, one of which must be a "financial expert"[97]), and expand duties for directors serving on audit, nominating, or compensation committees.[98]

As a result of these added responsibilities and independence requirements, some companies have had difficulty in finding willing, qualified directors (which, as noted above, was already somewhat difficult). Increased responsibilities bring increased workload for directors. Audit committee directors, particularly, should be, and have been, meeting more often.[99] Director compensation (generally handled on a per-meeting basis) and reimbursement of travel expenses is likely to disproportionately affect smaller companies. Directors' and officers' insurance costs have risen 100-400 percent, depending on the size of the company.[100] Also, as noted in a recent study by scholars at the University of Georgia,[101] director cash compensation has risen substantially, especially for small firms. While directors' compensation has risen only slightly for large companies post-Sarbanes-Oxley, from 13 cents per $1,000 in sales in 1998 to 15 cents per $1,000 in sales in 2004, small firms' costs have gone up significantly—small firms paid $5.91 to non-employee directors per $1,000 in sales in 1998, versus $9.76 per $1,000 in sales in 2004.[102] Overall, the authors find that the evidence they reviewed is "consistent with the notion that SOX has imposed disproportionate burdens on small

97. The SEC rules does not require companies to have an audit committee financial expert, but companies that do not have one must disclose that and explain why they do not. *See* 17 C.F.R. § 229.401(h) (2004).

98. *NYSE Listed Company Manual*, § 303A.00, *available at* http://www.nyse.com/Frameset.html?displayPage=/listed/1022221393251.html (last modified Nov. 3, 2004); NASD Rules 4200 and 4350, *available at* http://nasd.complinet.com/nasd/display/index.html (last visited Mar. 10, 2005).

99. *See* Deloitte & Touche *Audit Committee and Governance Survey Results*, *available at* http://www.deloitte.com/dtt/cda/doc/content/ACgovernSurvey_sc.pdf (Apr. 2003).

100. Jo Lynne Koehn & Stephen C. Del Vecchio, *Ripple Effects of the Sarbanes-Oxley Act*, 74 CPA J. 36, *available at* http://www.nysscpa.org/cpajournal /2004/204/essentials/p36.htm (last visited Mar. 10, 2005). Note that director and officer (D&O) costs are not wholly attributable to increasing liability (which roughly correlates with increasing responsibility) under Sarbanes-Oxley; D&O costs began to rise as a result of Enron. *See, e.g.*, Christopher Oster, *Insurers Expected to Try to Deny WorldCom Officers' Coverage*, WALL ST. J., July 1, 2002, at C14.

101. James S. Linck, Jeffry M. Netter & Tina Yang, *Effects and Unintended Consequences of the Sarbanes-Oxley Act on Corporate Boards*, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=687496 (last visited April 25, 2005).

102. *Id.* at 4.

firms."[103]

b. Additional Disclosure Requirements

Sarbanes-Oxley mandated new disclosure requirements, and mandatory certifications by the CEO and CFO with respect to the company's periodic reports build in an additional enforcement mechanism with respect to those disclosure requirements. Companies must now also disclose material off-balance sheet transactions and the use of non-GAAP financial measures.[104] Most controversial, however, is the requirement of an annual management report on, and audit of, the company's internal control over financial reporting.[105] The SEC added a related requirement that companies maintain disclosure controls and procedures, which essentially requires that management analyze whether the company's internal controls are "designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under Sarbanes-Oxley is recorded, processed, summarized and reported within the time period specified in the Commission's rules and forms."[106] Creating a reliable, robust internal control environment often requires significant outside advice from accountants, attorneys and other consultants, and the advice naturally comes at significant cost. The internal and disclosure controls requirements are probably the most costly (and thus, the most controversial) aspect of Sarbanes-Oxley.

Financial Executives International conducted a survey of public companies in July 2004 to assess implementation costs.[107] The end result is that all companies are going to have to pay significant amounts to comply with the internal controls requirement.[108] However, if we analyze the survey data by company size, it becomes clear that small companies pay a proportionately higher price. For compa-

103. *Id.*

104. *See* Securities Exchange Act of 1934 § 13(j) (adopted pursuant to Section 401(a) of the Sarbanes-Oxley Act). Non-GAAP financial measures include "financial information that is calculated and presented on the basis of methodologies other than in accordance with generally accepted accounting principles (GAAP)." Conditions for Use of Non-GAAP Financial Measures, Exchange Act Release No. 34-47226 (Jan. 22, 2003).

105. 17 C.F.R. § 229.308 (2004) (adopted pursuant to Section 404 of the Sarbanes-Oxley Act).

106. *See* Securities Exchange Act of 1934, Rule 13a-15.

107. *FEI Survey on Sarbanes-Oxley Section 404 Implementation, available at* http://www.fei.org/files/spacer.cfm?file_id=780 (last visited Mar. 10, 2005).

108. *Id.*

nies with less than $100,000,000 in revenues, vendor costs (for things like software and related consulting services) will cost an average of $192,000, roughly 400 percent the cost to the largest public companies as a proportion of their revenues.[109] These smaller companies estimate they will require an average of 837 hours of external support from accountants and lawyers, proportionately about 385 percent of the time required by the largest public companies.[110] The smaller companies estimate compliance will require over 2,000 hours from internal staff, proportionately about 150 percent of the time required by the largest public companies.[111] Finally, the auditor's report that companies must file with their periodic report will cost smaller companies an average of $259,500, nearly 650 percent of the cost to the largest public companies as a proportion of revenues.[112]

More importantly, however, the internal controls requirements have caused some small company managers to shift labor expenditures from revenue-developing employees, such as engineers, to monitors, such as lawyers and accountants.[113] Even if the labor costs for the accountants and lawyers equate to the cost for engineers, the opportunity costs will likely be significant, though difficult to quantify.

6. *Unintended Costs of Sarbanes-Oxley*

While the effects described above were largely intended or at least anticipated, a number of unintended effects have surfaced. Some effects are relatively minor; others have considerable ramifications. The following discusses a number of unintended effects of Sarbanes-Oxley.

a. *Increased Record-Keeping Burdens*

Prior to Sarbanes-Oxley, a charge of obstruction of justice by destruction of evidence required the government to show that an individual destroyed the evidence with knowledge that the evidence was

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109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

113. For example, the CEO of Agile Software had to lay off 11 engineers so that the company could afford to hire 11 accountants and lawyers. "This is requiring a level of bureaucracy and control that far exceeds any amount of reasonableness and return of cost." Deborah Lohse, *Crackdown on Books Strains Valley Firms*, SAN JOSE MERCURY NEWS, Sept. 27, 2004 (quoting Bryan Stolle).

sought in an official proceeding.[114] Sarbanes-Oxley shifts the burden.[115] Section 802(a) states the following:

> [W]hoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.[116]

Sarbanes-Oxley thus covers not only current investigations of a company, but possible investigations. Most (if not all) public companies have created document retention policies in order to avoid destroying important documents. Storage requirements must often be met through additional information technology spending (for software and servers) and warehousing of paper files with document management companies.

b. Effects on Audit Services

Commentators suspect that Sarbanes-Oxley will adversely affect audit services in several ways.[117] Some accounting firms have used audit services as a loss-leader,[118] selling non-audit services at a premium to make up for below-cost auditing services. Sarbanes-Oxley imposed restrictions on accounting firms' ability to provide both non-audit and audit services to the same client, eliminating an apparent conflict of interest.[119] However, Sarbanes-Oxley's restrictions on auditors will likely have negative consequences. Some accounting firms may decide to focus on more lucrative consulting work and drop audit services altogether, reducing competition in the marketplace. Reduced competition may provide upward pressure on audit

114. Gary G. Grindler & Jason A. Jones, *Please Step Away from the Shredder and the "Delete" Key: §§802 and 1102 of the Sarbanes-Oxley Act*, 41 AM. CRIM. L. REV. 67, 67-69 (2004).

115. 15 U.S.C. §§ 802, 1102.

116. 15 U.S.C. § 802.

117. Koehn & Del Vecchio, *supra* note 100.

118. However, Lynn Turner, former chief accountant of the SEC, contends that it is a myth that accounting firms use audit services as a loss-leader; industry commentators and executives dispute his views. *See* Richard H. Gifford & Harry Howe, *Regulation and Unintended Consequences: Thoughts on Sarbanes-Oxley*, *available at* www.nysscpa.org/printversions/cpaj/2004/ 604/p6.htm. (last visited Feb. 1, 2005).

119. Pub. L. No. 107-204, §301(2), 116 Stat. 745, 776.

pricing. More significantly, however, the enhanced requirements of Sarbanes-Oxley (such as the requirement of an auditor's report on the effectiveness of the company's internal controls[120]) will certainly require more work from the auditors, and thus more fees paid to the auditors.

c. Foreign Delistings

As noted by Professor Larry Ribstein,[121] foreign companies are balking at Sarbanes-Oxley's additional requirements, even though foreign companies are exempt from many of Sarbanes-Oxley's provisions.[122] As Ribstein explains, a poor fit between Sarbanes-Oxley's provisions and a foreign jurisdiction's governance requirements will necessitate extensive compliance efforts (assuming that a company is able to reconcile the requirements of Sarbanes-Oxley with its home jurisdiction), which may outweigh the benefits of listing in the United States.[123] Anecdotal evidence suggests that many foreign companies have decided against U.S. exchange listing as a result of Sarbanes-Oxley.[124]

d. Risk Aversion

Perhaps the most pernicious unintended consequence of Sarbanes-Oxley is the chilling effect it has had on management's willingness to take business risks. William Donaldson, Chairman of the SEC admitted that he "worr[ies] about the loss of risk-taking zeal. People are confusing business risk-taking with legal risk-taking, which is a mistake."[125] While some worry that Sarbanes-Oxley threatens to create "chronic economic paralysis,"[126] others, most notably Representative Michael Oxley, believe that the risk-aversion

120. *Id.*

121. *See* Larry E. Ribstein, *Cross-Listing and Regulatory Competition*, *available at* http://home.law.uiuc.edu/~ribstein/ribsteinclea.pdf (Oct. 6, 2004).

122. *See* Kenji Taneda, *Sarbanes-Oxley, Foreign Issuers and United States Securities Regulation*, 2003 COLUM. BUS. L. REV. 715 (2003) (discussing the exemptions at length).

123. Ribstein, *supra* note 121, at 34.

124. *Id.* at 27.

125. Adrian Michaels, *After A Year of US Corporate Clean-Up, William Donaldson Calls for a Return to Risk-Taking*, FinancialTimes.com. (July 24, 2003), *available at* http://securities.stanford.edu/news-archive/2003/20030724_Headline06_Michaels.htm (last visited Mar. 10, 2005).

126. Rich Karlgaard, "*Digital Rules*," Forbes.com., *available at* http://www.forbes.com/technology/free_forbes/2003/0929/037.html (Sept. 29, 2003).

created by Sarbanes-Oxley will diminish.[127] Risk aversion among managers is difficult to quantify. Given the SEC's expectation of expanded board oversight, however, Sarbanes-Oxley may indeed systematically penalize risk-taking, since directors tend to manage more cautiously than executives.

D. *Small-Business Responses Post-Sarbanes-Oxley*

Alan Beller, director of the SEC's Division of Corporation Finance, argues that we have not yet realized and accounted for all of the benefits from Sarbanes-Oxley.[128] Indeed, Sarbanes-Oxley has received some praise; a recent survey found that 74 percent of financial executives surveyed agreed that Sarbanes-Oxley has provided some benefits to companies and shareholders[129] through greater accountability of management and an emphasis on accurate financial reporting.[130] These benefits should contribute to higher stock prices, which is the one benefit that investors and companies, as a whole, really want to receive. A company and its investors presumably are concerned with the promotion of trust in the markets insofar as that trust can be translated into higher stock prices. Even if such benefits are being realized, the continuing disparity between the costs and benefits has driven many smaller companies to go private, or, in other cases, to go dark.

1. *Going Private*

The general proposition that Sarbanes-Oxley is causing firms, and especially small firms, to go private has already received some attention. However, some of the evidence provided in support of the proposition has been suspect.[131] One widely cited study of public companies by the law firm Foley & Lardner stated that 21 percent of

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127. "Risk aversion is a natural consequence of the shock the system went through. Don't expect it to be long term." Ari Weinberg, *No Party Hats For Sarbanes-Oxley*, FORBES.COM, *available at* http://www.forbes.com/2003/07/30/cx_aw_ 0730sarbanes.html (July 30, 2003).

128. Alan Beller, Remarks at the 58th National Conference of the American Society of Corporate Secretaries, *available at* http://www.sec.gov/news/speech/spch071004alb.htm (July 10, 2004).

129. Steve Burkholder, *Survey Cites Benefits of Sarbanes-Oxley Act*, CORP. COUNS. WKLY., Jan 26, 2005, at 28.

130. *Id.*

131. *See* Beller, *supra* note 128.

the study's respondents were considering going private.[132] However, the study relied on a very small sample size: 9,000 surveys were sent out, but only 115 public companies (1.3 percent) responded.[133] Furthermore, one should suspect that firms most negatively impacted by Sarbanes-Oxley would tend to respond at a relatively higher rate to a survey about the costs of Sarbanes-Oxley; therefore, the survey may not represent the general market impact of Sarbanes-Oxley.

A more recent study by scholars at the University of Chicago provides a more reliable indication of the effects of Sarbanes-Oxley.[134] In that study, the authors investigated the going-private decisions of firms from 1998 to 2004, and concluded that while the frequency of going private decisions of all companies has only increased modestly since the passage of Sarbanes-Oxley, going-private decisions of smaller firms increased significantly after the passage of Sarbanes-Oxley.[135] The authors attribute the increase not only to the greater burdens of Sarbanes-Oxley, but also to the relatively smaller net benefits of being a public company for smaller firms.[136]

2. Going Dark

Another study by scholars from Wharton indicates that many small companies have decided to "go dark," rather than go private, in response to Sarbanes-Oxley.[137] In 2003 alone, approximately 200 companies went dark.[138] "Going dark" means that a company delists its shares from the exchange on which it is traded. Perhaps a more apt term is "going pink," since the company typically continues to trade in the Pink Sheets, a web-based quotation service which is considered the lowest rung of public company exchange status. The Pink Sheets is largely composed of penny stocks, and Pink Sheets companies are not required to provide the kind of detailed financial disclosures that registered companies must provide under the Exchange

132. Thomas E. Hartman, *The Cost of Being Public in the Era of Sarbanes-Oxley* 12, at 12, *available at* http://www.foley.com/files/tbl_s31Publications/FileUpload137/2017/Public%20Study%20Results%20FINAL.doc.pdf (May 19, 2004).

133. *Id.* at 11.

134. *See* Ellen Engel et al., *supra* note 4.

135. *Id.* at 24.

136. *Id.* at 25.

137. Christian Leuz et al., *Why do Firms go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, *available at* http://ssrn.com/abstract=592421 (Nov. 2004).

138. *Id.* at 39.

Act,[139] unless, of course a company reaches the thresholds under § 12(g) discussed above.[140]

Companies that go private or go dark typically suffer a permanent decrease in the value of the company's stock, largely because of a decrease in liquidity. For example, a 2004 study found that shareholders of NASDAQ companies delisted between the years 1999-2002 experienced an average wealth-loss of 19 percent.[141] Investors will also pay less for the stock of a company that is no longer required to provide detailed disclosure since they will have less confidence in the quality of their investment. As a result of the decrease in share value, a company will not receive as much value for its stock in future offerings. Also, the company's stock as merger consideration will be less valuable. The increased costs will thus affect the company's ability to hire, to innovate, and to grow.

E. Protecting Smaller Businesses

If we acknowledge that the regulations described above do have an adverse effect on small companies, why not take the position that if small companies cannot meet the rigorous standards of public company status, then they should go private or remain private? Lynn Turner, former chief accountant for the SEC, seems to have taken that position, stating that the SEC's transparency and accounting standards are "part of the price of being a public company. If you don't want to pay the price, go private."[142] The statement reflects an SEC focus on the largest issuers, who, through economies of scale, are better able to absorb the costs of compliance (as played out in the Financial Executives International numbers described above).[143] While I believe that for efficiency reasons the SEC should indeed be focused on the largest issuers (as discussed below), the SEC should not unduly burden a particular segment of the market that it regulates.

With respect to small companies, particularly, there are several reasons why insuring that they have fair access to capital markets is

139. For a brief discussion of these rules, see the Pink Sheets discussion on quoting Pink Sheets securities, *available at* http://www.pinksheets.com/otcguide/brokers_index.jsp (last visited Mar. 10, 2005).

140. *See* discussion *supra* Part II.A.

141. James J. Angel et al., *From Pink Slips to Pink Sheets: Liquidity and Shareholder Wealth Consequences of NASDAQ Delistings* 25, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=628203 (Nov. 2, 2004).

142. Koehn & Del Vecchio, *supra* note 101, at 36.

143. *See FEI Survey on Sarbanes-Oxley Section 404 Implementation*, *supra* note 107.

important. First, small companies are relatively better innovators. Over the past decade, among patenting companies as a whole, small businesses produced 13 to 14 times more patents per employee than large patenting companies.[144] As a measure of the importance of these patents, small company patents are twice as likely as large firm patents to be among the one percent most cited as prior art in subsequent patent applications.[145]

Small businesses are also job-creators. While small businesses employ approximately 50 percent of the private workforce, they have accounted for 60-80 percent of the net new jobs annually over the last ten years.[146] Providing easy access to capital will help ensure that companies have the resources to innovate and grow.

Admittedly, other corporate arrangements, such as partnerships or collaborations (such as are used with many biotech companies) could provide some funding for companies, that under the current regulatory regime, cannot become or remain public. Many of the benefits described in Part I, however, would not be available in these arrangements. Furthermore, the availability of many different arrangements benefits businesses by allowing companies to match their goals and business models to appropriate contractual/regulatory schemes. The availability of other corporate forms and arrangements (and, in some cases, the availability of other regulators offering the same product) also generally encourages regulators to streamline and adapt their regulations to meet their constituents' needs.[147] The SEC understands the importance of small businesses—for example, the Commission has an office of small business policy which has served as a kind of ombudsman's office for small business owners. More importantly, however, the Commission has recently shown that it is taking seriously the concerns about how its regulations are effecting small businesses by creating an Advisory Committee on Smaller Public Companies.[148] This new committee held its first meeting on Tuesday, April 12th.[149]

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144. *See* Small Business Administration, Office of Advocacy, *Small Business by the Numbers*, *available at* http://www.sba.gov/advo/stats/sbfaq.pdf (last modified June 2004).

145. *Id.* at 1. The term "prior art" refers to the body of previously patented inventions.

146. *Id.*

147. *See* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 225-83 (1985).

148. 69 Fed. Reg. 244 (Dec. 21, 2004).

149. Notice of First Meeting of SEC Advisory Committee on Smaller Public Companies, Exchange Act Release No. 34-51417 (Mar. 23, 2005).

III. SUGGESTIONS ON REBALANCING BENEFITS AND BURDENS.

Part II discussed how the balance of costs and benefits have shifted such that many smaller companies are deciding to either go private or go dark. Part III discusses possible solutions to this imbalance.

A. *Increasing Benefits*

As discussed earlier, the benefits of being public are generally available to all issuers, although there is often a qualitative difference in these benefits depending on the size of the company. Smaller companies' shares are often less liquid since trading in the companies may be sporadic and thin, which means that smaller companies and their investors benefit less than larger companies and their investors because larger companies typically have more liquid shares. Unsurprisingly, small companies also have significantly less analyst coverage,[150] again, in part as a result of Regulation FD. The diminished benefits for smaller companies plausibly explains why, when viewing cross-sections of the stock market by market capitalization, price-to-earnings ratios tend to decrease as market capitalization decreases.[151] In other words, small companies' shares tend to sell for comparatively less even if their earnings relative to market capitalization are similar to larger companies.

Practically speaking, it is doubtful that the SEC can or even should impose further regulations in an effort to level the playing field for smaller companies. Would we want the SEC to require analyst coverage for smaller companies? How could the SEC (or stock exchanges, for that matter) provide the large-cap benefits of market liquidity for smaller companies? As a general matter, how could the SEC accomplish such goals without increased cost?

As a regulator, the SEC has the ability to control the imposition of burdens more easily than the endowment of benefits. The SEC imposes the burdens of disclosure on a company, for instance, but it generally does not affect liquidity benefits—the market itself determines whether a stock will be sold, how often, and at what price. Enhancing the benefits of small public companies thus seems an unlikely

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150. *See, e.g.*, Nicholas Galluccio, Analysis & Valuation of Small-Cap Stocks, Presentation at the AIMR 2002 Equity Research and Valuation Techniques Conference, *available at* http://www2.cfapubs.org/cp/issues/v2002n3/toc.html (last visited Mar. 13, 2005).

151. *Id.*

method of balancing the costs and benefits.

B. Reducing the Burdens Imposed by Sarbanes-Oxley

While certain requirements under Sarbanes-Oxley are probably non-negotiable since they are specifically set out in the Sarbanes-Oxley Act[152] (the CEO and CFO certifications required under Sections 302 and 906, for example), other requirements could be better tailored for small businesses. Alternatively, the SEC could suspend application of certain provisions of Sarbanes-Oxley for small companies. The SEC has granted some relief to smaller companies already:

- Public companies with less than $75 million in market capitalization were exempted from the accelerated deadlines for quarterly and annual reports.[153] (Under accelerated reporting rules, companies are required to produce periodic reports more quickly—from 90 to 60 days for annual reports, and from 45 to 35 days for quarterly reports).[154]
- Public companies with less than $25 million in revenues and $25 million in market capitalization were not required to provide a table of contractual obligations.[155]
- Small business issuers were given an extra six months to comply with the rule requiring disclosure of whether they have an audit committee financial expert.[156]
- Public companies with less than $75 million in market capitalization were given an additional nine months to comply with the new rules requiring a report on internal control over financial reporting.[157]

Further relief could be granted, however, for the more costly re-

152. Sarbanes-Oxley is a congressional act, so the SEC has limited ability to make alterations to it. For a general discussion of the SEC's exemptive authority, see James D. Cox, *Premises for Reforming the Regulation of Securities Offerings*, 63 LAW & CONTEMP. PROBS. 11 (Summer 2000).

153. *See* Acceleration Of Periodic Report Filing Dates And Disclosure Concerning Website Access To Reports; Correction, Exchange Act Release No. 33-8128 (Sept. 5, 2002).

154. *Id.*

155. Disclosure In Management's Discussion And Analysis About Off-Balance Sheet Arrangements And Aggregate Contractual Obligations, *supra* note 87.

156. Standards Relating To Listed Company Audit Committees, Securities Act Release No. 33-8220 (Apr. 9, 2003).

157. Management's Report On Internal Control Over Financial Reporting And Certification Of Disclosure In Exchange Act Periodic Reports, Securities Act Release No. 33-8238 (June 5, 2003).

quirements. For example, although the SEC has already extended the effective date for compliance with the internal controls requirements (until 2007 for some companies)[158] in order to give many companies time to put in place the necessary personnel and control structures necessitated by the requirement, the SEC should consider ways to alleviate the annual burden of compliance. Concerned with smaller companies' ability to absorb the annual costs of an internal control review, the Small Business Administration's advocacy group has proposed that smaller companies should only be required to perform the internal controls review once in order to certify that the internal controls system is effective.[159] After that, the company need only disclose changes in the internal controls system.[160] Presumably, such a rule should also require disclosure of any changes in the company's business or business environment that are reasonably likely to affect the efficacy of the internal controls system.

With respect to the design of an internal controls system, the Committee of Sponsoring Organizations (COSO) designed an internal control framework that serves as a model framework for public companies.[161] However, the system was created primarily for larger companies, and, therefore, is not ideally suited for use by smaller companies. Because of this, the SEC has suggested that an internal controls framework could be designed with smaller businesses in mind,[162] and COSO is beginning work on new guidance directed toward smaller companies.[163]

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158. *Id.*

159. *See* Letter of the Small Business Administration's Office of Advocacy, to the Securities and Exchange Commission, *available at* http://www.sba.gov/advo/laws/comments/sec02_0819.html (Aug. 19, 2002).

160. *Id.*

161. Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control—Integrated Framework, available at* http://www.coso.org/publications/executive_summary_integrated_framework.htm (last visited Mar. 13, 2005).

162. *See* Office of the Chief Accountant, SEC Division of Corporation Finance, *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports: Frequently Asked Questions, available at* http://www.sec.gov/info/accountants/controfaq1004.htm (last modified Oct. 6, 2004); *see also* Alan Beller, Director of the SEC's Division of Corporation Finance, Remarks at the 58th National Conference of the American Society of Corporate Secretaries, *available at* http://www.sec.gov/news/speech/spch071004alb.htm (July 10, 2004).

163. *COSO to Develop Guidance on Controls Framework,* CORP. COUNS. WKLY., Jan. 19, 2005, at 19.

C. Expansion of Regulation S-B

Another solution to the heavy burdens on small businesses imposed by current SEC regulations might be the expansion of Regulation S-B.[164] Regulation S-B offers disclosure relief to small companies through a more tailored small business reporting scheme (Form 10-KSB[165] and Form 10-QSB)[166]. The SEC developed Regulation S-B over a decade ago as part of its small business initiatives.[167]

The small business initiatives involved the adoption of a number of new regulations, including rule changes that simplified the process of registering small business issues for public sale,[168] increased the dollar threshold for certain exemptions from registration of securities offerings,[169] and simplified the ongoing reporting requirements for smaller companies through Regulation S-B.[170]

The small business initiatives were designed in part to respond to changes in the nature of banking that made it more difficult for small businesses to raise capital through bank loans.[171] The nature of banking changed primarily because the nature of investment changed; investors looked to equity or debt investing, including through the ascending mutual fund industry, as opposed to simply earning interest by depositing money in a bank in savings accounts or purchasing certificates of deposit.[172] In turn, banks looked to other, more profitable activities, such as underwriting, securities and derivatives trading, and cash management.[173]

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164. 17 C.F.R. § 228.10 (1995).

165. 17 C.F.R. § 249.310b (1992) (providing that a small business issuer may use this form for its transition and quarterly reports. The issuer "shall file within 45 days after the end of the first three fiscal quarters of each fiscal year. No report need be filed for the fourth quarter of any fiscal year. Transition reports shall be filed in accordance with the requirements set forth in Rule 13a-10 or Rule 15d-10.").

166. 17 C.F.R. § 249.308b (1992) (providing that a small business issuer has 75 days after the end of a fiscal year covered by the report for fiscal years ending on or after Dec. 15, 2003 and before Dec. 15, 2005 to provide annual and transition reports pursuant to section 13 or 15(d) of the Securities and Exchange Act of 1934).

167. Small Business Initiatives, Securities Act Release No. 33-6949, (July 30, 1992).

168. *See* 17 C.F.R. § 239.9 (1993) (Form SB-1); 17 C.F.R. § 239.10 (1992) (Form SB-2).

169. This was accomplished through the revision of Regulation A. *See* Small Business Initiatives, Securities Act Release No. 33-6949 (July 30, 1992).

170. *Id.*

171. William J. Coffey & Lewis Schier, *Small Business Initiatives under the Securities Acts*, CPA J., ¶ 3 (Jan. 1995), *at* http://www.nysscpa.org/cpajournal/old/16349293.htm.

172. *Id.*

173. *Id.*

While the small business initiatives, and Regulation S-B in particular, have benefited many smaller companies by providing easier access to capital, the regulations offer only limited relief for a couple of reasons. Most significantly, the regulations apply to very few issuers; since its adoption, Regulation S-B has been available only to public companies with less than $25 million in revenues and less than $25 million in market capitalization.[174] As a result of this restriction, Regulation S-B companies are often small, family-controlled companies or companies already trading on the Pink Sheets.[175]

Regulation S-B's requirements have also been criticized as merely being "S-K lite."[176] Indeed, Regulation S-B's disclosure requirements are almost identical to the rules under Regulation S-K (which, in part, governs the disclosure for larger public companies), although Regulation S-B's items generally require less detail.[177] Note, however, that Sarbanes-Oxley still applies, with limited exceptions, to Regulation S-B companies.[178]

A simple solution could remedy the problem of the limited applicability of Regulation S-B. The SEC should simply raise the revenue threshold above $25 million. Indeed, the SEC considered this solution in 1999 when the staff proposed raising the revenue threshold to $50 million.[179] Furthermore, the SEC also considered elimination of the $25 million market capitalization requirement. According to its calculations, these changes would have expanded the number of eligible businesses by a third.[180]

Recall that the SEC chose the figure of $75 million in market capitalization for relief from Section 404 (the internal controls requirement)[181] and the accelerated reporting deadlines.[182] If the SEC

174. *Id.* at ¶ 12.

175. *See* Marc Morgenstern & Peter Nealis, *The Impact of Sarbanes-Oxley on Mid-Cap Issuers*, at n.5, *available at* http://www.sec.gov/info/smallbus /mmorgensternmidcap.pdf (last visited Feb. 1, 2005).

176. *Id.* (quoting Richard Leisner).

177. Coffey & Schier, *supra* note 171, at ¶ 18.

178. *See supra* notes 153-57 and accompanying text.

179. *See* Testimony of Brian Lane, Director, Division of Corporation Finance, before the House Subcommittee on Government Programs and Oversight, Committee on Small Business, re: Providing Information to Small Businesses Concerning the Process of "Going Public," n.6, *available at* http://www.sec.gov/news/testimony/testarchive/1999/tsty2499.htm (Oct. 14, 1999).

180. *Id.*

181. *See supra* note 157 and accompanying text.

182. *See supra* note 153 and accompanying text.

currently views $75 million in market capitalization as an important threshold to divide larger and smaller public companies, they could certainly justify moving the small company definition under Regulation S-B up to this amount, which would provide the benefits of Regulation S-B, even if they are slight, to many more companies.

Note that the SEC focused on market capitalization rather than revenue when determining which companies should receive relief from Section 404. I take this as an indication that the SEC appropriately focuses on market capitalization when considering investor protection issues, since, put pessimistically, market capitalization indicates how much there is to lose with a particular company. Since Sarbanes-Oxley was designed to prevent massive losses by investors in black-hole companies like Enron, it is little wonder that the SEC focused on market capitalization when drafting its rules.

On the other hand, when considering how to help small businesses (as in 1999), the SEC should be less concerned with market capitalization and more concerned with revenue, which in part indicates the ability of small companies to shoulder the burdens of regulation. Post-Sarbanes-Oxley, it seems unlikely that the SEC would ignore market capitalization as a measure of the applicability of Regulation S-B. What would be a likely result, and still very beneficial to small businesses, is a Regulation S-B eligibility requirement that covers companies with revenues of $75 million or less and a market capitalization of $75 million or less. This would both provide relief to small businesses and reaffirm the SEC's concern with investor protection. Of course, the SEC could provide relief to many more companies by increasing the thresholds to $200 million or even $300 million, which would still only capture what the brokerage industry considers to be small-cap companies.[183]

The expansion of Regulation S-B would also benefit the SEC. Consider that each year, the SEC receives more than 600,000 documents, including annual reports from more than 12,000 reporting companies, totaling approximately 18,000,000 pages annually.[184] The SEC's Division of Corporation Finance, comprised of approximately 350 staff members (many of whom do not review disclosure as part of their jobs), is tasked with monitoring these disclosures.[185] Further-

183. *See supra* note 7.

184. *See* 2003 SEC ANN. REP. at 63, *available at* http://www.sec.gov/pdf/annrep03/ar03full.pdf (last visited Feb. 1, 2005).

185. *Id.* at 61.

more, Sarbanes-Oxley requires that the SEC review each issuer at least once every three years.[186] However, in 2003 the Division of Corporation Finance was able to review only 23 percent of the annual reports filed by the 12,830 reporting companies.[187] The Division of Corporation Finance must now review annually approximately one-third of all annual reports.

Given that the disclosures required under Regulation S-B are less detailed than those required under Regulation S-K, the SEC would presumably have less disclosure to review and would appropriately spend more time reviewing the more detailed larger company disclosures than reviewing smaller company disclosures. Such an allocation of SEC resources according to issuer size would fall in line with the SEC's determination to "review its procedures to comply with this provision of the Sarbanes Oxley Act and to ensure Division resources are directed toward those issuers, filers or industries that most warrant review."[188]

With respect to the content of Regulation S-B, and as a more ambitious project, the SEC should also reconsider the proper level of disclosure for Regulation S-B companies. Regulation S-B predates the OTCBB eligibility rule, Regulation FD, and Sarbanes-Oxley. This means that small companies eligible to use Regulation S-B are operating under a heavier overall regulatory burden than imposed a decade ago. In light of these additional regulations, some of the disclosure requirements of Regulation S-B could be revised or eliminated.

D. *Creation of a Small Companies Market*

Another option to alleviate regulatory burdens would involve the creation of a separate, small issuers market, administered by stock exchanges.[189] I consider this to be a less likely option than the expan-

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186. 15 U.S.C.§ 408.

187. 2003 SEC ANN. REP. at 63, *available at* http://www.sec.gov/pdf/annrep03/ar03full.pdf (last visited Feb. 1, 2005).

188. *Id.* at 62. To further this goal, the SEC has established an Office of Risk Assessment to consider how the SEC might better focus its examination and disclosure review programs. *See* SEC 2004-2009 Strategic Plan at 25, *available at* http://www.sec.gov/about/ secstratplan 0409.pdf (last visited Feb. 1, 2005).

189. Note that NASDAQ already has a small-cap market, but it has the same governance requirements for both the small-cap market and the national market. NASDAQ did consider introducing a small-company market, called the BBX, but gave up the idea in 2003. *See* Small Cap Market Watch, *BBX: The Market Exchange That Never Was*, *available at*

sion of coverage of Regulation S-B, since it would require significant expenditures and regulatory will to create the market. Creation of the market would require at least two major steps. First, the SEC would be required to eliminate (or allow exemptions for) registration and Exchange Act requirements for companies under certain revenues and market capitalization thresholds, such as revenues and market capitalization of $300 million. Second, the exchanges would be required to develop an adequate regulatory framework (such as disclosure requirements and listing standards) in place of the SEC's current regulatory regime.

1. Elimination of SEC Regulation

The SEC has been given broad rulemaking and exemptive power under Section 28 of the 1933 Act and Section 36 of the 1934 Act. Section 28 states that

> The Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation issued under this title, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

This grant of authority (and the similar grant of authority in Section 36 of the 1934 Act) would arguably encompass the exemption for small companies and small company securities that would be required to create a small companies market. Still, many technical issues would arise from such a rulemaking; the SEC would likely develop transition rules for companies moving up from the smaller companies market to SEC regulation, for instance, and, alternatively, rules for companies moving down to the smaller companies market.

Notwithstanding the problems posed by such technical issues (which, I suspect, would be comparatively less significant than the technical issues created by Sarbanes-Oxley), the SEC and the investing public would have much to gain from the creation of a small companies market. As noted above, since Sarbanes-Oxley requires the review of every issuer under its jurisdiction, the SEC will undoubtedly spend thousands of hours reviewing the disclosure of hundreds of companies each year that have relatively small economic impact on society. Given its limited resources, the SEC might spend

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http://smallcapmarketwatch.com/articles/66.asp?edition=most (June 28, 2003).

significant time reviewing disclosures of smaller companies, so that its staff may not have sufficient resources to detect and prevent problems at an Enron-sized company. On the other hand, if the SEC spends too much time on larger companies and only offers cursory review of smaller issuers' filings, it might miss the kind of widespread fraud that led to the enactment of the OTCBB eligibility rule.

Because the SEC has limited resources, and because it must direct resources to those issuers who most warrant review, the SEC could satisfy these concerns by effectively outsourcing much of the regulation of small issuers by allocating disclosure review functions to small company exchanges. Because the exchanges would be focusing on smaller companies with smaller market capitalizations, the SEC would serve investors better by focusing its resources on larger companies with larger market capitalizations—those companies whose shares are generally the most widely held and in which the total investment in dollar terms is more significant. From a risk-management perspective, the creation of a small companies market benefits the SEC. The crucial issue, however, is whether the creation of a small company market is "necessary or appropriate in the public interest, and is consistent with the protection of investors," as required under Section 28 of the 1933 Act and Section 36 of the 1934 Act. The following sections briefly discuss how regulation by one of more small company exchanges could satisfy these requirements.

2. *Regulation by Exchanges*

Regulation by exchanges has received some attention in recent years,[190] most notably by Professors Paul Mahoney[191] and Adam Pritchard.[192] Both Mahoney and Pritchard argue that exchanges may provide more effective regulation than government regulators such as the SEC, in large part because competitive pressures among exchanges will create incentives to provide listing and disclosure standards that are more appealing to investors and issuers. From an investor's standpoint, appealing listing and disclosure standards are those which provide adequate protection of the investment.

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190. *See, e.g.*, Roberta Romano, *Empowering Investors: Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1997-1998); *see also* Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 VA. L. REV. 1509 (1997) (discussing some concerns with this approach).

191. Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

192. Adam C. Pritchard, *Self-Regulation and Securities Markets*, REGULATION, Spring 2003, at 32.

a. Multiple Exchanges

Ideally, a smaller companies market would be comprised of a number of stock exchanges, which would allow for regulatory competition among the exchanges. The most efficient means of developing such exchanges would be through the efforts of existing SROs, such as the NYSE, NASDAQ and the AMEX. Indeed, except through the expansion of existing SROs, small company exchanges would be unlikely to form because the lack of the head-start provided by existing regulatory experience and structures would likely be unjustifiably high.

Smaller companies exchanges could also develop from existing alternatives such as the Pink Sheets and the OTCBB. While these exchanges would necessarily undergo significant changes in order to create a governance regime acceptable to investors and governmental monitors, they have a head start in understanding the concerns of smaller companies and investors in those companies, which would help them develop rules appropriate to a smaller companies market.

b. Disclosure and Governance Rules

What sort of disclosure and governance rules should smaller companies exchanges develop? With respect to disclosure rules, the lessons learned through the scandals that resulted in the enactment of Sarbanes-Oxley would hopefully not be lost on the exchanges. Undoubtedly the exchanges would keep strong investor protections, not only because investors would demand them, but also because the SEC would likely keep the exchanges on a short leash. The SEC currently has supervisory authority over SROs through Section 19 of the Exchange Act of 1934,[193] and would, as a condition to the creation of a smaller companies market, retain authority over exchanges in the market. In practice (and similar to the process for existing SROs), the exchanges would likely be required to obtain SEC approval for proposed disclosure regulations, and would engage in extensive negotiations with SEC staff in order to insure that the regulations provide adequate investor protection.

While the content of the disclosure regulations would perhaps

193. The SEC's oversight of the exchanges has been called "raised eyebrow" regulation, however, I believe that the expression underestimates the practical regulatory force of the SEC with respect to SROs. *See* Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545, 571 (1984).

vary from exchange to exchange, the exchanges would undoubtedly require less disclosure than is required under Regulation S-K, and perhaps even significantly less than is required under Regulation S-B. As noted above, regulatory competition among several markets would allow for some experimentation, flexibility, and varied investor focus; varied disclosure regulations would spur competition among the exchanges. One might imagine a market that provides a fairly sophisticated set of disclosure rules, while another market may require relatively fewer disclosures but impose more strict governance requirements.

c. Enforcement

An exchange enforcement regime involves at least two components. The first is a mechanism designed to respond to violations of exchange rules, such as a violation of listing standards. The second mechanism must respond to securities law violations. To the extent that a small company's exchange was affiliated with a larger exchange, such as the NYSE or NASDAQ, the exchange could rely on similar listing standards enforcement mechanisms as used for the larger exchanges. The smaller-companies exchange possibly would also piggyback on the enforcement provided by regulatory structures that are in place in the larger exchanges. Without relying on similar standards in the larger exchanges, the small-companies exchanges would be required to create such structures. Furthermore, smaller companies exchanges, like the larger exchanges, would rely on the SEC and the Department of Justice for assistance with securities law violations.

d. Vertical Competition

In Part III.D.2.a I noted how regulatory competition among the exchanges (horizontal competition) would help ensure that the exchanges develop more optimal market rules for issuers and investors. Another means of ensuring that a small companies market as a whole remains competitive would be to allow these smaller companies the right to trade in the major markets—in essence, allow for vertical competition between the NYSE, the AMEX, and NASDAQ and small company exchanges—so long as they comply with current Exchange Act requirements and the listing standards of the larger exchanges. I suspect that a fair number of smaller companies would want to stay in the major markets if they believed that doing so signaled stability and high governance standards. Such vertical competition would test whether investors are willing to pay for the benefits of regulations like Sarbanes-Oxley. Of course, many companies may not have the economic luxury of staying in the larger market, despite the benefits.

IV. CONCLUSION

In this Article I have sketched out some possibilities that would provide relief for smaller companies such that the benefits of being public outweigh, or are at least balanced, with the costs of being public. As studies now suggest, recent regulations have had a significant, disproportionate, negative effect on small companies. The SEC, with assistance from the newly-formed Advisory Committee on Smaller Public Companies, is now beginning to consider ways to alleviate these effects. The SEC may be tempted to simply perform a line-item revision of Sarbanes-Oxley, but other alternatives would likely prove more beneficial in the long term. The heavy regulatory burden on small companies is not just a Sarbanes-Oxley problem, however. Sarbanes-Oxley may be a proximate cause of many small companies' going private or going dark, but the existing regulatory structure was already making public life difficult for smaller companies.

Instead of trying to adapt Sarbanes-Oxley for smaller companies (or instead of merely adapting Sarbanes-Oxley for smaller companies), the SEC could expand the coverage of Regulation S-B and could take a fresh look at S-B's regulations post Sarbanes-Oxley, Regulation FD and the OTCBB eligibility rule. Because of the relative simplicity of this solution, it is perhaps the most preferable; providing relief through the expansion of Regulation S-B would not involve the creation of new rules, nor would it create significant transaction costs.

Although less ideal, and less likely, because of the significant costs required by its creation, a small-companies market would allow for more experimentation with the securities regulatory scheme affecting small businesses (such as the governance restrictions under Sarbanes-Oxley). Competitive pressures would hopefully encourage small-company exchanges to precisely tailor disclosure and other regulations, an advantage over the one-size-fits-all regulation under an expanded regulation S-B. Furthermore, allowing exchanges to govern issuers themselves would alleviate the SEC's logistical and risk-management concerns created by the triennial review requirement under Sarbanes-Oxley.