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

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NOTES

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

I. INTRODUCTION

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

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

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

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

² JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 1 (3d

set of hearings in 2001 and 2002 resulted in the most sweeping changes to the federal securities laws since their enactment.³ Each time, the result was new federal securities rules and regulations that were designed to prevent future fraud and financial losses.⁴ The most recent overhaul – the Sarbanes-Oxley Act of 2002⁵ – is the most aggressive and prescriptive securities law in the world today.⁶ It not only expands on the existing laws' underlying philosophy of full and fair disclosure,⁷ but goes further to dictate how companies must be organized and what procedures companies must use to ensure compliance.⁸ This note will focus on this last type of regulation,

ed. 2003) (“The Securities and Exchange Commission was created at the conclusion of the Senate Banking and Currency Committee’s 1932-1934 investigation of stock exchange practices . . .”).

³ President George W. Bush, Remarks on Signing the Sarbanes-Oxley Act of 2002, 38 WEEKLY COMP. PRES. DOC. 1283, 1284 (July 30, 2002) (stating that the Sarbanes-Oxley Act represents “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt”). See also 1 CORPORATE FRAUD RESPONSIBILITY: A LEGISLATIVE HISTORY OF THE SARBANES-OXLEY ACT OF 2002, at v (William H. Manz ed., 2003) [hereinafter Manz] (describing Sarbanes-Oxley as “the most far-reaching reform of American business practices since the Great Depression”).

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

⁵ Sarbanes-Oxley Act of 2002 – An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.) [hereinafter Sarbanes-Oxley].

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

⁷ See Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 5 (2003) (calling disclosure the “prevailing regulatory strategy in the securities markets”); Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 670 (1996) (describing disclosure as securities law’s “favorite strategy”); Marc Levy, *Japanese and U.S. Financial Derivatives Markets: Recommendations for Loosening Japan’s Tightly Regulated Market*, 18 FORDHAM INT’L L.J. 1970, 1990 n.143 (1995) (stating that the SEC emphasizes disclosure as an enforcement strategy).

⁸ See *Boardroom Burdens: U.S. Corporate Governance Reforms Are a Necessary Evil*, FIN. TIMES (LONDON), June 4, 2004, at 16 (“Congressional legislation is highly prescriptive and lacks . . . flexibility . . .”); John Berlau, *Sarbanes-Oxley Is Business Disaster*, INSIGHT MAG., Jan. 22, 2004, <http://www.insightmag.com/news/2004/02/03/National/SarbanesOxley.Is.Business.Disaster-582737.shtml> (stating that Sarbanes-Oxley prescribes a “one-size-fits-all” approach that applies to nearly all public companies).

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

Congress passed Sarbanes-Oxley in the summer of 2002, in the wake of the financial scandals at Enron⁹ and WorldCom.¹⁰ The abbreviated process that spawned this sweeping legislation, however, ignored the potential unintended consequences of the law on small businesses, such as the high relative costs of complying with its new requirements.¹¹ Sarbanes-Oxley's most problematic provisions apply uniformly to almost all publicly held companies.¹² The

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

¹⁰ WorldCom, once the nation's second largest telecommunications firm, also went to great lengths to disguise its true financial condition. Its senior management engaged in massive accounting fraud by hiding debt, double-counting revenues and failing to record expenses. Shortly after WorldCom's CEO, Bernard Ebbers, resigned in April 2002, new management began to unravel the tangled web of the company's finances. In June 2002, the company announced that it had uncovered \$3.8 billion in "accounting irregularities" and fired the architect of the accounting fraud, CFO Scott Sullivan. Less than one month later, WorldCom filed the largest bankruptcy in United States history. See Charles Haddad et al., *WorldCom's Sorry Legacy*, BUS. WK., July 8, 2002, at 38; Patrick McGeehan, *Grubman Attended 10 Board Meetings*, N.Y. TIMES, Aug. 10, 2002, at C2; Steven Rosenbush et al., *Inside the Telecom Game*, BUS. WK., Aug. 5, 2002, at 34; Jared Sandberg et al., *WorldCom Internal Probe Uncovers Massive Fraud*, WALL ST. J., June 26, 2002, at A1.

¹¹ See *infra* notes 217-34 and accompanying text.

¹² Sarbanes-Oxley amended numerous sections of both the Securities Act of 1933 (15 U.S.C. §§ 77a-77aa (2005)) and the Securities Exchange Act of 1934 (15 U.S.C. §§ 78a-78mm (2005)). See, e.g., Sarbanes-Oxley § 2(a)(10)(A)(i) (amending Securities Act of 1933 § 19(b)); Sarbanes-Oxley § 2(a)(15) (amending Securities Exchange Act of 1934 § 3(a)(47)); Sarbanes-Oxley § 401(a) (amending Securities Exchange Act of 1934 § 13). See also Roberta S. Karmel, *Realizing the Dream of William O. Douglas: The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 133 (2005) ("Federal regulation under Sarbanes-Oxley, on the other hand, is proscriptive and applies to all public companies regardless of their size, age, or

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

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

business structure."); Berlau, *supra* note 8 ("Sarbanes-Oxley goes where the federal government has never gone before in securities regulation, not just prohibiting conduct but prescriptively . . . dictating one-size-fits-all processes for testing internal controls for nearly all public companies.").

¹³ See, e.g., Regulatory Flexibility Act, 5 U.S.C. §§ 601-612 (2005) [hereinafter RFA]. Congress enacted the RFA in 1980 as part of its continued attentiveness to the problems of small business. The RFA requires agencies to consider regulatory alternatives that are less burdensome to small businesses. Paul R. Verkuil, *A Critical Guide to the Regulatory Flexibility Act*, 1982 DUKE L.J. 213, 216-30 (1982).

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

¹⁵ Sarbanes-Oxley § 404 (codified in 15 U.S.C. § 7262 (2005)) [hereinafter Section 404]. See also JAMES HAMILTON & N. PETER RASMUSSEN, *GUIDE TO INTERNAL CONTROLS UNDER SECTION 404 OF THE SARBANES-OXLEY ACT* 11-12 (2004).

¹⁶ 17 C.F.R. §§ 230.501-230.508 (2005) [hereinafter Regulation D]. See also Securities Act Release No. 33-6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106 (Mar. 8, 1982) [hereinafter Release No. 33-6389] (adopting the final rules for Regulation D and stating that "[t]he new regulation is designed to simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between Federal and state exemptions in order to facilitate capital formation consistent with the protection of investors.").

¹⁷ Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L.Q. 225, 239 (1990) ("The SEC . . . intended the substantive provisions of the Regulation [D] to relieve issuers of substantial costs.").

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

Part II of this note will describe briefly the Securities Act of 1933²¹ and the Securities Exchange Act of 1934²² by explaining the history and circumstances under which they became law. Part III will then define “small business” and describe the role that small businesses play in the American economy. This section will also explain why small businesses have historically received special treatment in federal regulations by analyzing one significant small business exemption – Regulation D of the Securities Act of 1933. Part IV of this note will describe the history and impetus behind the Sarbanes-Oxley Act and compare the environments in which Sarbanes-Oxley and the Securities and Exchange Acts were passed.²³ Part IV will also examine Section 404’s requirements, document the drastic costs involved with Section 404 compliance, and scrutinize the process that Congress used to create the law. Part V will then argue for a specific exemption from Section 404 for small businesses similar to Regulation D. This exemption is both necessary and feasible because the reasoning and concepts behind other securities law exemptions, including Regulation D, can apply to a Section 404 exemption as well.

¹⁸ 17 C.F.R. § 230.501(e) (2005).

¹⁹ See *infra* Part V.D.

²⁰ See Sarbanes-Oxley §§ 802(a) (18 U.S.C. §§ 1519-1520 (2005)) and 1106(1) (15 U.S.C. § 78ff(a) (2005)) for examples of the increased penalties imposed by Sarbanes-Oxley.

²¹ 15 U.S.C. §§ 77a-77aa (2005) [hereinafter Securities Act].

²² 15 U.S.C. §§ 78a-78mm (2005) [hereinafter Exchange Act].

²³ See William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders – The Rise of the New Corporate Kleptocracy*, 8 STAN. J. L. BUS. & FIN. 69, 73 n.9 (2002) (“The current climate is regularly compared to the 1930s.”).

II. HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934

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

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

²⁴ See S. REP. NO. 73-1455, at 1 (1934); SELIGMAN, *supra* note 2, at 1.

²⁵ The hearings are named after Ferdinand Pecora, who played an influential role in the hearings as the Committee's counsel. An Italian immigrant born in Sicily, he eventually became known as the "hellhound of Wall Street." After a successful career in the office of New York City's district attorney in which he was credited with the successful prosecution of over 150 fraudulent securities salesmen, he was offered the position of counsel to the Committee in 1933. His political ambitions, however, were not as successful. He failed to become the Democratic nominee for district attorney in 1930, and later ran unsuccessfully as the Democratic nominee for mayor of New York City in 1950. SELIGMAN, *supra* note 2, at 20-21.

²⁶ Lerach, *supra* note 23, at 75 ("In the wake of the 1929 Crash, Congress's Pecorra [sic] hearings exposed the rawest kind of self-dealing, abuse and fraud by corporate insiders, Wall Street bankers (coining the term 'banksters'), and the accounting firms during the 1920s.").

²⁷ H.R. REP. NO. 73-85, at 2 (1933).

²⁸ *Id.*

²⁹ LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 28 (4th ed. 2001).

³⁰ *Id.* Adjusted for inflation, the \$74 billion decline in aggregate market value during that time period is equivalent to a decline of over \$1 trillion in 2004 dollars. Figures adjusted for inflation using the Consumer Price Index; CPI statistics obtained from the Bureau of Labor Statistics, *available at* <ftp://ftp.bls.gov/pub/special.requests/cpi/cpia1.txt> (last visited Aug. 18, 2005).

the political momentum to enact the federal securities laws.³¹ In fact, twice during 1933 the Senate authorized its Committee on Banking and Currency to expand its investigation beyond the original mandate of stock exchange practices to include broad areas of banking and business.³² During the course of the investigation, prominent members of the financial community testified before the Committee, including the president of the New York Stock Exchange³³ and J.P. Morgan, who at the time was head of the largest private bank in the world.³⁴ In addition, numerous traders and investment bankers from Wall Street's most prominent firms³⁵ described the details of manipulative trading devices such as stock pools³⁶ and other deceptive practices in commercial and investment banking.³⁷

The stated purpose of the investigation was to “lay the foundation for remedial legislation.”³⁸ In doing so, the Pecora Hearings sought to determine the reasons for the “staggering decreases” in the values of securities and to propose legislation that would prevent another stock market crash.³⁹ The Hearings had another obvious, yet unstated, purpose as well – to diminish the public's faith in the nation's financial institutions.⁴⁰ In order to enact effective securities regulation

³¹ JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 3 (4th ed. 2004) (“[I]t was the Great Depression and the market collapse in October 1929 that provided the political momentum for congressional action that would over the course of a decade produce a collection of acts known as the federal securities laws.”).

³² S. REP. NO. 73-1455, *supra* note 24, at 2-4 (“The subcommittee has endeavored to investigate thoroughly and impartially some of the complex and manifold ramifications of the business of issuing, offering, and selling securities and the business of banking and extending credit. It has endeavored to expose banking operations and practices deemed detrimental to the public welfare; to reveal unsavory and unethical methods employed in the floatation and sale of securities; and to disclose devices whereby income-tax liability is avoided or evaded.”).

³³ *Id.* at 19-29 (excerpted testimony of Richard Whitney).

³⁴ *Id.* at 84 (excerpted testimony of J.P. Morgan).

³⁵ *Id.* at 5-154. Investment bankers and traders from firms such as Chase Securities Corp, Dillon, Read, & Co., and National City Bank testified before the Committee. *See id.* at 13, 40, 86. *See also* SELIGMAN, *supra* note 2, at 24-38.

³⁶ S. REP. NO. 73-1455, *supra* note 24, at 30-31. A stock pool is an agreement between several people to actively trade a stock in order to raise its price so that a profit can be made later by selling their shares at the artificially inflated price to the unsuspecting public. *Id.* at 31.

³⁷ *Id.* at 83-153.

³⁸ *Id.* at 4.

³⁹ SELIGMAN, *supra* note 2, at 2.

⁴⁰ *Id.*; Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 *YALE L.J.* 1521, 1592-93 (2005) (stating that the Pecora hearings “were orchestrated to develop an explanation of the market crash as having

on the federal level, the Pecora Hearings sought to “galvanize[] broad public support for direct federal regulation of the stock markets.”⁴¹ In its reports on the Pecora Hearings, the Senate Committee indicted the system as a whole by demonstrating that the system had failed to impose essential fiduciary standards on persons whose responsibility it was to handle other people’s money.⁴²

Broad public support and political momentum for sweeping reform resulted in the passage of the Securities Act in 1933 and the Exchange Act one year later.⁴³ The Securities Act focuses on disclosure⁴⁴ and requires corporations to disclose information about their financial conditions and future prospects in order to inform investors and allow them to make educated decisions.⁴⁵ The Securities Act also requires registration for securities that are sold to the public in order to record transactions and facilitate other corporate operations, such as dividend payments and elections.⁴⁶ The Exchange Act established the SEC, regulates broker-dealers and securities markets, and imposes disclosure requirements on publicly held companies and proxy solicitations.⁴⁷ More than any other securities law, it defines the industry’s regulatory system and governs how securities are traded.⁴⁸

Congress gave the SEC the power to create rules and regulations as the principal securities regulator in the United

been caused by market manipulation, fraud, and abuse by financial firms, in order to implement an agenda for market regulation.”). It has also been suggested that Congress exaggerated the “effect and existence” of market abuses in the 1920s for political purposes – to make the new securities laws seem more necessary. See Paul Mahoney, *The Stock Pools and the Securities Exchange Act*, 51 J. FIN. ECON. 343, 367 (1999).

⁴¹ SELIGMAN, *supra* note 2, at 2.

⁴² James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

⁴³ SELIGMAN, *supra* note 2, at 54, 75.

⁴⁴ Choi & Pritchard, *supra* note 7, at 5 (noting that disclosure is the “prevailing regulatory strategy in securities markets”).

⁴⁵ DAVID P. MCCAFFREY & DAVID W. HART, WALL STREET POLICES ITSELF: HOW SECURITIES FIRMS MANAGE THE LEGAL HAZARDS OF COMPETITIVE PRESSURES 47 (1998). See also THE SECURITIES AND EXCHANGE COMMISSION (SEC): BACKGROUND, ISSUES, BIBLIOGRAPHY, at xxv-xxx (Brian J. Wilder ed., 2003) [hereinafter Wilder].

⁴⁶ MCCAFFREY & HART, *supra* note 45, at 47.

⁴⁷ See NORMAN POSER, BROKER-DEALER LAW & REGULATION, § 13.01 (2d ed. 2001); MCCAFFREY & HART, *supra* note 45, at 47; Wilder, *supra* note 45, at xxvii.

⁴⁸ MCCAFFREY & HART, *supra* note 45, at 47. See also Wilder, *supra* note 45, at xxv-xxx.

States,⁴⁹ but also placed restrictions on that power.⁵⁰ In Section 2 of the Securities Act, Congress dictated that the Commission's rules must protect investors and promote efficiency, competition, and capital formation.⁵¹ In fulfilling that mandate, the SEC has regularly recognized the importance of small businesses and carved out special provisions designed to address the unique problems they face.⁵²

III. THE PRECEDENT FOR SMALL BUSINESS EXEMPTIONS

A. *Importance of Small Businesses*

Small businesses are the lifeblood of the American economy⁵³ and the source of most of the economy's innovation and opportunity.⁵⁴ According to the U.S. Census, in 2000 there were approximately 5.6 million small businesses in the United States.⁵⁵ During 2000 and 2001, small businesses with fewer

⁴⁹ See 15 U.S.C. § 78d (2005) (establishing the Securities and Exchange Commission). See also James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200, 1205 (1999) (“[T]he Securities and Exchange Commission has been the supreme regulatory authority in the United States since its creation in 1934.”); Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 320 n.8 (2002) (“The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934.”).

⁵⁰ 15 U.S.C. § 77b(b) (2005) (describing the rulemaking considerations the SEC must make).

⁵¹ *Id.*

⁵² See *infra* Part III.

⁵³ Susan Ness, *Regulating Media Competition: The Development and Implications of the FCC's New Broadcast Ownership Rules*, 53 AM. U. L. REV. 533, 543 (2004) (“Small business is the lifeblood of this country.”); Mark E. Roszkowski, *State Oil Company v. Kahn and the Rule of Reason: The End of Intra-brand Competition?*, 66 ANTITRUST L. J. 613, 634 (1998) (“Interests of entrepreneurs and small business have been a recurrent concern because independent entrepreneurs have been seen as the heart and lifeblood of American free enterprise”); Comm’r Norman S. Johnson, *Small Business: The Lifeblood of Our Nation's Economy*, Remarks at the 18th Annual Government-Business Forum on Small Business Capital Formation (Sept. 13, 1999), at <http://www.sec.gov/news/speech/speecharchive/1999/spch292.htm> (“Small business is truly the lifeblood of this nation's economy.”).

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

⁵⁵ U.S. Census Bureau, *Statistical Abstract of the United States: 2003*, § 15: Business Enterprise 493, 506, tbl. 747 (2003), available at <http://www.census.gov/prod/2004pubs/03statab/business.pdf>. The U.S. Small Business Administration Office of Size Standards defines small business as a business that has between one and five hundred employees. Office of Advocacy, Small Business Administration, Small

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

Despite their importance, however, small businesses face unique challenges in conforming to federal laws because of their size.⁵⁸ The Small Business Administration has exhaustively documented the unique burdens faced by small businesses in complying with all types of federal regulations.⁵⁹ In response, Congress has passed laws such as the Regulatory Flexibility Act⁶⁰ that recognize the impact that federal regulation has on small business entities⁶¹ and require regulatory agencies to consider types of exemptions and reduced standards for them.⁶² Regardless of how “small business” is defined,⁶³ the exemptions are all based on the common belief that a business’s small size justifies exemption

Business By The Numbers (June 2004) (on file with author), at <http://www.sbaonline.sba.gov/advo/stats/sbfaq.pdf> [hereinafter Small Business By The Numbers].

⁵⁶ Small Business By The Numbers, *supra* note 55. In those two years, large business employment decreased by 150,905, while small businesses saw a net increase of 1,150,875 jobs. *Id.*

⁵⁷ *Id.*

⁵⁸ See Verkuil, *supra* note 13, at 221 (stating that the complexity of federal regulations and economies of scale combine to disadvantage small businesses).

⁵⁹ See generally The Impact of Regulatory Costs on Small Firms, A Report for The Office of Advocacy, U.S. Small Business Administration, available at <http://www.sba.gov/advo/research/rs207tot.pdf> (last visited Aug. 18, 2005) (stating that it costs firms employing fewer than 20 employees \$6,975 per employee to comply with all required federal regulations, nearly 60% more than the cost per employee for firms with more than 500 employees.).

⁶⁰ RFA, *supra* note 13.

⁶¹ THOMAS O. MCGARITY, REINVENTING RATIONALITY: THE ROLE OF REGULATORY ANALYSIS IN FEDERAL BUREAUCRACY 115 (1991) (“A primary purpose of the Regulatory Flexibility Act is to make regulatory agencies sensitive to the impacts of their regulations on small business entities. This reflects a legislative determination that small businesses bear a disproportionate share of the regulatory compliance expenses . . .”).

⁶² Verkuil, *supra* note 13, at 271 (stating that the RFA urges agencies “to recognize differences in size when promulgating rules”); C. Steven Bradford, *Does Size Matter? An Economic Analysis of Small Business Exemptions from Regulation*, 8 J. SMALL & EMERGING BUS. L. 1, 3 (2004) [hereinafter Bradford, *Size*].

⁶³ United States Regulatory Council, TIERING REGULATIONS; A PRACTICAL GUIDE 4-9 (1981) (stating that while small firms are often characterized as such by the number of employees they have, “small” is defined in a wide variety of ways for different laws, including the amount of the firm’s assets and the size of the transaction being regulated). See *e.g.*, 17 C.F.R. § 230.504(b)(iii)(2) (2005) (enacting an exemption for securities offerings made by non-reporting companies if the amount of the offering does not exceed \$1 million.).

from some regulations.⁶⁴ This belief is not only reflected in laws passed by Congress – there is broad public support for reduced regulation of small businesses as well.⁶⁵

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

⁶⁴ Bradford, *Size*, *supra* note 62, at 3.

⁶⁵ See, e.g., Robert A. Peterson et al., *Opinions About Government Regulation of Small Business*, 22 J. SMALL BUS. MGMT. 56, 59 (1984) (citing results of a survey which found that a majority of the general public surveyed favored less governmental regulation for small business).

⁶⁶ Perry E. Wallace, Jr., *Integration of Securities Offerings: Obstacles to Capital Formation Remain for Small Businesses*, 45 WASH. & LEE L. REV. 935, 935-36 (1988) (stating that small issuers are particularly deserving of relief from unnecessary legal strictures because of the significant economic benefits they confer on American society).

⁶⁷ Securities Act § 3(b) (codified in Securities Act of 1933, ch. 38, § 3b, 48 Stat. 75 (1933) (current version at 15 U.S.C. §77c (2005))). The threshold for this exemption is currently \$5 million.

⁶⁸ See, e.g., Securities Act § 4(6) (codified in 15 U.S.C. § 77d (2005)) (exempting transactions of \$5 million or less that involve accredited investors).

⁶⁹ Johnson, *supra* note 53 (“[T]he Commission and small businesses share an interest in streamlining the capital formation process.”).

⁷⁰ C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 3-4 (2001) [hereinafter Bradford, *Securities*] (“[B]ecause of economies of scale in registration, the cost of registering small offerings is disproportionately burdensome, consuming a greater percentage of the offering price than in larger offerings.”).

⁷¹ Stuart R. Cohn, *The Impact of Securities Laws on Developing Companies: Would the Wright Brothers Have Gotten off the Ground?*, 3 J. SMALL & EMERGING BUS. L. 315, 317 (1999). See also Verkuil, *supra* note 13, at 226 n.73 (stating that the SEC’s Office of Small Business seeks to minimize the negative impact of the Commission’s rules on small business).

certain exemptions to the registration requirements for transactions done by small businesses.⁷²

B. Regulation D

Almost 50 years after the Securities Act was passed,⁷³ the SEC adopted Regulation D in response to concerns about small businesses' access to the capital markets.⁷⁴ For years before Regulation D was enacted, many commentators criticized the regulations and requirements of the federal securities laws because of the comparatively disproportionate costs they imposed on small businesses that attempted to raise capital in the public securities markets.⁷⁵ In response, the SEC held a series of public hearings to examine the special problems faced by small issuers under the federal securities laws,⁷⁶ especially the effects of regulations on small businesses' access

⁷² Cohn, *supra* note 71, at 317 n.2 (listing several recent rule changes, including reforms to Regulation D of the Securities Act of 1933).

⁷³ Regulation D replaced three earlier exemptive rules. Release No. 33-6389, *supra* note 16 ("Regulation D replaces exemptions that currently exist under Rules 146, 240, and 242.").

⁷⁴ *Id.* ("Regulation D is the product of the Commission's evaluation of the impact of its rules and regulations on the ability of small businesses to raise capital. This study has revealed a particular concern that the registration requirements and the exemptive scheme of the Securities Act impose disproportionate restraints on small issuers."). See also Tom A. Alberg & Martin E. Lybecker, *New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registration for the Sale of Securities*, 74 COLUM. L. REV. 622, 622 (1974) (stating that most small businesses are precluded from raising capital by selling securities to the public due to the high cost of SEC registration); Roy L. Brooks, *Small Business Financing Alternatives Under the Securities Act of 1933*, 13 U.C. DAVIS L. REV. 543, 546 (1980) (stating that the regulatory burden on small business issuers is a significant factor in the high cost of obtaining capital).

⁷⁵ Securities Act Release No. 33-5914, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,530 (Mar. 6, 1978) [hereinafter Release No. 33-5914] (acknowledging that calls for action had come from a variety of sources, including "the Small Business Administration, venture capital groups, and a substantial number of professional commentators."). See Brooks, *supra* note 74, at 545-46 (stating that small business growth had been stagnant due to the "high cost of long term equity capital"); Lawrence A. Coles, Jr., *Has Securities Law Regulation in the Private Capital Markets Become a Deterrent to Capital Growth: A Critical Review*, 58 MARQ. L. REV. 395, 462-63 (1975) (arguing that the exemptive scheme was "less useful than intended").

⁷⁶ Release No. 33-6389, *supra* note 16; Release No. 33-5914, *supra* note 75 (stating that the SEC began its evaluation in 1978 with 21 days of hearings in six different cities). See also Rutherford B. Campbell, Jr., *The Plight of Small Issuers (And Others) Under Regulation D: Those Nagging Problems That Need Attention*, 74 KY. L.J. 127, 130 (1985) ("[T]he Commission . . . realized that it needed to take a hard look at the special problems of small issuers under the federal securities laws.").

to capital.⁷⁷ As will be discussed in Part III.C of this note, the economic rationale for Regulation D – like all small offering exemptions – was the high relative cost to small businesses of registering securities.⁷⁸

Regulation D consists of eight rules enacted by the SEC which provide exemptions from the registration requirements for offerings made under the Securities Act of 1933.⁷⁹ According to the SEC, Regulation D was designed to accomplish three goals: 1) to simplify and clarify the existing exemption scheme; 2) to eliminate unnecessary restrictions on issuers, and small businesses in particular; and 3) to achieve uniformity between state and federal exemptions “in order to facilitate capital formation consistent with the protection of investors.”⁸⁰ Regulation D sets out three separate exemptions in Rules 504,⁸¹ 505,⁸² and 506.⁸³ Rule 504 provides an offering exemption from registration for transactions totaling less than \$1 million,⁸⁴ provided the issuer meets certain other specified conditions.⁸⁵ Rule 505 provides an exemption for offerings up

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

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

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

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

⁸¹ 17 C.F.R. § 230.504 (2005).

⁸² 17 C.F.R. § 230.505 (2005).

⁸³ 17 C.F.R. § 230.506 (2005).

⁸⁴ 17 C.F.R. § 230.504(b)(2) (2005). When Regulation D was adopted in 1982, the limit was \$500,000. The dollar amount was raised to \$1 million in 1988. *See* Securities Act Release No. 33-6758, [1987-1988 Transfer Binder] Fed. Sec. L Rep. (CCH) ¶ 84,221 (Mar. 3, 1988) [hereinafter Release No. 33-6758].

⁸⁵ 17 C.F.R. § 230.504(b) (2005). In an offering made under Rule 504, general solicitation is permitted in limited circumstances. MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 49 (3d ed. 2001). In addition, the aggregate amount of securities offered under Rule 504 cannot exceed \$1 million for any 12 month period. *Id.*

to \$5 million,⁸⁶ but imposes more restrictions on the characteristics of the offering than Rule 504.⁸⁷ Most importantly, offerings made under Rule 505 are limited in the types and numbers of investors who may participate⁸⁸ and, as a result, issuers are required to account for the number and nature of the purchasers of these securities.⁸⁹ Rule 506 differs from the other two rules in that it does not set a limit on the size of the transaction.⁹⁰ It instead focuses on the number and nature of the investors who participate in the offering⁹¹ to an even greater extent than does Rule 505.⁹²

Together, these three rules provide a comprehensive set of exemptions⁹³ that, while technically available to companies of all sizes, were specifically designed to benefit small companies attempting to obtain financing through a public securities offering.⁹⁴ According to the SEC, this design has been effective in practice as well as in theory. In a recent release, the Commission estimated that small businesses continue to be the principal beneficiaries of Regulation D.⁹⁵ In

⁸⁶ 17 C.F.R. § 230.505(b)(2)(i) (2005).

⁸⁷ 17 C.F.R. § 230.505(b)(2)(ii) (2005).

⁸⁸ This restriction is based on the distinction between accredited and unaccredited investors. Accredited investors typically have more wealth at their disposal and are irrebuttably presumed to be sophisticated investors. As a result, they do not require registration-type disclosure from companies making exempt offerings. STEINBERG, *supra* note 85, at 41. Rule 501(a) lists eight types of accredited investors, among them any individual with a net worth of more than \$1 million and any individual with an annual income of more than \$200,000 (or, if married, a combined annual income of more than \$300,000). While an offering made under Rule 505 cannot be purchased by more than thirty-five unaccredited investors, an unlimited number of accredited investors may participate. 17 C.F.R. § 230.501(a) (2005).

⁸⁹ Sargent, *supra* note 17, at 233 (stating that the amount and type of purchasers dictates the type of disclosure that is required).

⁹⁰ Compare 15 U.S.C. § 77d(2) (2005) (codifying § 4(2) of the Securities Act, which grants authority for exemptions (such as Rule 506) that are not limited by the size of the transaction), with 15 U.S.C. § 77c(b) (2005) (codifying § 3(b) of the Securities Act, which grants authority for exemptions (including Rules 504 and 505) that are restricted to offerings where the aggregate amount does not exceed \$5 million).

⁹¹ 17 C.F.R. §§ 230.506(b)(2)(i)-(ii) (2005).

⁹² Sargent, *supra* note 17, at 235. Like Rule 505, Rule 506 allows for a maximum of 35 unaccredited investors to participate in an offering. In addition, Rule 506 also requires that all unaccredited investors meet certain “sophistication standards.” Release No. 33-6389, *supra* note 16.

⁹³ Sargent, *supra* note 17, at 236.

⁹⁴ Donahue, *supra* note 80, at 496 (“[T]he new rules were primarily adopted to facilitate capital growth by small businesses . . .”).

⁹⁵ Securities Act Release No. 33-7644, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,114, at 86,114 (Feb. 25, 1999) (“While it is not possible to know with certainty, it is believed that most of these [Regulation D] offerings were done by small businesses.”).

addition, the SEC has reported on the increasing popularity of the exemptions, with over 17,000 Form Ds – the required notice of the sale of unregistered securities under Regulation D – filed in fiscal year 2003.⁹⁶

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

C. *Small Businesses and the Need for Regulatory Exemptions*

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

⁹⁶ See Release No. 33-6389, *supra* note 16; Small Business Regulation D Exemption Process (Mar. 29, 2004), <http://www.sec.gov/about/oig/audit/371fn.pdf>.

⁹⁷ These provisions include Section 17(a) of the Securities Act (15 U.S.C. § 77q (2005)) and Section 10(b) of the Exchange Act (15 U.S.C. § 78j (2005)).

⁹⁸ Bradford, *Securities*, *supra* note 70, at 31 (“The choice is not simply between full registration or nothing at all.”).

⁹⁹ 17 C.F.R. § 230.502(c) (2005).

¹⁰⁰ 17 C.F.R. § 230.501(e) (2005).

¹⁰¹ Sargent, *supra* note 17, at 292 (“Regulation D substantially reduces the costs of compliance for small business issuers without substantially increasing investors’ risk of fraud or overreaching.”). Congress gave the SEC an explicit mandate in Section 2 of the Securities Act, stating that when the Commission creates a rule pursuant to the Act, it must consider whether the rule protects investors and the public interest, as well as promotes efficiency, competition, and capital formation. 15 U.S.C. § 77b (2005). The SEC further acknowledged the need to strike this balance in its final release describing Regulation D, stating that the rules were designed “to facilitate capital formation consistent with the protection of investors.” Release No. 33-6389, *supra* note 16.

regulation must outweigh its cost.¹⁰² In fact, one commentator has said that any government regulation whose costs exceed its benefits is “senseless.”¹⁰³ In the case of small businesses, the relative costs of compliance with federal regulations can be disproportionately high, both in terms of dollars and manpower.¹⁰⁴ This is the result of economies of scale, the idea that the average costs per dollar of proceeds decrease as the size of the company or transaction increases because fixed costs can be spread out.¹⁰⁵ As a result, only larger companies and larger transactions benefit from lower average costs.¹⁰⁶

Economies of scale are particularly prominent in securities regulations.¹⁰⁷ For example, paperwork and record keeping requirements, such as the number of reports and the time required to complete them, often do not vary with the size of the business.¹⁰⁸ In addition, the costs of interpreting a regulation are often extensive.¹⁰⁹ In many small businesses, the owners or managers perform several different tasks in managing and operating the business.¹¹⁰ Since the personnel in many small businesses are not specialized,¹¹¹ it often falls to

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

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

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

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

¹⁰⁶ Bradford, *Size*, *supra* note 62, at 14.

¹⁰⁷ “There are scale economies in regulatory compliance if the average cost of complying with regulation – measured by the total cost of complying with regulations divided by firm size . . . decreases with firm size.” WILLIAM A. BROCK & DAVID S. EVANS, *THE ECONOMICS OF SMALL BUSINESSES: THEIR ROLE AND REGULATION IN THE U.S. ECONOMY* 65 (1986).

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

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

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

¹¹¹ See *Federal Paperwork Requirements: Hearing Before the Subcomm. on Gov’t Reg. and Paperwork of the S. Select Comm. on Small Bus.*, 96th Cong. 12 (1979)

the owner or manager of the business to ensure compliance with federal regulations, which takes time and energy away from running the business itself.¹¹² Further, complex regulations that require expert interpretation, such as Sarbanes-Oxley Section 404, must be outsourced to expensive professionals such as lawyers and accountants.¹¹³ On the other hand, large businesses have staff specifically dedicated to regulatory compliance, which allows management to devote its time and efforts to running the business.¹¹⁴

In a securities offering, for example, the substantial cost of registering the offering with the SEC consumes a larger percentage of the offering proceeds in a smaller offering than in a larger offering.¹¹⁵ The costs of registration, which by one estimate can range from \$200,000 to \$500,000,¹¹⁶ include fees for legal and accounting work, filing fees paid to the SEC, and printing costs.¹¹⁷ In addition, this amount does not include the fee paid to the underwriters, which is taken out of the offering price in the form of a discount.¹¹⁸ Companies can use several types of forms to register offerings, depending on their size and characteristics.¹¹⁹ Form S-3 is used to register public securities offerings from most large, established companies.¹²⁰ Forms SB-

(statement of Wayne G. Granquist, Associate Director, Management and Regulatory Policy, Office of Management and Budget) (stating that government requirements for information are exceptionally difficult for small businesses because their employees are not specialized).

¹¹² See *Hearing on Overregulation of Small Business*, *supra* note 104, at 30.

¹¹³ See Thomas Watterson, *Accountants Riding the Sarbanes-Oxley Wave*, BOSTON GLOBE, Oct. 10, 2004, at G7 (stating that companies and external auditors need accountants with at least three to five years experience to handle the relatively challenging work related to Sarbanes-Oxley); Bradford, *Size*, *supra* note 62, at 8 (“Federal laws and regulations are often complex – as one congressional witness complained, ‘written . . . by lawyers for lawyers.’”).

¹¹⁴ *Hearing on Overregulation of Small Business*, *supra* note 104, at 30 (statement of Donald S. Shoup, President, Winnepesaukee Aviation) (“In a large business the compiling and submission of required reports is the specific job of certain individuals.”).

¹¹⁵ Bradford, *Securities*, *supra* note 70, at 24.

¹¹⁶ Bradford, *Exemptions*, *supra* note 78, at 603.

¹¹⁷ Bradford, *Securities*, *supra* note 70, at 24.

¹¹⁸ *Id.* at 24-25. The fee received by the underwriter is the difference between the public offering price and the proceeds received by the issuer company. In a hypothetical offering where the offering price is \$10 per share, the underwriter would sell shares to the public at \$10 share, but only pay the issuer company \$9.50 per share, keeping the \$0.50 per share difference as a fee.

¹¹⁹ STEINBERG, *supra* note 85, at 114-15.

¹²⁰ *Id.* at 114. Form S-3 is available to companies which have been subject to the reporting requirements of the Exchange Act for 12 months and have a market value of \$75 million or more. Form S-3 requires the least disclosure to be presented in

1 and SB-2 are special registration forms provided by the SEC for small business issuers.¹²¹ Small business issuers can use Form SB-1 to register up to \$10 million of securities,¹²² while Form SB-2 can be used by small business issuers to sell any amount of securities.¹²³ Finally, Form S-1 is used primarily by first-time issuers for initial public offerings.¹²⁴

The cost and preparation time required for each of these types of forms varies greatly. In a 1998 Securities Act Release, the SEC made its own estimate of the hours of work required by a company's internal staff and external professionals to prepare a registration statement for a public offering.¹²⁵ It found that only 398 hours were required to prepare Form S-3.¹²⁶ In contrast, the special registration forms provided by the SEC for small or newly public companies required much more time to prepare. According to the SEC's estimates, 710 hours were required for Form SB-1 and 876 hours were required to prepare Form SB-2.¹²⁷ The most preparation time was required to complete Form S-1, consuming 1,267 hours of internal and external staff time.¹²⁸

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

¹²¹ A small business issuer is a U.S. or Canadian issuer that 1) has annual revenues of less than \$25 million, 2) an aggregate market value of less than \$25 million, and 3) is not an investment company. 17 C.F.R. § 240.12b-2 (2005). *See also* STEINBERG, *supra* note 85, at 115. Forms SB-1 and SB-2 are part of the framework of Regulation SB, which was adopted by the SEC in 1992 to facilitate small businesses' access to the capital markets. *Id.*

¹²² Regulation of Securities Offerings, Securities Act Release No. 33-7606A, Exchange Act Release No. 40632A, Investment Company Act Release No. IC-23519A, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,108, at 81,461-63 (Nov. 13, 1998) [hereinafter Release No. 33-7606A]. Form SB-1 is used only if no more than \$10 million in securities, including the present offering, have been registered in any 12-month period. STEINBERG, *supra* note 85, at 430.

¹²³ Release No. 33-7606A, *supra* note 122, ¶ 81,584; STEINBERG, *supra* note 85, at 430.

¹²⁴ STEINBERG, *supra* note 85, at 429. Form S-1 is the basic, long-form registration statement and requires full registrant and transaction information to be included in the prospectus. *Id.*

¹²⁵ Release No. 33-7606A, *supra* note 122, ¶¶ 81,461-63 (proposing rules changes to allow more companies to use the small business forms, thereby reducing the costs of registered offerings for small issuers). The SEC estimated that 75% of the time required to prepare the forms would be used by external professionals, as opposed to internal corporate staff. *Id.* ¶¶ 81,584-85.

¹²⁶ *Id.* ¶¶ 81,584-85.

¹²⁷ *Id.*

¹²⁸ *Id.* ¶ 81,584 (detailing the regulation of securities offerings). The forms used by less seasoned issuers require more disclosure than those used by larger, more established companies. Form S-3, for example, allows companies to incorporate much of the required information by reference to other disclosure documents filed with the SEC, such as quarterly and annual reports. Adoption of Integrated Disclosure System,

Further, in a separate study the SEC's Advisory Committee on Capital Formation and Regulatory Processes found that the costs per dollar raised were highest in offerings made by companies using Form SB-2 for small business issuers.¹²⁹ On a percentage basis, though, the costs were lowest for companies using Form S-3.¹³⁰ The Committee concluded that the costs of a registered public offering for small companies and new entrants to the capital markets equal a larger percentage of offering proceeds than for larger and more seasoned issuers.¹³¹ Due to economies of scale, therefore, regulations that impose high fixed costs can be a substantial impediment to the growth and flexibility of small businesses.¹³²

Economies of scale do not only apply to the costs of securities transactions, however. The SEC has also recognized that they exist in regulatory and compliance costs as well.¹³³ During the course of its investigation leading up to the adoption of Regulation D, the SEC acknowledged that "the cost of compliance with Exchange Act reporting requirements is not only substantial in absolute amounts but is relatively greater for smaller companies than for larger issuers."¹³⁴ In adopting Regulation D, the SEC intended it to substantially reduce costs to small business issuers of securities.¹³⁵ Additionally, there is significant anecdotal evidence, much of it collected by the SEC itself, regarding the extent of the negative effect of

Securities Act Release No. 33-6383, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328 (Mar. 3, 1982) [hereinafter Release No. 33-6383] (adopting the basic framework for registration statements); Securities Act Release No. 33-6964, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,385, at 83,385-86 (Oct. 22, 1992) [hereinafter Release No. 33-6964] (revising the rules for using the Form S-3 short-form registration statement).

¹²⁹ Securities and Exchange Commission, Report of the Advisory Committee on Capital Formation and Regulatory Processes, Fed. Sec. L. Rep. (CCH) Special Report No. 1725 app. at 5, tbl. 1 (July 24, 1996), available at <http://www.sec.gov/news/studies/capform.htm>.

¹³⁰ *Id.*

¹³¹ *Id.* app. A, at 2.

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

¹³³ Exchange Act Release No. 34-16866, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,606, at 83,227 (June 2, 1980).

¹³⁴ *Id.*

¹³⁵ Sargent, *supra* note 17, at 239 (describing the SEC's intent that "the substantive provisions of the Regulation" would "relieve issuers of substantial costs").

overregulation of small businesses.¹³⁶ In recognizing these small business concerns, the SEC has carved out numerous exceptions to its rules and requirements in addition to Regulation D, including exemptions based on the size of the company¹³⁷ and those based on the size of the transaction.¹³⁸ As will be discussed in Part V of this note, the company size threshold used by other SEC exemptions serves as an appropriate model for an exemption to Sarbanes-Oxley Section 404 that would alleviate the comparatively disproportionate impact which it has on small businesses.

IV. HISTORY OF SARBANES-OXLEY

A. *Background*

The Sarbanes-Oxley Act instituted the most comprehensive changes to the federal securities laws since they were enacted in the 1930s.¹³⁹ The Act strengthened and modernized the laws¹⁴⁰ in response to the financial and accounting scandals of the early twenty-first century, including the financial collapses and bankruptcies of major companies such as Enron and WorldCom,¹⁴¹ and sought to “enhance the

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

¹³⁷ See Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2 (2005) (defining “small business issuer” as a U.S. or Canadian issuer with less than \$25 million in revenues and public float that is not an investment company); Securities Act Release 33-8128, Exchange Act Release No. 34-46464, [2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,724 (Sept. 5, 2002) [hereinafter Release No. 33-8128] (describing the small company exemption from the accelerated periodic reporting dates).

¹³⁸ See Regulation D, *supra* note 16.

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

¹⁴⁰ The Sarbanes-Oxley Act “seeks, in essence, to revitalize the spirit of the Securities Act of 1933 and the Securities and Exchange Act of 1934.” Thomas O. Gorman & Heather J. Stewart, *Is There a New Sheriff in Corporateville? The Obligations of Directors, Officers, Accountants, and Lawyers After Sarbanes-Oxley of 2002*, 56 ADMIN. L. REV. 135, 138 (2004).

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

quality of reporting and increase investor confidence in the financial markets.”¹⁴²

Enron’s free-fall from grace began with its quarterly earnings announcement in mid-October 2001, in which the company disclosed a large decrease in shareholder equity.¹⁴³ In the less than two months that followed, a torrent of bad news, including an earnings restatement,¹⁴⁴ cash shortages, credit downgrades, an SEC investigation and an aborted merger,¹⁴⁵ drove the seventh largest corporation in the United States to file for bankruptcy in December 2001.¹⁴⁶

In late 2001 and early 2002, Congress held numerous hearings on the collapse of Enron, which at the time was the largest bankruptcy in U.S. history.¹⁴⁷ Various committees in both the Senate and the House of Representatives examined the impact of the Enron scandal on the financial¹⁴⁸ and energy markets,¹⁴⁹ accounting practices,¹⁵⁰ and retirement accounts and pension plans.¹⁵¹ The House Committee on Financial Services

¹⁴² HAMILTON & RASMUSSEN, *supra* note 15, at 11.

¹⁴³ Floyd Norris, *Where Did the Value Go at Enron?*, N.Y. TIMES, Oct. 23, 2001, at C1.

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

¹⁴⁵ Opper & Atlas, *supra* note 9.

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

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

¹⁴⁸ See, e.g., *The Enron Collapse: Impact on Investors and Financial Markets: Joint Hearing Before the Subcomm. on Capital Markets, Insurance, and other Government Sponsored Enterprises and the Subcomm. on Oversight and Investigations of the House Comm. on Financial Services*, 107th Cong. (2001).

¹⁴⁹ See, e.g., *The Effect of the Bankruptcy of Enron on the Functioning of Energy Markets: Hearing Before the Subcomm. on Energy and Air Quality of the House Comm. on Energy and Commerce*, 107th Cong. (2002).

¹⁵⁰ See, e.g., *Destruction of Enron-related Documents by Andersen Personnel: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 107th Cong. (2002).

¹⁵¹ See, e.g., *Protecting the Pensions of Working Americans: Lessons from the Enron Debacle: Hearing Before the Senate Comm. on Health, Education, Labor, and Pensions*, 107th Cong. (2002); *The Enron Collapse and Its Implications for Worker*

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

Retirement Security: Hearings Before the House Comm. on Education and the Workforce, 107th Congress (2002).

¹⁵² See Manz, *supra* note 3, at ix.

¹⁵³ *Id.*

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

¹⁵⁵ “We [should not] look to a significant expansion of regulation as the solution to current problems Regulation has, over the years, proven only partially successful in dissuading individuals from playing with the rules of accounting.” Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks at the Stern School of Business, New York University (Mar. 26, 2002), *available at* <http://www.federalreserve.gov/boarddocs/speeches/2002/200203262/default.htm>.

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

consequences of adopting a hasty response could far outweigh any potential benefits.¹⁵⁷

Current events, however, pressured Congress to act quickly and decisively. New revelations following just a few months after Enron's bankruptcy about accounting abuses at WorldCom and elsewhere fueled public support for prompt action.¹⁵⁸ In an election year, no one wanted to appear soft on the issue of corporate fraud.¹⁵⁹ As a result, the bill passed by a nearly unanimous vote in both the House of Representatives¹⁶⁰ and the Senate¹⁶¹ only seven months after Enron declared bankruptcy.¹⁶² In the same month it was introduced in both chambers of Congress,¹⁶³ President Bush signed Sarbanes-Oxley into law,¹⁶⁴ declaring that "[t]he era of low standards and false profits is over. No boardroom in America is above or beyond the law No more easy money for corporate criminals, just hard time."¹⁶⁵

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

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

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

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

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

¹⁶¹ On July 25, 2002, the Senate voted 99-0 in favor of the bill. 148 CONG. REC. S7365 (daily ed. July 25, 2002).

¹⁶² John Paul Lucci, *Enron – The Bankruptcy Heard Around the World and the International Ricochet of Sarbanes-Oxley*, 67 ALB. L. REV. 211, 215 (2003).

¹⁶³ *Id.*

¹⁶⁴ Bush, *supra* note 3, at 1285.

¹⁶⁵ *Id.* at 1284-85.

responsibilities and obligations of a company's audit committee¹⁶⁶ and its management,¹⁶⁷ as well as the structure of the audit committee.¹⁶⁸ Sarbanes-Oxley also established the Public Company Accounting Oversight Board ("PCAOB"),¹⁶⁹ which along with the SEC, has prescribed rules for complying with Sarbanes-Oxley.¹⁷⁰ These other provisions, however, are beyond the scope of this note. The focus of this note is Section 404 and how in its haste to adopt Sarbanes-Oxley, Congress ignored its potentially disproportionate impact on small businesses.¹⁷¹ The small business exemption proposed in this note addresses some of the unintended, yet serious consequences of Sarbanes-Oxley Section 404 for small businesses.

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

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

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

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

¹⁷⁰ *See, e.g.*, Exchange Act Release No. 34-49544, [2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,203 (Apr. 8, 2004) [hereinafter Exchange Act Release No. 34-49544] (describing PCAOB's adoption of Accounting Standard No. 2 to govern auditors' attestations and reports under Section 404).

¹⁷¹ *See infra* Part IV.D.

*B. Sarbanes-Oxley Section 404*¹⁷²

Of the many provisions of Sarbanes-Oxley,¹⁷³ Section 404 has proven to be one of the most complicated and expensive for companies to implement.¹⁷⁴ This relatively short section¹⁷⁵ is one of the most significant new obligations for companies under Sarbanes-Oxley,¹⁷⁶ and as will be shown, one of the most problematic as well.¹⁷⁷

Specifically, Section 404 requires a company's annual report¹⁷⁸ to include an assessment by the management of the effectiveness of the company's internal control structure and

¹⁷² Sarbanes-Oxley Section 404: Management Assessment of Internal Controls:

(a) Rules Required: The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. § 78m or § 78o(d)) to contain an internal control report, which shall:

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) Internal Control and Evaluation: With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

¹⁷³ See *supra* notes 166-70 and accompanying text.

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

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

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

¹⁷⁷ See *infra* Part IV.C.

¹⁷⁸ As required by section 13(a) or 15(d) of the Exchange Act (15 U.S.C. § 78m(a)(2) or § 78o(d) (2005)).

procedures.¹⁷⁹ Section 404 also requires the company's auditor to report on and attest to the management's assessment of the company's internal controls.¹⁸⁰ The goal of these two required reports is to provide investors with information to better evaluate the management and financial health of the company¹⁸¹ and the SEC has adopted rules in order to achieve this purpose.¹⁸²

Internal control is a broad concept that goes beyond the accounting operations of a company and includes procedures and processes in every part of a business.¹⁸³ Therefore, a company's report on its internal controls will not only contain an appraisal of its financial condition, but will include an evaluation of things such as the company's risk assessment policies and its information and communications systems.¹⁸⁴ In addition, both of the Section 404 reports are very detailed and labor-intensive to prepare. For example, preparation of the report by management on internal controls alone will likely require contributions from multiple parties, including senior management, internal auditors, in-house counsel, outside counsel and audit committee members from the board of directors.¹⁸⁵ These contributions are needed for management to

¹⁷⁹ Section 404(a)(2), *supra* note 15 (codified at 15 U.S.C. § 7262 (2005)). *See also* Securities Act Release No. 33-8238, Exchange Act Release No. 34-47986, Investment Company Act Release No. IC-26068, [2003 Transfer Binder] Federal Sec. L. Rep. (CCH) ¶ 86,023 (June 5, 2003) [hereinafter Release No. 33-8238] (requiring that each annual report assess the effectiveness of the internal control structure and the issuer's financial reporting procedures).

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

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

¹⁸² HAMILTON & RASMUSSEN, *supra* note 15, at 12. *See also* Exchange Act Release 34-49544, *supra* note 170; John C. Coffee, Jr., *Sarbanes-Oxley Section 404 and Auditing Standard No. 2*, 97 N.Y.L.J. 5 (2004) (stating that an auditor preparing an internal controls report must conduct a complete audit of a company's internal controls and give an opinion on their effectiveness, not simply comment on management's statements).

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

¹⁸⁴ *Id.* at 19.

¹⁸⁵ Release No. 33-8238, *supra* note 179, ¶ 87,706 ("The preparation of the management report on internal control over financial reporting will likely involve multiple parties, including senior management, internal auditors, in-house counsel, outside counsel and audit committee members."). *See also* HAMILTON & RASMUSSEN, *supra* note 15, at 13.

report on such things as the company's framework for internal control and the system used to evaluate it.¹⁸⁶

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

Simply put, preparing an internal control report to comply with Section 404 requires a significant amount of time and labor from many different people in different capacities throughout a business. As a result, it is not surprising that the costs of compliance can be substantial¹⁹² and due to economies

¹⁸⁶ According to the SEC, the internal control report must include:

a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company; management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year; a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting; and a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.

Release No. 33-8238, *supra* note 179, ¶ 87,676.

¹⁸⁷ HAMILTON & RASMUSSEN, *supra* note 15, at 25.

¹⁸⁸ *Id.* at 20.

¹⁸⁹ *Id.* at 67 ("Auditors must not audit their own work.").

¹⁹⁰ *Id.* at 81 ("Because of the potential significance of the information obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control over financial reporting, the auditor cannot audit internal control over financial reporting without also auditing the financial statements.").

¹⁹¹ *Id.* at 67 ("This prohibition [on auditors auditing their own work] is in keeping with the auditor independence principles of the Sarbanes-Oxley Act and the SEC rules under which auditors impair their independence if they audit their own work . . .").

¹⁹² *See infra* Part IV.C.

of scale, these compliance costs disproportionately impact small businesses.¹⁹³ These high relative costs to small businesses are the most serious problem with Section 404 and the most compelling reason for a small business exemption to its requirements.

C. *Cost Problems with Sarbanes-Oxley and Section 404*

It has been widely acknowledged that Section 404 is the most expensive and challenging aspect of Sarbanes-Oxley.¹⁹⁴ While neither Congress nor the SEC expected that the new law would not cost anything to implement,¹⁹⁵ the tremendous increases in costs that have been seen beg the question of whether the benefits of these regulations justify their costs.¹⁹⁶ Due to economies of scale, the costs of these regulations are especially burdensome for small businesses.¹⁹⁷

A report on a company's internal controls under Section 404 amounts to a complete evaluation of a company's business by both management and the company's auditors.¹⁹⁸ As many firms have seen, the costs of audit fees as well as the costs of producing information to auditors have increased dramatically.¹⁹⁹ Since the reporting requirements are the same

¹⁹³ See *supra* Part III.C.

¹⁹⁴ See, e.g., *Sox and Stocks*, WALL ST. J., Apr. 19, 2005, at A20 ("The most notorious part of the law [Sarbanes-Oxley] is Section 404..."); Jackie Calmes & Deborah Solomon, *Snow Says "Balance" Is Needed in Enforcing Sarbanes-Oxley Law*, WALL ST. J., Dec. 17, 2004, at A1 ("Much of the Sarbanes-Oxley criticism stems from an SEC rule based on the law that requires companies to improve their internal controls to prevent accounting and other types of financial fraud."); Adrian Michaels & Dan Roberts, *Compliance Brings Business Benefits*, FIN. TIMES (LONDON), Apr. 23, 2004, at 2 ("[Section 404] is the most expensive part of the new corporate governance laws to implement . . .").

¹⁹⁵ HAMILTON & RASMUSSEN, *supra* note 15, at 12 (stating that Congress originally did not intend the auditor attestation requirements in Section 404(b) to be "the basis for increased charges or fees"); Release No. 33-8238, *supra* note 179, ¶ 87,706 ("The final rules will increase costs for all reporting companies.").

¹⁹⁶ See, e.g., Cait Murphy, *Keeping Small Business off the Street*, FORTUNE, Nov. 7, 2003, available at <http://www.fortune.com/fortune/print/0,15935,538294,00.html> (documenting the burdensome costs of compliance for small businesses).

¹⁹⁷ See *supra* Part III.C.

¹⁹⁸ See *supra* Part IV.B.

¹⁹⁹ Ribstein, *supra* note 158, at 40 ("Post-Enron . . . regulation directly increases firms' costs in part by requiring them to spend more to get information. In particular, new auditor regulation significantly increases firms' audit fees as well as their costs of dealing with and producing information for auditors."). See also Deborah Solomon & Cassell Bryan-Low, *Companies Complain About Cost of Corporate-Governance Rules*, WALL ST. J., Feb. 10, 2004, at A1 (describing the costs of Sarbanes-

regardless of size, all companies have to devote significant resources to the effort to conform to Sarbanes-Oxley's requirements.²⁰⁰ Costs incurred by companies to rearrange and disclose their corporate structure can be extremely oppressive, and potentially devastating, for new and smaller companies,²⁰¹ since they often do not have an extensive infrastructure or extra staff to absorb these new and more complex requirements.²⁰² Large, established issuers, however, have found it easier to comply with new regulations than smaller or newer firms.²⁰³

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

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

Oxley in terms of out-of-pocket expenses as well as the time and attention of management).

²⁰⁰ J. Michael Cook, *Moving Forward – A Guide to Improving Corporate Governance Through Effective Internal Control*, available at WL 1449 PLI/Corp 1135, 1148 (Oct. 2004).

²⁰¹ Peri Nielsen & Claudia Main, *Company Liability After the Act Sarbanes-Oxley*, 18 No. 10 INSIGHTS 2, 4 (2004).

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

²⁰³ Ribstein, *supra* note 158, at 46.

²⁰⁴ Financial Executives International, FEI Special Survey on Sarbanes-Oxley Section 404 Implementation Executive Summary (July 2004), <http://www.feio.org/download/SOXSurveyJuly.pdf>.

²⁰⁵ *Id.*

²⁰⁶ *Id.*

²⁰⁷ *Id.*

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

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

²⁰⁸ Cook, *supra* note 200, at 1148.

²⁰⁹ *Id.*

²¹⁰ Directors and officers (D&O) insurance provides protection to individual directors and officers from personal liability and financial loss arising out of their capacity as corporate officers and/or directors. See Aon Corp., Directors and Officers Liability Insurance, http://www.aon.com/risk_management/d_and_o.jsp (last visited Aug. 29, 2005).

²¹¹ Richard A. Epstein, *Sarbanes Overdose*, NAT’L L. J., Jan. 27, 2003, at A17 (stating that independence requirements for boards and new heightened disclosure standards have made directors’ duties much more onerous).

²¹² Greg Farrell, *Accounting Costs Rising as Wary Companies Play It Safe*, USA TODAY, July 31, 2003, at 2B (citing George Davitt, an attorney with Testa, Hurwitz & Thibeault in Boston). See also Robert Max Crane, *Going Private Transactions: A Serious Alternative for Small and Midsized Public Companies*, 177 N.J.L.J. 406 (2004) (“[B]y all accounts, the costs of directors’ and officers’ insurance has tripled or even quadrupled over the last year.”).

²¹³ Epstein, *supra* note 211 (“As the duties become more onerous, the willingness of individuals to serve as independent directors decreases Insurance coverage supplied to these directors now costs more and has higher deductibles and more exclusions.”).

²¹⁴ Tamara Loomis, *Costs of Compliance Soars [sic] After Sarbanes-Oxley*, 229 N.Y.L.J. 1 (2003) (citing a Foley & Lardner study which found that the average annual costs of being a public company increased from \$1.3 million to \$2.5 million in the year after Sarbanes-Oxley became law).

²¹⁵ Nielsen & Main, *supra* note 201, at 4.

some significant costs that recur annually, however, such as the auditor evaluation and attestation.²¹⁶

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

D. Legislative Problems with Sarbanes-Oxley and Section 404

In the words of one SEC Administrator, “[o]ut of anger, haste and politics came Sarbanes-Oxley.”²¹⁷ That is not to say that reform wasn't necessary, however. While Enron and WorldCom were the two biggest companies to be engulfed by scandals, scores of others were forced to restate earnings, which led to falling stock prices and a crisis of confidence in the markets.²¹⁸ Making matters worse was the fact that the events in the financial markets that led up to the summer of 2002 were not unprecedented.²¹⁹ In fact, many of the fraudulent devices seen during the frenetic bull market of the late 1990s were simply old schemes labeled with new names. These conspiracies included variations on the classic “pump-and-dump” scheme,²²⁰ which was reminiscent of the stock pool

²¹⁶ See Shevory, *supra* note 202 (“The expenses won't end when companies become compliant Businesses will have to monitor their internal controls every year and devote additional staff or consultant time.”); Thomas Watterson, *Accountants Riding the Sarbanes-Oxley Wave*, BOSTON GLOBE, Oct. 10, 2004, at G7 (“[E]xternal auditors have to go in and test the operational effectiveness of the internal control procedures every year This work isn't going to go away.”).

²¹⁷ Tom Fowler, *Five Questions with Hal Degenhardt: SEC Regional Office Beefs Up to Fight Corporate 'Betrayals'*, HOUSTON CHRONICLE, Oct. 12, 2004 (Business), at 2 (quoting Hal Degenhardt).

²¹⁸ Ribstein, *supra* note 158, at 7 (“Other accounting shenanigans in public corporations include Xerox's accelerating revenues from long-term equipment leases, Qwest's and Global Crossing's manipulation of revenues and expenses on sales and swaps of fiber optic capacity, and apparently rampant looting by the family controlling Adelphia.”).

²¹⁹ See *supra* Part II.

²²⁰ In a “pump-and-dump” scheme, several investors buy shares in thinly traded companies, fraudulently inflate their price (the “pump”) in order to sell to the public at an artificial profit (the “dump”). For an example of a modern pump-and-dump conspiracy, see *U.S. v. Benussi*, 216 F.Supp. 2d 299, 302 (S.D.N.Y. 2002), *aff'd sub nom.*

schemes of the late 1920s.²²¹ Furthermore, the seemingly innovative use of special purpose entities (“SPEs”)²²² and other off-balance sheet devices by Enron²²³ and others bore close resemblance to similar practices during the late 1920s.²²⁴ While rampant market speculation was not a new phenomenon,²²⁵ the fact that history had repeated itself with such massive and widespread financial fraud at the highest levels of business indicated that some changes needed to be made.²²⁶

It is widely acknowledged, however, that Sarbanes-Oxley was created, passed and signed at a speed almost unheard of in Washington.²²⁷ In contrast, the Exchange Act

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

²²¹ S. REP. NO. 73-1455, at 44-45 (1934) (stating that in both cases, manipulation of the trading volume by a small group of active traders was accompanied by dissemination of false and overly optimistic information about the stocks).

²²² A Special Purpose Entity (“SPE”) is a “business interest formed solely in order to accomplish some specific task or tasks. A business may utilize a special purpose entity for accounting purposes, but these transactions must still adhere to certain regulations.” Investorwords.com, Special Purpose Entity Definition, http://www.investorwords.com/5799/special_purpose_entity.html (last visited Aug. 30, 2005).

²²³ See *supra* note 9.

²²⁴ Ribstein, *supra* note 158, at 19 (“This is not the first time that widespread financial chicanery has occurred in the context of rampant market speculation. For example, some of the speculation preceding the 1929 Crash has a familiar ring. J.K. Galbraith recounts Goldman Sachs’ launching of a series of ‘exiguous’ trading companies whose assets consisted largely of their own stock, rose sharply with their own value, and fell just as fast.”).

²²⁵ See CHARLES MACKAY, EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS (Wordsworth Editions Ltd. 1995) (1841) (describing the rampant speculation that has seized markets specializing in everything from land to tulips throughout history). See also Lerach, *supra* note 23, at 73 n.8 (“This was not the first speculative bubble. The broadband boom has its match in the railway boom of the late 19th century. The Internet boom resembled the radio boom of the 1920s, when one of the favorite stocks, RCA, went from \$1 a share to almost \$600 a share in just a few years.”).

²²⁶ Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 Stan. J.L. BUS. & FIN. 127, 132 (2002) (“Enron served as a wake-up call for investors who realized that financial fraud threatened the very existence of a large number of public companies and our financial market system itself.”).

²²⁷ See *supra* notes 152-65 and accompanying text. See also H.R. Con. Res. 139, 108th Cong. § 3 (2003), available at <http://thomas.loc.gov/home/lawsmade.bysec/lawsnew.txt> (explaining that bills are drafted by congressional committees and based on studies and hearings that often last a year or more). Commentators have also noted the unusual speed at which Sarbanes-Oxley became law. See, e.g., Hilzenrath, *supra* note 159 (stating that the convergence of concerns over the drastic decline in the stock market and the series of admissions of corporate malfeasance by some of the nation’s largest corporations harnessed a “perfect storm” which enabled Sarbanes-Oxley to be ratified by both chambers of Congress in a

was passed two years after the Pecora Hearings had begun to illuminate the fraud and manipulation it sought to remedy.²²⁸ Since Sarbanes-Oxley's passage, critics have remarked that because Congress hurried to pass the Act, it was unable to achieve the necessary but delicate balance between the costs and benefits of these reforms.²²⁹ Specifically, the unique needs and concerns of small businesses were ignored during the abbreviated legislative process.²³⁰ According to one Congressman, "[s]mall business is one of the areas we could have focused on if we hadn't been rushed to pass this law."²³¹

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

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

matter of days.); Novarese, *supra* note 158 (Sarbanes-Oxley was ratified after a "lightning passage" by Congress).

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

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

²³⁰ See Berlau, *supra* note 8.

²³¹ *Id.* (quoting Rep. Jeff Flake (R-Ariz.)).

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

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

²³⁴ See *supra* Part IV.C.

towards small business in creating Sarbanes-Oxley demonstrate that a targeted small business exemption is necessary for the continued growth and prosperity of small businesses.

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

Recently, the SEC has publicly acknowledged the serious burdens faced by small businesses in complying with some of Sarbanes-Oxley's requirements and taken preliminary steps to alleviate these burdens. In December 2004, the SEC created a taskforce to examine the effects of Sarbanes-Oxley on smaller public companies.²³⁵ The Securities and Exchange Commission Advisory Committee on Smaller Public Companies ("Advisory Committee"), as the taskforce is known, will also make recommendations on where and how to scale back regulations for companies based on size.²³⁶ In announcing the creation of the Advisory Committee, then-SEC Chairman William Donaldson stated that he wanted to examine Section 404 in particular to see if compliance costs can be reduced for small companies.²³⁷

Even though the Advisory Committee is not scheduled to make its final report until April 2006,²³⁸ it has already influenced the SEC's policy regarding Section 404 and small business. In August 2005, the Advisory Committee recommended that the SEC further extend the Section 404 compliance dates for small companies known as "non-accelerated filers,"²³⁹ and the SEC adopted the Advisory Committee's recommendation without alteration one month

²³⁵ Press Release, U.S. Securities and Exchange Commission, SEC Establishes Advisory Committee to Examine Impact of Sarbanes-Oxley Act on Smaller Public Companies (Dec. 16, 2004), at <http://www.sec.gov/news/press/2004-174.htm> [hereinafter Advisory Committee Release]. See also Parker, *supra* note 174.

²³⁶ Charter, Securities and Exchange Commission Advisory Committee on Smaller Public Companies, art. B (Mar. 23, 2005), at <http://www.sec.gov/rules/other/acspc-charter.pdf>. See also Advisory Committee Release, *supra* note 235; Calmes & Solomon, *supra* note 194 ("The agency is focusing on smaller companies . . . because the cost is proportionally larger.").

²³⁷ See Andrew Parker & David Wighton, *SEC Sticks to Core Purpose*, FIN. TIMES (LONDON), Dec. 3, 2004, at 33.

²³⁸ Securities and Exchange Commission Advisory Committee on Smaller Public Companies, Hearing Schedule (July 7, 2005), at <http://www.sec.gov/info/smallbus/acspc/acspc-mastersched.pdf>.

²³⁹ See *infra* Part V.A.

later.²⁴⁰ This followed two other similar postponements by the SEC since 2004.²⁴¹ The Advisory Committee based its recommendation on hearings, testimony, and comments it had received over the course of its investigation up to that point.²⁴² In its resolution, the Advisory Committee expressly acknowledged that “[t]he costs of implementing Section 404 have been far more expensive than originally forecasted and these costs are disproportionately larger for small companies.”²⁴³ The Advisory Committee chose not to wait for its final report to advocate this change because “the advisability of implementing these recommendations seemed apparent to the Committee; further study did not seem justified.”²⁴⁴ As of October 2005, the compliance date for non-accelerated filers stands at July 15, 2007,²⁴⁵ over two years later than the original deadline set by the SEC for Section 404 compliance.²⁴⁶

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

²⁴⁰ Securities Act Release No. 33-8618, Exchange Act Release No. 34-52492 (Sept. 22, 2005), at <http://www.sec.gov/rules/final/33-8618.pdf> [hereinafter Release No. 33-8618] (extending the compliance date for a non-accelerated filer to the end of its first fiscal year ending on or after July 15, 2007).

²⁴¹ Securities Act Release No. 33-8545, Exchange Act Release No. 34-51293, [2004-2005 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,335 (Mar. 2, 2005) (extending the compliance date for a non-accelerated filer to the end of its first fiscal year ending on or after July 15, 2006); Securities Act Release No. 33-8392, Exchange Act Release No. 34-49313, Investment Company Act Release No. IC-26357, [2003-2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,144 (Feb. 24, 2004) (extending the compliance date for a non-accelerated filer to the end of its first fiscal year ending on or after July 15, 2005).

²⁴² Securities and Exchange Commission Advisory Committee on Smaller Public Companies, Resolution Regarding Section 404 Compliance Dates For Non-Accelerated Filing Companies (Aug. 10, 2005), at <http://www.sec.gov/info/smallbus/acspc/coxacspletter081805.pdf> [hereinafter Advisory Committee Resolution].

²⁴³ *Id.*

²⁴⁴ Letter from SEC Advisory Committee on Smaller Public Companies, to Christopher Cox, Chairman, Securities and Exchange Commission (Aug. 18, 2005), at <http://www.sec.gov/info/smallbus/acspc/coxacspletter081805.pdf>.

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

²⁴⁶ Release No. 33-8238, *supra* note 179, ¶ 86,023 (establishing the original compliance date for non-accelerated filers as April 15, 2005).

creating these types of exemptions,²⁴⁷ there are provisions currently in Sarbanes-Oxley, such as the accelerated filer provision,²⁴⁸ which specifically address other small business issues in the federal securities laws.²⁴⁹ Unfortunately, Congress and the SEC have failed to address the most troublesome requirement of the Act – Section 404 – and the creation of the Advisory Committee is recognition that they have not gone far enough to alleviate the regulatory burden on small businesses.

Second, the immense and disproportionate burden that Section 404 imposes on small companies has restricted their access to capital for growth. This result directly contradicts the statutory mandate of the SEC, which is required to consider the effects of its rules on capital formation.²⁵⁰ In many cases, Section 404 offers small companies a Hobson's Choice of accepting the crushing burden of federal securities regulations that could lead to bankruptcy in order to stay public, or a slow, suffocating existence without access to capital for growth. In some cases there is no choice at all because Section 404 reaches beyond the realm of publicly traded companies to influence companies that otherwise would not be affected by the federal securities laws.²⁵¹

Finally, any company that would qualify for the proposed exemption from Section 404 would still be subject to the other provisions of the Sarbanes-Oxley Act, as well as antifraud regulations such as Rule 10b-5.²⁵² As a result, this proposed exemption would not weaken or have any detrimental effect on the federal securities laws. In fact, this proposed exemption draws on the provisions and policies of several existing exemptions, making it both a pragmatic and effective solution to Section 404's shortcomings.

²⁴⁷ See *supra* notes 137-38 and accompanying text.

²⁴⁸ See *infra* Part V.A.

²⁴⁹ *Id.*

²⁵⁰ 15 U.S.C. § 77b(b) (2005) (stating that whenever the Commission engages in rulemaking, it is required to evaluate whether its action will promote capital formation). See also 15 U.S.C. § 78c(f) (2005) (laying out a similar provision in § 3(f) of the Exchange Act).

²⁵¹ See *infra* Part V.B.

²⁵² 17 C.F.R. § 240.10b-5 (2005) (prohibiting the use of manipulative or deceptive devices to defraud by any means of interstate commerce or on any national securities exchange).

A. *Precedent for Small Business Exemptions in Sarbanes-Oxley*

Even in the current environment of heightened sensitivity to corporate governance issues, the SEC has already adopted rules pursuant to Sarbanes-Oxley that explicitly address the concerns and problems faced by small businesses and provide targeted exemptions to alleviate those burdens. For example, in the wake of Sarbanes-Oxley, the SEC shortened the amount of time that some companies have to file their quarterly and annual reports in order to increase the relevance and timeliness of the information in these reports.²⁵³ These companies, which are generally larger and more established, are called “accelerated filers.”²⁵⁴ In creating this new requirement, the SEC has also created a corresponding exemption for companies with an aggregate market value of less than \$75 million.²⁵⁵ These companies still have to file disclosure documents such as quarterly and annual reports, but they do not have to meet the new accelerated deadlines.²⁵⁶ In a release describing these accelerated filing deadlines, the SEC acknowledged that costs would likely increase for companies to comply with the accelerated filer requirements, and as a result, the Commission only imposed the new requirement on more seasoned public companies.²⁵⁷

The facts surrounding the accelerated filer provision support an exemption from Section 404 for small businesses for

²⁵³ Release No. 33-8128, *supra* note 137.

²⁵⁴ 17 C.F.R. § 240.12b-2 (2005) (defining “accelerated filer” as “an issuer after it first meets the following conditions as of the end of its fiscal year: (i) The aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer is \$ 75 million or more; (ii) The issuer has been subject to the requirements of Section 13(a) or 15(d) of the Act for a period of at least twelve calendar months; (iii) The issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Act; and (iv) The issuer is not eligible to use Forms 10-KSB and 10-QSB for its annual and quarterly reports.”) (citations omitted).

²⁵⁵ 17 C.F.R. § 240.12b-2 (2005). *See also* Release No. 33-8238, *supra* note 179.

²⁵⁶ *See* Release No. 33-8238, *supra* note 179.

²⁵⁷ Release No. 33-8128, *supra* note 137 (“Although we believe investors in less large or unseasoned companies may want and benefit from more timely disclosures just as much as investors in larger, listed companies, we are concerned that this may impose undue burden and expense on these companies. Smaller companies are likely to be more sensitive to any increased costs in preparing their reports. These entities may not have the infrastructure and resources available or necessary to prepare their reports on a shorter timeframe. Accordingly, we are only shortening the filing deadlines for companies with a minimum public float or reporting history as proposed.”).

two reasons. First, they demonstrate the importance of cost-benefit analysis in the SEC rulemaking process. The Exchange Act explicitly prohibits the SEC from adopting any rule that places an undue burden on competition and requires the SEC to state its cost-benefit justification for its rules.²⁵⁸ To that end, in its release announcing the accelerated filer rule, the SEC included an extensive section describing the cost-benefit analysis it undertook in creating the rule. The SEC explained that the benefits of the rule, such as more meaningful disclosure to investors, would outweigh the costs of getting information to investors faster.²⁵⁹ To be consistent, the SEC should also apply this measure of efficiency in evaluating the application of Section 404 to small businesses. As described in Part III.C and IV.C, imposing Section 404 on all companies universally, regardless of their size, fails a cost-benefit test because of economies of scale in the costs of compliance.²⁶⁰

Second, the accelerated filer exemption implicitly acknowledges that Sarbanes-Oxley will need to be adjusted for the unique concerns of small businesses. As described in Part IV.D, in Congress's zeal to combat fraud and provide investors with the best information possible, it largely ignored the disproportionate impact its proposals would have on small businesses.²⁶¹ This acknowledgement has been explicitly reinforced by the SEC's recent formation of the Advisory Committee on Smaller Public Companies.²⁶²

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

As foreshadowed by one commentator,²⁶³ another side effect of Sarbanes-Oxley has been a trend of small, public companies going private²⁶⁴ or deregistering²⁶⁵ to avoid some of

²⁵⁸ Exchange Act § 23(a)(2) (codified in 15 U.S.C. § 78w(a)(1) (2005)).

²⁵⁹ Release No. 33-8128, *supra* note 137.

²⁶⁰ *See supra* Part IV.

²⁶¹ *See supra* Part IV.D.

²⁶² *See supra* Part V; *see also* Parker, *supra* note 174; Advisory Committee Release, *supra* note 235.

²⁶³ Ribstein, *supra* note 158, at 39 ("Moreover, a trend toward going-private transactions could reduce the available investment options. The effect might be exacerbated if going-private transactions were concentrated in particular industries that will have particularly high liability and auditing costs under Sarbanes-Oxley.").

²⁶⁴ When a company "goes private," it or a controlling group eliminates all or substantially all of the company's publicly held shares. This is usually done through a tender offer, exchange offer, reverse stock split or merger. Going private transactions

the more costly requirements of the law.²⁶⁶ In the first full year after Sarbanes-Oxley was passed, 198 companies deregistered, while the following year in 2004, another 134 followed suit.²⁶⁷ This was a sharp increase over the 67 companies in 2002 and 43 companies in 2001 that deregistered.²⁶⁸ Given the law's intent to restore investors' confidence in the market and encourage their continued investment, this effect has been ironic.²⁶⁹ This trend is important and disturbing because of the importance of the public securities markets to small business growth.²⁷⁰

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

are more complicated and expensive than deregistration. See David Alan Miller & Marci J. Frankenthaler, *Delisting/Deregistration of Securities Under the Securities Exchange Act of 1934*, 17 NO. 10 INSIGHTS 7, 7 (Oct. 2003).

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

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

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

²⁶⁸ *Id.*

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

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

²⁷¹ See Crane, *supra* note 212, at 406.

²⁷² *Id.*

²⁷³ Deutsche, *supra* note 269 (stating that some companies would rather use their time and money to grow their businesses than spend it on compliance).

removing themselves from the requirements of being public by deregistering or going private.

The recent trend in companies leaving the public markets has been largely attributed to the new Sarbanes-Oxley requirements,²⁷⁴ and specifically to Section 404.²⁷⁵ For example, another study examined the 198 firms that deregistered in 2003 and found that most of them did so because of the extreme costs associated with the regulations.²⁷⁶ In addition, numerous recent articles have documented anecdotal evidence that small public companies are fleeing the public markets in droves because of stifling compliance costs.²⁷⁷ As a result of these costs, more and more companies are trading some of their long-term growth potential for short-term solvency.²⁷⁸

Furthermore, while Sarbanes-Oxley is the law for most public companies, small businesses do not have to be public companies for Sarbanes-Oxley to affect them.²⁷⁹ Companies only need to consider the prospect of becoming public for these overly burdensome requirements to chill their plans to seek public financing.²⁸⁰ While there are no statistics kept on the number of private companies that eschew public financing or why they do so, there has been increasing anecdotal evidence that fewer private companies are considering going public

²⁷⁴ Loftus, *supra* note 266.

²⁷⁵ Susan Greco, *Is Life Really Better Without Sarbanes-Oxley and Quarterly Earnings Calls? Three Public Companies That Went Private Say Yes*, D & O ADVISOR, Jan. 1, 2005, at 20 (“Things like Section 404 push more companies to want to go private . . .”).

²⁷⁶ Loftus, *supra* note 266.

²⁷⁷ See, e.g., Angus Loten, *Sarbox No Picnic for Teddy Bear Maker*, INC. MAGAZINE, Oct. 5, 2005, available at <http://www.inc.com/criticalnews/articles/200510/bears.html> (describing the extensive costs and burdens placed on the Vermont Teddy Bear Company by Section 404); Laurence B. Beckler, *Outside Counsel; Deregistering with the Securities and Exchange Commission*, 231 N.Y.L.J. 4 (2004); Deutsche, *supra* note 269; Greco, *supra* note 275; Melinda Ligos, *When Going Public May Not Be Worth It*, N.Y. TIMES, June 3, 2004, at C7.

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

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

²⁸⁰ See Peter H. Ehrenberg & Anthony O. Pergola, *Why Private Companies Should Not Ignore the Sarbanes-Oxley Act*, WALL STREET LAW., Dec. 2002, at 12 (stating that private companies that are considering accessing the public markets should consider the costs of complying with Sarbanes-Oxley); Greco, *supra* note 275 (stating that a company that is thinking about going public or being acquired by a public company may adopt Section 404-type controls).

because of Sarbanes-Oxley compliance costs.²⁸¹ It is also noteworthy that some of the other hurdles that companies would have to overcome in order to sell securities to the public are relatively low. For example, notwithstanding several shareholder-specific requirements, a company need only have \$1 million of annual income before taxes and a share price of five dollars in order to list on the NASDAQ National Market,²⁸² and the threshold is even lower for the NASDAQ Small Cap Market.²⁸³

C. *Antifraud Provisions of the Securities Laws Still Apply*

As important as what a small business exemption to Section 404 would do is what an exemption would not do. Any small business exemption to Section 404 would not compromise the goals of investor protection and fraud prevention, which are at the heart of Sarbanes-Oxley and all of the federal securities laws.²⁸⁴ All exemptions, including Regulation D, require that companies still comply with the antifraud provisions of the federal securities laws,²⁸⁵ including Section 17(a) of the Securities Act²⁸⁶ and Rule 10b-5,²⁸⁷ the chief anti-fraud provision promulgated under the Exchange Act.²⁸⁸

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

²⁸¹ See, e.g., Murphy, *supra* note 196.

²⁸² NASDAQ Marketplace Rule 4420(a)(1).

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

²⁸⁴ STEINBERG, *supra* note 85, at 1.

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

²⁸⁶ 15 U.S.C. § 77q (2005).

²⁸⁷ 17 C.F.R. § 240.10b-5 (2005).

²⁸⁸ J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 318 n.6 (2004) (describing Rule 10b-5 as the “most significant antifraud provision” of the federal securities laws); Robert A. Prentice, *The Future of Corporate Disclosure: The Internet, Securities Fraud, and Rule 10b-5*, 47 EMORY L.J. 1, 4 (1998) (stating that Rule 10b-5 is the “most significant antifraud securities provision in the world”).

for individuals.²⁸⁹ In addition, any person who knowingly alters or destroys documents in order to obstruct an investigation can be sentenced to up to twenty years in prison.²⁹⁰ Furthermore, each incidence of mail and wire fraud is now punishable by up to twenty years in prison as well.²⁹¹ These severe penalties serve as powerful deterrents to securities fraud on their own and operate independently of the management reporting requirement of Section 404.

There is a common sense aspect to this argument as well. The corporate misconduct that was committed at companies like Enron and WorldCom was criminal before Sarbanes-Oxley.²⁹² If a corporate officer or director had no qualms about violating existing rules against fraud and manipulation, then it is doubtful that simply adding another report to complete would have any more of an effect on his or her behavior.²⁹³ On the other hand, the threat of twenty years in prison and a \$5 million fine for each incident of securities fraud will serve as a much more powerful deterrent for wrongdoing than the additional reporting requirements of Section 404.²⁹⁴

D. *The Proposed Exemption*

For the reasons stated above, a small business exemption to Section 404 must be created in order to protect the continued growth and prosperity of the nation's small businesses. While the Advisory Committee could recommend action by either Congress or the SEC,²⁹⁵ the language of the

²⁸⁹ Sarbanes-Oxley § 1106(1) (codified in 18 U.S.C. § 1513 (2005)).

²⁹⁰ Sarbanes-Oxley § 802(a) (codified in 18 U.S.C. § 1519 (2005)).

²⁹¹ Sarbanes-Oxley §§ 903(a)-(b) (codified in 18 U.S.C. §§ 1341, 1343 (2005)).

²⁹² Karmel, *supra* note 12, at 133 ("The financial misreporting at Enron, Adelphia, WorldCom, and elsewhere was already illegal, indeed criminal.").

²⁹³ Douglas M. Branson, *Enron - When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?*, 48 VILL. L. REV. 989, 1008 (2003) ("Corporate codes of conduct have been around for approximately twenty years. Enron had a code. Codes can serve to raise the level of ethical behavior within an organization, but only if they are taken seriously and enforced.").

²⁹⁴ Andrew Hill, *Scandals Are Nothing New To Wall Street*, FIN. TIMES (LONDON), Aug. 12, 2002, at 32 ("[I]t has taken the threat of criminal litigation to persuade the firms they need to take more radical action than they originally suggested was necessary.").

²⁹⁵ It is not clear if such an exemption can be created by the SEC or if Congress would have to amend the statute. While Section 404 gives the SEC explicit power to make rules regarding the internal control reports that a company must file as part of its annual report, Section 404 does not give the SEC explicit exemptive authority. This is in contrast to other exemptions that are based on explicit statutory

release that announced the creation of the Advisory Committee indicates that the SEC presumes to have the power to make these rule changes.²⁹⁶ A complete analysis of the SEC's rulemaking and exemptive authority, however, is beyond the scope of this note.

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

In order to be eligible for this proposed small business exemption, a company would have to have a public float²⁹⁷ of less than \$75 million, as measured on the last day of the company's most recent fiscal year. This size threshold is the same as in the accelerated filer exemption as well as other

authority, such as Regulation D (promulgated under § 3(b) of the Securities Act). There is a precedent, however, for the SEC exercising exemptive rulemaking power without specific statutory authority. Pursuant to the Williams Act (Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2005))), which protects securities holders from unfair and deceptive practices in tender offers, the SEC created Rule 14d-8, which provides an exemption for bidders in a tender offer. 17 C.F.R. § 240.14d-8 (2005). *See also* AARON RACHELSON, CORPORATE ACQUISITIONS, MERGERS AND DIVESTITURES § 8:21 (2005) (describing the exemption created by Rule 14d-8). Rule 14d-8, however, was adopted as part of § 14d-6 of the Exchange Act (15 U.S.C. § 78n(d)(6) (2005)), which does not grant specific exemptive authority to the Commission. Instead, the SEC relied on its authority under a different section of the Williams Act to adopt Rule 14d-8. In doing so, the Commission acknowledged that it had technically exceeded its authority under § 14d-6 but asserted that its expanded power was justified based on necessity and the intent of Congress. Exchange Act Release No. 34-18761, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,221 (May 25, 1982) (describing the SEC's rationale for its authority to adopt Rule 14d-8). *See also* William C. Tyson, *The Williams Act After Hanson Trust v. SCM Corporation: Post-Tender Offer Purchases by the Tender Offeror*, 61 TUL. L. REV. 1, 6 n.32 (1982) (describing the SEC's questionable authority to adopt Rule 14d-8). In that case, the Commission also relied on its general rulemaking power granted by § 23(a) of the Exchange Act. 15 U.S.C. § 78w(a)(1) (2005) (granting the SEC the power to make rules and regulations to implement provisions of the Exchange Act).

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

²⁹⁷ A company's float is the market value of the company's equity shares outstanding. This number is calculated by multiplying the number of shares outstanding by the market price of the shares. Investorwords.com, Public Float Definition, at http://www.investorwords.com/3936/public_float.html (last visited Aug. 30, 2005).

significant securities regulations,²⁹⁸ and this consistency will simplify one aspect of the notoriously complex federal securities laws.²⁹⁹ By measuring the company's float at the end of the fiscal year, this proposal is also consistent with the standard established in the accelerated filer provision.³⁰⁰ In addition, the SEC has already explained that the public float test serves as a "reasonable measure of company size and market interest."³⁰¹ The SEC also established that this threshold, which excludes nearly half of all publicly traded companies and all the companies eligible for the SEC's small business reporting system from the accelerated filer provision, forms a group of companies worthy of an exemption based on their size.³⁰² It is therefore likely that the SEC would consider this group deserving of an exemption from the high relative costs of Section 404 as well.

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

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

²⁹⁸ 17 C.F.R. § 240.12b-2 (2005) (defining "accelerated filer"). *See also* Release Nos. 33-6383 & 33-6964, *supra* note 128 (describing Form S-3 for registration statements).

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

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

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

³⁰² *Id.*

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

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

³⁰³ SEC Form 10-K, 17 C.F.R. § 249.310 (2005).

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

VI. CONCLUSION

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

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

By forming the Advisory Committee on Smaller Public Companies, the SEC has taken an important first step in a much-needed reevaluation of Sarbanes-Oxley and its effects on small businesses. While the Advisory Committee will have to examine the balance between the costs and benefits of the new regulations, it is clear that Section 404 does not strike an appropriate balance between these costs and benefits for small businesses. As a result, a small business exemption from Section 404 is both necessary and long overdue.

The small business exemption proposed in this note addresses some of the main problems with the current state of the law, most importantly the high relative costs to small businesses and their impact on businesses' access to capital. The proposal is based on the reasoning and concepts behind two existing exemptions and incorporates aspects of both to create a practical and effective exemption that successfully balances the investor protection and capital formation goals of the federal securities laws. This proposal also draws on the effectiveness of other recent corporate governance reforms, including strengthened antifraud laws. These reforms provide an important safety net that would enable this exemption to function effectively while continuing to serve the important policy goals of Sarbanes-Oxley. The positive effects of such an exemption would extend beyond small businesses and have a beneficial impact on the economy as a whole.

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