THINKING SMALL: ADJUSTING REGULATORY BURDENS INCURRED BY SMALL PUBLIC COMPANIES SEEKING TO COMPLY WITH THE SARBANES-OXLEY ACT*

I. INTRODUCTION

In recent years, the topic of corporate scandals has become highly discussed as a result of the substantial fraud and resulting failures of many large corporations such as Enron, WorldCom, Sunbeam, Waste Management, Adelphia, Xerox, and Global Crossing.¹ As these corporate scandals effected a destructive impact on the public securities market through negative beliefs held by investors regarding unreliability of corporate managers, uncertainty as to the truth of the accounting representations of companies, and insecurity in the market, government regulators were determined to implement regulations to restore the public’s confidence in the marketplace.² Therefore, Congress and the Securities and Exchange Commission (SEC) began debating the appropriate approach to regulating public companies.³

In response to these spectacular problems and corporate scandals, Congress passed the Sarbanes-Oxley Act on July 29, 2002.⁴ The Sarbanes-Oxley Act has been viewed as “the most dramatic change to the securities laws regulating corporate governance since the Great Depression”⁵ and “the most significant securities rulemaking since the Exchange Act of 1934,”⁶ due to the considerable changes for companies required by the Act with regard to corporate governance and the board of directors.⁷ The purpose of the Sarbanes-Oxley Act, “as reported by Congress, [was] ‘to address the systemic and structural weaknesses affecting our capital markets which

* The author gratefully thanks Professor George S. Geis and Professor Kenneth M. Rosen for their assistance, guidance, and suggestions in writing this Comment.
2. Id. at 3.
3. See id. at 2.
7. Linck et al., supra note 5, at 41.
were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility. . . .

However, since Congress hurriedly enacted the Sarbanes-Oxley Act in an attempt to quickly address the problems within corporate America, the Act has resulted in numerous presumably unintended consequences caused by Congress’s failure to fully deliberate over the resulting effects of the regulation. Thus, while the Sarbanes-Oxley Act focuses on reducing the amount of corporate fraud and accounting misrepresentations by holding corporate executives and the members of the board of directors personally liable for the company’s accounting procedures, it, in turn, may result in the unintended consequence of disproportionately burdening small public companies.

This Comment reviews those aspects of the Sarbanes-Oxley Act that are burdening small public companies, explores the effects that the Sarbanes-Oxley Act is having on small companies in the public market, discusses whether small public companies should be required to comply with the Sarbanes-Oxley Act, and suggests that the requirements of the Act should be scaled to better fit the needs of small public companies. Part II will define a “small public company” in order to determine what type of company should fall within the regulatory relief and how that relief should be tailored to alleviate some of the burdens placed on these companies. In addition, this Part will briefly discuss the importance of small companies to the public market in order to illustrate why such regulatory relief is needed not only to reduce the disproportionate burden placed on small companies but also to benefit the overall economy. Part III provides a general overview of the key requirements of the Sarbanes-Oxley Act being considered by the Advisory Committee on Smaller Public Companies. The Advisory Committee is evaluating these regulatory requirements to specifically determine how the Act’s provisions can be modified in order to minimize the costs placed on small public companies while still protecting investors. Part IV reviews the benefits and costs that the Sarbanes-Oxley Act imposes on small public companies and discusses how the requirements of the Sarbanes-Oxley Act disproportionately burden small public companies, causing such companies to suffer the onerous costs inherent in the Act. Part V discusses the actions that companies have taken in order to remove themselves from the burdens of complying with the Sarbanes-Oxley Act. Part VI suggests several possible methods of governmental relief for small public companies from the burdensome provisions of the Sarbanes-Oxley Act. This Part further discusses the positive and negative aspects of each possible solution, conclud-

9. Wilda, supra note 4, at 672.
ing that the best method of minimizing the cost burden of the Sarbanes-
Oxley Act on small public companies would be to tailor the regulatory
treatment based on company size. This method would relieve the costs in-
curred by small public companies and still allow for SEC oversight. Part VII
provides a conclusion.

II. DEFINING A SMALL PUBLIC COMPANY

Understanding what regulatory relief should be provided to small com-
panies begins by considering what makes a company “small” for regulatory
purposes. In defining a small public company, numerous factors have been
cited, inconsistently by various parties, as the determinant factor of what
constitutes a “small” public company. Recently, however, the SEC sug-
gested six determinant factors that will indicate whether a public company
can be classified as “small.”11 According to the SEC, a small public com-
pany is determined by: (1) “[t]he total market capitalization of the com-
pany,” (2) “[a] measurement metric that facilitates scaling of regulation,”
(3) “[a] measurement metric that is self-calibrating,” (4) “[a] standardized
measurement and methodology for computing market capitalization,” (5)
“[a] date for determining total market capitalization,” and (6) “[c]lear and
firm transition rules”—from a small company to a large company and vice
versa.12 Among these factors, the Advisory Committee on Smaller Public
Companies has specified that the primary metric for determining whether a
company fits within the definition of a “small” public company is the mar-
ket capitalization factor.13 Therefore, in considering the determinant factors
while focusing on the market capitalization, “a company ranking in the bot-
tom 6% of total U.S. public market capitalization, as defined by the SEC,
when the capitalization of all public companies is combined, would qualify
as a smaller public company.”14 If the six factors were to indicate that the
company fell within the definition of a small public company, then that
company would be able to benefit from the governmental regulatory relief
for small public companies discussed later in this Comment.

Although small public companies may have less public market capitali-
ization than large public companies, these small companies are extremely
important to the U.S. economy. Small public companies have been referred
to as the “lifeblood of the American economy and the source of most of the
economy’s innovation and opportunity.”15 In addition, reports such as the

11. See Letter from the SEC Advisory Comm. on Smaller Pub. Cos. to Christopher Cox, Chairman,
081805.pdf (setting out the suggested factors in an attachment).
12. Id.
Reg. 11,090, 11,096 (Mar. 3, 2006).
14. Letter from the SEC Advisory Comm. on Smaller Public Cos. to Christopher Cox, supra note
11.
15. Joseph A. Castelluccio III, Note, Sarbanes-Oxley and Small Business: Section 404 and the Case
for a Small Business Exemption, 71 BROOK. L. REV. 429, 437 (2005); see also Susan Ness, Former
U.S. Census indicate that small businesses create the majority of new jobs in the U.S. marketplace.\textsuperscript{16} Therefore, even though small public companies fall in the lower portion of market capitalization, such companies significantly contribute to the job market, market innovation, and the overall economy.

Despite the immense contributions of small public companies to the U.S. economy, they suffer disproportionate burdens in complying with the federal securities regulations. The SEC has generally recognized the need to tailor its regulations both to protect investors’ expectations and to reduce costs on public companies.\textsuperscript{17} In doing so, the ideal result is a regulatory regime in which the costs are outweighed or at least balanced by the benefits. However, with the implementation of the Sarbanes-Oxley Act, an imbalance between these costs and benefits has resulted, particularly for small companies.\textsuperscript{18}

This disproportionate burden on small companies led Congress and the SEC to consider how to most effectively reduce the burden and still protect investors’ interests. As a result of the accumulating evidence showing this burden on smaller companies, the SEC created a panel—the Advisory Committee on Smaller Public Companies—“to examine the effects of Sarbanes-Oxley on small businesses” and to consider how to tailor the regulations to better fit the varying sizes of public companies.\textsuperscript{19} In establishing the Advisory Committee on Smaller Public Companies, the SEC charged the Advisory Committee with the task of helping it evaluate the securities regulatory system, specifically indicating certain key aspects of the Sarbanes-Oxley Act relating to “disclosure, financial reporting, internal controls, and offering exemptions for smaller public companies” for the Advisory Committee to take into account.\textsuperscript{20} Since small public companies are vital to the economy, it is essential for the Advisory Committee to determine how to scale the requirements of the Sarbanes-Oxley Act to minimize the burdens suffered by small public companies and maximize the benefits.

\begin{thebibliography}{99}
\bibitem{note16} Castelluccio, \textit{supra} note 15, at 437-38.
\bibitem{note18} See discussion \textit{infra} Section IV.
\bibitem{note20} Advisory Committee on Smaller Public Companies, 69 Fed. Reg. 76,498, 76,498 (Dec. 21, 2004).
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III. KEY REQUIREMENTS OF THE SARBANES-OXLEY ACT

The Sarbanes-Oxley Act was enacted in order to “protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.”21 In furtherance of this purpose, the Act includes provisions for an accounting oversight board, auditor independence, corporate responsibility, enhanced financial disclosures, internal controls, and corporate and criminal punishments.22 With regard to smaller public companies, the Advisory Committee on Smaller Public Companies was instructed to direct its focus on the impact of the following key requirements of the Sarbanes-Oxley Act: (1) corporate disclosure, reporting, and “corporate governance requirements”; (2) “[a]ccounting standards and financial reporting requirements”; and (3) the framework “for internal control over financial reporting applicable to smaller public companies.”23 In considering each of these provisions of the Sarbanes-Oxley Act, the Advisory Committee was directed to determine how each requirement burdened small public companies in proportion to large public companies and, in doing so, to indicate measures to reduce these burdens.24 To better understand the task at hand, some key requirements of the Sarbanes-Oxley Act are described below.


1. Corporate Governance

In response to the recent corporate scandals, government regulators felt that an essential aspect of corporate governance reform concerned the independent decision-making of the board of directors and corporate responsibility.25 For example, a significant modification for public companies regarding the board of directors is the requirement of independent directors, also commonly referred to as the “monitoring” board.26 The establishment of a monitoring board provision resulted from the government regulators’ presumption that the decisions of the corporation should be made not only by inside directors, who are employed by the corporation, but also by outside directors, who would monitor the actions of the inside directors and look out for the interests of the shareholders.27 This requirement for independent directors is one of the primary corporate governance provisions that

22. See generally id.
24. Id. at 76,498-99.
25. Ribstein, supra note 1, at 11.
26. See id.
27. Id.
the Advisory Committee on Smaller Public Companies is focusing on in order to determine if smaller public companies should be forced to comply or if some type of regulatory relief should be granted. In addition to requiring a monitoring board, the corporate governance provisions of the Sarbanes-Oxley Act prohibit directors from engaging in insider trades during blackout periods, taking out personal loans from the corporation, and receiving certain bonuses and profits. In regards to trades during a blackout period, a director or inside corporate executive officer is banned from selling shares he received as part of his compensation during a pension blackout period.

2. Gatekeeper Regulation

In order to effectively monitor the actions taken by the senior executive officers of the corporation, in addition to the requirement of a monitoring board, “gatekeepers,” including senior executive officers, auditing firms, attorneys, and securities analysts, have been delegated specific functions to monitor the managers. Under the provisions of the Sarbanes-Oxley Act, the SEC requires attorneys to report fraud, or any evidence thereof, and to disclose facts or other evidence supporting the allegations of fraud. In addition, the Act establishes an independent accounting oversight board to ensure that the financial accounting practices and procedures of the corporation comply with the board’s requirements. Further, as more fully discussed below, auditors are required to work independently from both officers of the corporation and from the firm so that there will be an assurance that the audit reports provide an accurate report of the company’s financial condition.

3. Enhanced Disclosure

Since the Sarbanes-Oxley Act was enacted to address and improve the financial reporting disclosures of corporations, the provisions for enhanced disclosure could be viewed as a natural result of the regulation. The Sarbanes-Oxley Act requires disclosures not only relating to the financial structure of the company but also relating to internal control mechanisms, the corporate “code of ethics, off-balance-sheet transactions and pro forma
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earnings.” Also, when material changes occur in the corporation’s financial condition, the Act requires a “rapid and current” disclosure, “which may include trend and qualitative information and graphic presentations” to the auditors and the public. 

In terms of the disclosure provisions, the Advisory Committee on Smaller Public Companies considered whether the small companies should be forced to comply with the enhanced nature of the disclosure requirement since the provisions tend to become duplicative. Therefore, the Advisory Committee contemplated whether small companies should have to provide the enhanced disclosure or whether scaled disclosure accommodations should be provided to such companies.

4. Corporate Responsibility by the Regulation of Misconduct

In order to ensure compliance with the Sarbanes-Oxley Act, the Act includes increased punishment for failure to comply with its provisions. The Act not only increases the amount of fines for failure to comply but also provides for imprisonment of officers and directors who violate the provisions. In effect, a director, officer, company, or a combination of these critical corporate players could face a multimillion dollar fine or up to twenty years imprisonment for violating the provisions of Sarbanes-Oxley.

B. Accounting Standards and Financial Requirements

In addition to providing investors and the public with confidence through increased responsibility by the corporation and its officers, the Sarbanes-Oxley Act also encourages market confidence due to its provisions related to the accuracy of the company’s financial reports. To promote the accuracy of financial reporting by the company, Congress enacted regulations specifying the accounting procedures that a company must follow and requiring independence of the auditors. In regards to financial regulations, the Act requires auditors to act independently from the corporation or anyone associated with the corporation; therefore, the auditor cannot make financial reports to the company except through the audit committee. In addition, the executives of the company could not previously have worked for the auditing firm, as this would undermine the purpose of requiring an

40. See id.
41. Id.
43. Id.; see also Ribstein, supra note 1, at 3.
44. Sarbanes-Oxley Act §§ 201-09.
independent audit committee.45 Further, the audit reports must be certified, stating that the reports do not contain misrepresentations of the company’s financial condition.46

With regard to the accounting and financial provisions, the Advisory Committee on Smaller Public Companies reviewed the accounting standards and financial reporting requirements applicable to smaller public companies to determine if regulatory relief should be granted to reduce the burdens associated with complying with these provisions. In particular, the Advisory Committee reviewed the general accounting requirements to discern whether smaller public companies should be granted relief in terms of the information that has to be contained in the reports.47 In addition, the Advisory Committee examined the auditor independence requirement to determine whether some form of relief should be granted, either through reduction of the types of prohibited relationships between the company and the auditor or by allowing the auditor to engage in other financial work at the company.48

C. Internal Control

While the provisions addressing corporate disclosure and financial document accuracy have been viewed as reasonable measures following the numerous corporate scandals, thus creating less political debate, the provisions for internal monitoring and controls have been one of the most controversial aspects of the Sarbanes-Oxley Act. The Act requires all public companies to establish and maintain a system of internal controls for the corporation.49 Internal control is a broad concept, which extends beyond the financial operations of a company and requires certain procedures and processes to be followed in various aspects of the company.50 In regard to internal controls, the Sarbanes-Oxley Act includes provisions that require “documenting, testing[,] and certifying the adequacy of [the] internal controls.”51 These provisions are beneficial to large corporations but are of less certain value for smaller public companies, which rely on monitoring con-

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45. Id.
46. Ribstein, supra note 1, at 63; see also Sarbanes-Oxley Act § 302.
48. Id. at 11,123-24.
49. Sarbanes-Oxley Act § 404; see also Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies, 71 Fed. Reg. at 11,098, Sarbanes-Oxley Act directed the SEC to adopt internal control requirements, “requiring all reporting companies . . . to include in their annual reports a statement of management’s responsibility for establishing and maintaining adequate internal control over financial reporting, together with an assessment of effectiveness of those internal controls.” Id. The internal control requirements also “required that the company’s independent auditors attest to, and report on, this management assessment.” Id.
50. See Ribstein, supra note 31, at 6.
trols that may be undocumented and untested. In addition, the Act directs the officers of the corporation to disclose and attest to the company’s internal control structures. Further, in order to encourage employees of a company to disclose information regarding fraudulent conduct or financial misrepresentations, the Sarbanes-Oxley Act provides protection for whistleblowers.

In reviewing the internal control provisions of the Sarbanes-Oxley Act, the Advisory Committee on Smaller Public Companies focused primarily on three reporting concerns that arise when these provisions are applied to small public companies. To begin, the Advisory Committee considered whether the “lack of segregation of duties” in small public companies “creates an internal control environment that is not primarily relied upon for financial reporting purposes by either management or auditors” as to make the current requirements ineffective in small public companies. In addition, the serious risk of “management override” in companies produces an increased need for controls at the corporate level and oversight by the board; therefore, the Advisory Committee contemplated whether there are more effective controls that can be implemented in small companies to reduce the risk of management override yet alleviate some of the burdens of complying with the current internal control provisions. Third, the fact that auditors must document the internal controls limits the flexibility and competitiveness of smaller companies; therefore, the Advisory Committee considered whether granting regulatory relief would benefit small companies by making them more competitive in the market.

Overall, the regulations encompassed in the Sarbanes-Oxley Act were designed to encourage corporations to assume responsibility for their management and to disclose accurate financial information in order to promote public confidence in the corporation and in the capital market generally. However, since compliance with each of the provisions requires a significant amount of time and labor, the costs of compliance can be substantial. Moreover, due to economies of scale, these compliance costs disproportionately impact small businesses, indicating a need to tailor these requirements to better fit small public companies.

52. Id.
54. Id. Section 806 prohibits adverse employment actions taken against employees who lawfully “provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes” a securities law violation. 18 U.S.C.A § 1514A(a)(1) (West Supp. 2006).
56. Id.
57. Id.
IV. COST VERSUS BENEFIT TO SMALL PUBLIC COMPANIES

In determining whether small public companies should be forced to comply with the provisions of the Sarbanes-Oxley Act, it is essential to weigh the cost of compliance against the benefits received from adhering to the regulatory regime. In this spirit, the SEC specifically directed the Advisory Committee on Smaller Public Companies to “conduct its work with a view to protecting investors, considering whether the costs imposed by the current securities regulatory system for smaller companies are proportionate to the benefits, identifying methods of minimizing costs and maximizing benefits, and facilitating capital formation by smaller companies.”

A. Costs of Compliance

As a general matter, the costs associated with complying with the Sarbanes-Oxley Act are burdensome for all public companies. Perhaps, the most frequent complaint about the Act is that it “is unduly costly and burdensome given its benefits to shareholders and the general public.”

When the Sarbanes-Oxley Act was initially enacted, Congress did not consider the varying effects on firms of different sizes; however, since enactment, large firms have found it easier to comply with the regulations than smaller firms. According to numerous recent studies, regulations enacted by Congress and the SEC, particularly the Sarbanes-Oxley Act, have burdened small public companies in an unequal, negative manner.

One of the reasons for this disproportionate burden on small companies is the fixed costs of compliance. Because some of the Sarbanes-Oxley compliance costs are fixed, smaller companies may be more likely to experience the negative effects of the Act than larger companies. For example, Section 404 of the Act, which requires internal control mechanisms to

59. Rose, supra note 6, at 720.
60. Ribstein, supra note 1, at 46.
61. See Rose, supra note 6, at 730, for an examination of a survey performed by Financial Executives International in which the data indicated that small companies pay a proportionately higher price to comply with federal securities regulations than larger public companies. For example, for companies with less than $100,000,000 in revenues, vendor costs will account for an average of $192,000 of a small company’s revenues, which is about 400% of the proportion of revenues of a large public company. Id. Also, small companies require significant amounts of external support, about 837 hours, which amounts to about 385% of the time required by the large public companies. Id. Further, the requisite auditors’ report will cost small companies, on average, nearly 650% of the cost to large public companies as a proportion of revenues. Id. For a discussion of a recent study by scholars at the University of Georgia in which data indicated that director cash compensation has risen substantially, especially for small firms, see Linck et al., supra note 5, at 4. For example, small firms’ costs have gone up significantly, from $1.98 to nonemployee directors per $1,000 of net sales in 1998 to $3.19 per $1,000 of net sales in 2004. Id.
63. Id.; see also Skouvakis, supra note 8, at 1280.
be established within the corporation,\textsuperscript{64} has been cited as one of the principal factors for the increased fixed costs.\textsuperscript{65} Specifically, this provision overburdens small public companies because it requires them “to divert their resources, both capital and personnel, to insuring compliance with the securities regulatory system, to the detriment of the pursuit of business initiatives, with potentially modest benefit to investors.”\textsuperscript{66}

To state it simply, large public companies have more extensive resources at their disposal than smaller public companies, which allows these large companies to rely on their own personnel to comply with the securities regulations rather than having to outsource operations such as internal auditing, legal work, and compliance.\textsuperscript{67} On the other hand, small public companies, “which are required to record, process, disclose and report the same information within the same time periods as large public companies, have fewer internal resources available to them.”\textsuperscript{68} Therefore, smaller public companies have to incur the costs of retaining “outside consultants and other professionals to assist them in their compliance activities”\textsuperscript{69} while large companies can simply look internally, resulting in a disproportionate cost burden on the smaller public companies.

In analyzing a recent survey of public companies, it is apparent that small public companies pay a proportionately higher amount in complying with Sarbanes-Oxley requirements than larger public companies due to the fixed costs of compliance.\textsuperscript{70} The survey suggests that third party costs, to meet the Sarbanes-Oxley requirements, for smaller public companies will


\textsuperscript{67} Letter of Supplemental Material to Jonathan G. Katz, \textit{supra} note 66.

\textsuperscript{68} \textit{Id.}

\textsuperscript{69} \textit{Id.}

\textsuperscript{70} See Rose, \textit{supra} note 6, at 730.
consume a vastly larger percentage of their revenue as compared to the percentage cost to larger public companies.\textsuperscript{71}

Another reason for the disproportionate financial burden on small companies is attributed to the additional burdens on directors due to their increased supervisory responsibilities and the new listing standards that require a majority of directors to be independent.\textsuperscript{72} In many cases, smaller public companies are having an extremely difficult time trying to find enough qualified directors.\textsuperscript{73} Independent directors are harder for small public companies to persuade to join the board of directors because individuals do not want to undertake the potential liability inherent in the position.\textsuperscript{74}

Attracting and retaining independent directors is burdensome for smaller public companies due to the fact that “competitive factors for qualified public company directors given their expanded role and time commitment, the increased cost of director compensation, and the cost of obtaining director and officer insurance, . . . is prohibitively expensive for smaller public companies (at least in terms of coverage limits that are attractive to independent directors).”\textsuperscript{75} Evidence suggests that the provision concerning independent directors costs small public companies a significant percentage of profits\textsuperscript{76} in comparison to larger public companies, who barely notice the inherent costs of obtaining independent directors.\textsuperscript{77} A recent survey, conducted by Foley & Lardner, indicates that small public companies bear a disproportionate burden in terms of expenses for directors.\textsuperscript{78} In terms of complying with the director provisions of Sarbanes-Oxley, small public companies have been “hit the hardest with 11\% increases for director compensation, and a potential 500\% increase in D\&O premiums.”\textsuperscript{79} Moreover, since inde-

\textsuperscript{71} Id. In addition to vendor costs, the external support will require an average of “385 percent of the time required by the largest public companies.” Id. Also, the auditor’s report is expected to cost smaller public companies “nearly 650 percent of the cost to the largest public companies as a proportion of revenues.” Id.

\textsuperscript{72} Id. at 727; see also Linck et al., supra note 5, at 2 (stating that the Sarbanes-Oxley Act has “dramatically affected corporate boards, their activities, and their costs,” particularly for small firms).

\textsuperscript{73} See Wilda, supra note 4, at 683.

\textsuperscript{74} Id.

\textsuperscript{75} Letter via Fax to Jonathan G. Katz, Comm. Mgmt. Officer, Sec. & Exch. Comm’n. (Aug. 31, 2005), available at http://www.sec.gov/rules/other/265-23/2652393.pdf; see Rose, supra note 6, at 728-29. Director compensation and reimbursement for travel disproportionately affects smaller companies. Id. Also, “director cash compensation has risen substantially, especially for small firms,” which is “consistent with the notion that [Sarbanes-Oxley] has imposed disproportionate burdens on small firms.” Id. (quoting Linck et al., supra note 5, at 4) (internal quotation marks omitted); see also Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 YALE L.J. 1521, 1588 (2005) (finding that smaller public companies’ expenditures on directors’ compensation affects these companies in a more negative manner than the effect on larger public companies).

\textsuperscript{76} See Wilda, supra note 4, at 683 (noting that the compliance with independent director provisions has “drastically increased costs, because director fees have more than doubled due to search firm expenses, lack of qualified candidates, the increased time required to perform accounting and auditing duties, and increased D\&O insurance premiums”); Carney, supra note 65, at 6 (indicating that a recent study showed that “the cost of D\&O insurance has risen by 25-40\% for companies with healthy balance sheets, and as much as 300-400\% for companies with financial troubles”).

\textsuperscript{77} See Ribstein, supra note 1, at 26-27.

\textsuperscript{78} See Wilda, supra note 4, at 684.

\textsuperscript{79} Id.
dependent directors often are “‘recycled’ due to the typically smaller size of the board,” smaller public companies often have very similar board committees, which may inhibit the potential growth of the company and thus limit overall success. In addition to the fact that the costs of independent directors are higher for smaller companies, some evidence suggests that the independence of the board has not even achieved the purpose of effectively preventing mismanagement and fraud, suggesting that the financial costs in this situation do not outweigh the benefits.

In addition to the unequal costs resulting from the provisions for independent directors and director supervision, some of the underlying reasons for the Sarbanes-Oxley Act, such as agency costs and gatekeeping, are not as evident in small companies since they are typically able to directly supervise each officer; therefore, the costs of compliance may be more burdensome for small companies due to the fact that there is no real need for them to comply with certain provisions of the Act. When a corporation employs the services of a non-agent in order to comply with the gatekeeping provisions of Sarbanes-Oxley, the corporation endures substantial agency costs. These agency costs include “the owner’s costs of monitoring the agent . . . and residual losses that agents impose on owners.” For example, the independence rules applicable to auditors, as amplified by Sarbanes-Oxley, increase the costs of implementing certain business strategies or initiatives. Public companies “are prohibited from availing themselves of their independent auditor’s knowledge of the [company’s] business in . . . analyzing various business opportunities, strategies, [and decisions,] and are required to retain the services of a third party, often unfamiliar with [the company’s] business,” which results in increased costs to the company.

Therefore, the regulations essentially result in smaller public companies focusing more on how to pay the fees of the outside auditors and the appropriate measures for complying with the Act rather than focusing on the success and growth of the business. Further, studies have even indicated that
audit committee independence fails to improve the financial reporting of the company.88

The cost of enhanced disclosure is another type of expense that unequally affects a smaller public company.89 Probably the most costly aspect of Sarbanes-Oxley for smaller public firms is the “internal and disclosure controls requirements.”90 The enhanced disclosures and shorter time periods of regulatory reporting have proven to result in a significant burden on smaller public companies.91 In analyzing a survey of public companies performed by Financial Executives International, it is apparent that small public companies pay a proportionately higher amount in complying with disclosure requirements.92 For example, the survey indicates that costs in order to meet the disclosure requirements for smaller public companies will, on average, total “roughly 400 percent [of] the cost to the largest public companies as a proportion of their revenues.”93 Therefore, the disclosure requirements, while based on the rationale of providing investor confidence, actually result in a considerable and inequitable burden on small public companies.

Further, as a result of the high financial costs that small public companies have to endure in order to comply with Sarbanes-Oxley, society as a whole may also be suffering due to the fact that many small companies are leaving the public market.94 For example, since small companies represent more than “99.7% of all employers” and “generate 60 to 80% of new jobs annually,” the economy will suffer because the high compliance costs will lead small public companies to eliminate jobs in order to stay afloat.95 Additionally, many reports suggest that Sarbanes-Oxley restricts the smaller public company’s risk taking ability.96 Due to the requirement addressing the supervision of the company’s affairs, a small public company may be impeded from taking risks because directors are more likely to manage the business with a greater degree of caution97 and because executive officers

88. Romano, supra note 75, at 1532.
89. See Rose, supra note 6, at 714-16; see also Christian Leuz et al., Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations 8 n.7 (Nov. 2004), available at http://knowledge.wharton.upenn.edu/papers/1285.pdf (reporting that a recent survey of chief financial officers indicated that “48% of their companies will spend at least $500,000 on Sarbanes-Oxley compliance”).
90. See Rose, supra note 6, at 729; see also Skouvakis, supra note 8, at 1283 (noting that the increased disclosure requirements create additional costs in terms of the increase in the number of staff hours, the additional computer software required to make the disclosures, and the outside agency costs).
91. Letter via Fax to Jonathan G. Katz, supra note 75.
92. Rose, supra note 6, at 730.
93. Id. In addition to vendor costs, the external support will require “about 385 percent of the time required by the largest public companies.” Id. Also, the auditor’s report is expected to cost smaller public companies “nearly 650 percent of the cost to the largest public companies as a proportion of revenues.” Id.
94. Id. at 736.
95. Wilda, supra note 4, at 684.
96. See Rose, supra note 6, at 720.
97. See Ribstein, supra note 1, at 37.
will be more likely to operate the business conservatively, which will “lead to a slow economy and a weak job market.”

While one purpose of the Sarbanes-Oxley Act was to make the market more effective, it may have actually made the market less effective by lowering public interest in public corporations and decreasing companies’ ability to compete. In looking at the public market in terms of a free enterprise, it is evident that the Act has resulted in “disastrous consequences for our nation’s ability to compete.” In addition, many corporate executives have reported that the increased burden of Sarbanes-Oxley compliance has had “very little or ‘no effect’ on the efficiency of their current processes.” These relatively high costs incurred by small businesses are the most serious problem with the Sarbanes-Oxley Act and the most compelling reason that action should be taken regarding their compliance with these requirements.

B. Benefits

Public companies typically obtain benefits both generally from being in the public market and more specifically from complying with the Sarbanes-Oxley Act. From a general view, “[c]ompanies obtain benefits both from going public and from being [a] public [company].” For example, companies profit from operating as a public company by receiving benefits such as liquidity, access to the markets, enhancement of the company’s profile, creation of currency for company projects, and benefits to the investors due to disclosure. In addition to the general benefits of being a public company, with the enactment of the Sarbanes-Oxley Act, companies have experienced further benefits in terms of more transparent disclosure, improvement in corporate governance, and confidence in the market.

The Sarbanes-Oxley Act was enacted in order to ensure proper behavior by companies. Based on the underlying purpose of ensuring appropriate corporate behavior, the securities regulations have provided beneficial oversight of corporate actions. For example, the Sarbanes-Oxley Act has pro-

98. Wilda, supra note 4, at 685.
99. See id.
100. Factor, supra note 66.
101. Leuz et al., supra note 89, at 8 n.7.
102. Rose, supra note 6, at 710 (emphasis omitted).
103. Id. at 710-14. A “primary justification for going public is the creation of liquidity” because the “public market not only benefits employee-shareholders by providing them an easier means of selling their shares, but it also benefits the company by allowing it to incentivize employees, directors and executives by basing equity compensation on the actual market value of the shares.” Id. In addition, the public market provides a company with cash, which the companies can use to pursue “acquisitions, expansion of research and development, or operating capital.” Id. at 712. Further, “[a] company that goes public will raise its profile and enhance its credibility. . . . Because public companies are often deemed to be more stable, potential customers may be more willing to contract with or purchase goods and services from public companies than private companies.” Id. at 713.
104. Cf. Engel et al., supra note 62, at 5-6 (discussing the benefits associated with certain types of disclosure such as those required by Sarbanes-Oxley and concluding that the compliance with the Act’s requirements may be beneficial for some firms).
vided benefits to smaller public companies and their shareholders due to the
greater accountability of management and emphasis on truthful financial
reporting. The benefits of more accurate financial reporting and manage-
ment accountability typically lead to further benefits such as confidence in
the market and higher stock prices. With this in mind, even many private
companies are complying with the provisions of the Sarbanes-Oxley Act
because the practices that it mandates have become the standard by which
judges measure the “best practices” of the actions of a company.

In addition, Sarbanes-Oxley has benefited companies through its en-
hanced disclosure requirements. While mandatory disclosure undoubtedly
imposes significant costs on public companies, it also brings certain advan-
tages. Proponents of the Act have stated that increased disclosure require-
ments will lead to greater transparency and in turn will lead to increased
investor trust in the company’s results and greater generation of profits for
the investors. Investors benefit from the mandatory disclosure require-
ments because if companies did not have to disclose information, they
might be induced to withhold or misrepresent any negative information.
Since mandatory disclosure requires companies to reveal both the positive
and negative information about their performance—reinforced by penalties
when companies omit information or provide false or misleading informa-
tion—the SEC’s disclosure requirements benefit public companies by
reassuring investors and encouraging investment.

Further, since the Sarbanes-Oxley Act was enacted to prevent frauds
such as those that occurred at Enron and WorldCom, the Act was an attempt
by Congress “to address the problem of gatekeeper failure by limiting or
eliminating conflicts of interest and by increasing penalties for ignoring or
facilitating illegal activities.” Sarbanes-Oxley has been referred to as “the
most important piece of antifraud legislation enacted since the Great De-
pression,” and it includes procedures and penalties for failure to comply
with its provisions. Therefore, through the heightened penalties for corpo-
rate misconduct, the Act will lead to more confidence in the market and
thereby potentially generate more profits for investors.

Although small public companies may realize some benefits from com-
plying with securities laws, the costs of Sarbanes-Oxley appear to outweigh

105. Steve Burkholder, Survey Cites Benefits of Sarbanes-Oxley Act, CORP. COUNS. WKLY., Jan. 26,
2005, at 28.
106. Id. (reporting a survey where 74% of executives believed Sarbanes-Oxley contributed some
benefits to the company).
107. Skouvakis, supra note 8, at 1291-92.
108. Engel et al., supra note 62, at 1.
109. See id.
110. Rose, supra note 6, at 713-14.
111. Id. at 721-23.
nic.com/magazine/20050901/surviving-so.html.
113. Rose, supra note 6, at 713-14, 722, 727.
114. See Engel et al., supra note 62, at 2.
the benefits. Sarbanes-Oxley has tipped the cost versus benefit “balance for many companies, pushing many smaller companies to exit the public markets.”115 Even small public companies that are realizing benefits may be compelled to “go private” or “go dark” due to the enormous compliance costs. While the Act has provided some benefits to small public companies, including access to the markets, enhancement of the company’s profile, improvement in corporate governance, and confidence in the market, the relatively high burden of disclosure costs, internal controls, supervision, fixed compliance costs, and director costs have resulted in a serious problem for small public companies and are the most compelling reasons for granting regulatory relief to small public companies.

V. SMALL COMPANIES’ REACTION TO COMPLIANCE WITH THE SARBANES-OXLEY ACT

As a result of the disproportionately heavy burden imposed by the Sarbanes-Oxley Act, numerous corporate executives have complained that these “extra costs of compliance with the Act are crippling smaller companies” in such a manner that smaller companies are being driven out of the market.116 These complaints ring true as many companies have chosen to completely abandon the public market while others have chosen to go dark, opting for a less regulated market.117

A. Go Private

Since many small public companies feel penalized for being public companies due to the heavy burdens with which they are faced, a significant number of small firms have chosen to exit the public market entirely by going private.118 A private company can be defined either as a company whose ownership is entirely private or a company with a relatively low number of shareholders that does not need to meet the strict SEC filing requirements of public companies, thereby foregoing the SEC requirement to file reports.119 Along with the fact that the company is not mandated to file reports with the SEC, a private company is also exempt from compliance with the Sarbanes-Oxley Act, which is one of the reasons for a small public company to choose to go private.120

115. Rose, supra note 6, at 717.
116. Wilda, supra note 4, at 679-80; see also Tamara Loomis, High Cost of Being Public: In First Months of Existence, Sarbanes-Oxley Act is Doubling Cost of Complying with Law, DAILY BUS. REV., May 7, 2003, at A7 (stating that on average, the costs in remaining a public company have doubled for small public companies, which has further lead to companies going private).
117. See Engel et al., supra note 62, at 2.
118. Loomis, supra note 10; see also John Gibeaut, New Twists in Sarbanes-Oxley May Compel More Smaller Companies to Exit the Market, A.B.A. J., Jan. 2005, at 20, 20 (stating that companies that choose to go private are motivated by the removal of the government regulators).
119. Engel et al., supra note 62, at 11.
120. See id.
Decisions by small public companies to go private increased significantly after the enactment of Sarbanes-Oxley because of the great burdens imposed the Act and the relatively smaller net benefits of being a public company for smaller firms. Evidence in a survey conducted by Grant Thornton International indicates that “the number of companies that have announced plans to go private has risen steadily since the passage of [the Sarbanes-Oxley Act].”\footnote{Carney, supra note 65, at 13; see also Factor, supra note 66 (reporting a recent survey indicating that approximately 20% of public companies are contemplating going private in order to avoid compliance with the Sarbanes-Oxley Act).} For example, in 2004, of the 114 firms which filed papers to go private, forty-four “specifically mentioned the cost of compliance with the federal securities laws” as the primary reason for exiting the public market.\footnote{Carney, supra note 65, at 8. The survey reports the average costs of compliance for the smaller public firms that went private as $263,000—with $174,000 accounting for the increased costs to comply with Sarbanes-Oxley. Id. at 9.} Specifically, “smaller firms and firms with greater inside ownership [have] see[n] higher going-private announcement returns in the post-[Sarbanes-Oxley] period compared to the pre-[Sarbanes-Oxley] period.”\footnote{Engel et al., supra note 62, at 3.}

When a small company chooses to abandon the public market and go private, it will likely observe numerous advantages. As one study suggests, “the value of being public post- [Sarbanes-Oxley], relative to the value of being private, is lower for smaller firms.”\footnote{Engel et al., supra note 62, at 21; see also Gibeaut, supra note 118, at 21 (reporting a survey conducted by Foley & Lardner in which 21% of the companies were contemplating a move to the private market due to the Sarbanes-Oxley Act).} Since the benefits inherent in being a public company are outweighed by compliance costs with the securities regulations for many small public companies, operation as a private company will likely be a more viable option. The costs of complying with federal securities regulations may amount to a large percentage of a small public company’s revenues; therefore, going private provides small public companies with the benefit of eliminating the increased cost of complying with these regulations.\footnote{Engel et al., supra note 62, at 10.} Due to this elimination of additional expenses, small companies are able to more freely invest their assets in innovations and other business growth as opposed to regulatory compliance. Thus, by avoiding the costs inherent in compliance, small companies retain more of their net revenues, which is beneficial for investors because these companies can then use their assets to grow.

On the other hand, commentators have stated that there is a problem with companies going private merely to escape the costly compliance associated with being a public company. While a large number of small public companies have been driven to go private due to the increased regulation of the Sarbanes-Oxley Act, these companies will lose the advantages and benefits associated with being in the public market, such as liquidity of the com-
pany’s stock and the goodwill associated with being a public company. Therefore, the decision to go private is generally not the best long-term business strategy for small public companies that desire to expand and grow.

B. Go Dark

If a small public company chooses not to completely eliminate all ties with the public market but wants to avoid compliance with the Sarbanes-Oxley Act, it also has the option to go dark. In order to go dark, the company must have less than 300 shareholders, deregister from public markets, and potentially satisfy other requirements, such as not having any contractual obligations or restrictions in the bylaws that require the company to continue filing reports with the SEC.

In the past few years, there has been a surge of public companies that have decided to deregister and go dark. The increased disclosure and related internal control requirements introduced by the Sarbanes-Oxley Act have been frequently cited as the “catalysts in this recent movement to ‘go dark.'” For example, in 2003, roughly 200 companies went dark to avoid compliance with federal securities regulations. Managers of small public companies typically state that the reporting costs, which are particularly burdensome for smaller firms, have led to the decision to go dark. Small public companies that opt to go dark rather than go private tend to be the smallest, underperforming companies with high leverage and little growth opportunity.

While small public companies have the option to go dark, there is a significant “negative market reaction of roughly -10%” when firms decide to go in that direction. Commentators have argued that if a company decides to go dark, the decision would be received in a more negative manner by the public than a decision for the company to go private because shareholders may “view[] deregistration as a mechanism for management to hide poor performance that might otherwise lead to their dismissal.” Therefore, the company’s decision to deregister and go dark may reveal to investors that growth opportunities no longer exist for the company. This has resulted in

126. Skouvakis, supra note 8, at 1280.
127. Id. at 1291.
128. Leuz et al., supra note 89, at 2.
129. Id. at 1.
130. Id.
131. See id.
132. Id. at 7.
133. Id. at 18.
134. Id. at 2. The negative market reaction may be a result of either investors’ uncertainty of the further growth opportunities of the company or the outside directors’ belief that the insiders are only looking out for themselves. Id. at 2-3.
135. Id. at 3.
136. Id. at 2.
“highly negative event . . . returns” for firms that have gone dark after the enactment of the Sarbanes-Oxley Act.\textsuperscript{137} In addition to the negative reaction by the market, there are numerous costs associated with the decision to go dark. When a company deregisters its stock, it no longer has the transparency inherent in compliance with the SEC disclosure rules; therefore, this leads to an imbalance regarding the information between insiders in the company and outside investors.\textsuperscript{138} With this loss of transparency, the number of investors may decrease because they will no longer have access to the information and will not have the ability to monitor their investment. Also, a company may lose its bargaining power with banks and with other types of companies. Therefore, the costs associated with being dark tend to outweigh the benefits from not having to adhere to the SEC regulatory regime.

\section*{C. Ramifications of Going Private or Going Dark}

The decision to go private or go dark, while benefiting small public companies in the short run by avoiding the costs of complying with Sarbanes-Oxley, will typically lead to negative long-term results. When small public companies abandon the public market, they tend to suffer a permanent decrease in the value of their stock because of a decrease in liquidity and a lack of investor confidence in the accuracy of the companies’ standing. For example, a recent survey indicated that shareholders of public companies that had exited the public market from 1999-2002 experienced an average loss of 19\% on their investment.\textsuperscript{139} Also, since the decision to exit the public market generally results in a decrease in investor confidence, investors will usually pay less for the stock because they will be unsure as to the profitability of their investment. As a result of the decrease in share price, a company will not receive as much value for its stock. Thus, when a company decides to go private or go dark, the decision will affect the company’s ability to generate revenue, innovate, and grow.

\section*{VI. Evaluation of Governmental Solutions to the Costs of Compliance with the Sarbanes-Oxley Act}

Because studies indicate that the Sarbanes-Oxley Act unduly burdens small public companies, it is necessary to consider appropriate remedies to decrease the burdens of complying with the Act. Even though Congress did not consider the varying effects on firms of different sizes when the Sarbanes-Oxley Act was initially enacted, evidence indicates that, from the start, large firms have found it easier than smaller firms to comply with the

\textsuperscript{137} Id. at 20.
\textsuperscript{138} Id. at 2.
Since “it is clear that the smaller companies are bearing a larger part of the burden,” the issue has to be addressed.\textsuperscript{141} Congress and the SEC, in response to the reports of the disproportionate burden of Sarbanes-Oxley on smaller public companies, are seeking solutions to aid small public companies in complying with the Act. In establishing the Advisory Committee on Smaller Public Companies to consider the impact of the Sarbanes-Oxley Act on small public companies with respect to corporate disclosure and reporting requirements, corporate governance provisions, accounting and financial reporting requirements, and internal control mechanisms,\textsuperscript{142} the SEC has taken the initial steps to formulate a more effective regulatory regime that will be less burdensome on small public companies.

In considering each of the key aspects of the Sarbanes-Oxley Act while still protecting the interests of public investors, the Advisory Committee is determining whether the costs of compliance imposed on smaller companies are proportionate to the benefits and is identifying methods of reducing costs and maximizing benefits.\textsuperscript{143} Since the SEC can more easily control the burdens imposed on small public companies than bestow more benefits on large public companies, balancing the costs and benefits of federal regulations on smaller public companies may be best accomplished by focusing on the former approach. Thus, in order to prevent small public companies from going private or going dark to avoid compliance costs, the SEC should take steps to decrease the burden on small public companies, as they serve an important role in the public securities market and in the economy as a whole.\textsuperscript{144} Some suggested methods for decreasing the disproportional burden imposed on small public companies are discussed below, indicating both the positive and negative aspects of each approach.

\textit{A. Creation of a Small Companies Market}

One option that has been suggested to alleviate the regulatory burdens imposed by the Sarbanes-Oxley Act and other such federal securities regulations is the creation of a distinct market for small public companies.\textsuperscript{145} While the establishment of a small companies market has been proposed,

\begin{itemize}
\item \textsuperscript{140} Ribstein, supra note 1, at 46.
\item \textsuperscript{141} Feldman, supra note 112, at 138 (quoting Bruce Aust, Executive Vice President of the Corporate Client Group at Nasdaq). With Alan Beller, the head of the SEC’s corporation-finance division, announcing his resignation from the SEC, the restructuring of the SEC’s corporate governance system in order to relieve some of the extra burdens on smaller public companies may not come as quickly as was previously conceived. See Kara Scannell, SEC Losing Torchbearer on Corporate Behavior, WALL ST. J., Jan. 12, 2006, at C3, available at 2006 WLNR 639394. But see Factor, supra note 66 (reporting a recent agenda meeting where Representative Nancy Pelosi, then House Democratic leader, acknowledged the specific need to “ensure Sarbanes-Oxley requirements are not overly burdensome” and stated that reform was necessary).
\item \textsuperscript{142} Feldman, supra note 112, at 137.
\item \textsuperscript{143} Id.
\item \textsuperscript{144} Castelluccio, supra note 15, at 468.
\item \textsuperscript{145} Rose, supra note 6, at 743-44.
\end{itemize}
B. Deferral of Compliance for Small Public Companies

Due to the fact that small public companies are incurring much higher costs in implementing the mechanisms to comply with the Sarbanes-Oxley Act than the SEC originally believed they would have to endure, another possible solution would be to defer the compliance date for small companies. For example, the SEC could defer implementation of Section 404 for smaller companies until better guidance is in place upon which to base enforcement of the rules.\textsuperscript{146} While the SEC already extended compliance with the totality of the Sarbanes-Oxley Act until July 15, 2006, the SEC has proposed that this date should be extended until December 15, 2007, for non-accelerated filers.\textsuperscript{147} The SEC has also explored extending the date for compliance with the Section 404(b) requirement that a company must provide an auditor’s report on internal control over financial reporting until December 15, 2008.\textsuperscript{148} In contemplating the extension of the compliance date, both the Advisory Committee on Smaller Public Companies and the Commission reasoned that in addition to the costs of complying with Sarbanes-Oxley, companies also have to expend considerable management time and effort to establish and attest to the effectiveness of internal control over their financial reporting.\textsuperscript{149} Therefore, the extension period would ease the compliance burden because better guidance as to how to comply would be in place by the time small public companies were required to comply. However, while the deferral of compliance with the Sarbanes-Oxley Act may be a viable solution for the short-term, it would not generate the best long-term result.


\textsuperscript{148} SEC Press Release, \textit{supra} note 147.

\textsuperscript{149} Id.
because even though the small public companies would be able to delay compliance, thus temporarily avoiding the costs of the Sarbanes-Oxley Act, the companies would eventually have to comply and would incur the overly burdensome costs at that time.

C. Exempt Small Companies

Under the Sarbanes-Oxley Act, Congress expressly gave the SEC the power to create rules “necessary or appropriate in the public interest.”\(^{150}\) In addition, the SEC has been instilled with the flexibility to exempt small public companies from numerous requirements of securities law.\(^{151}\) Despite this, the SEC has not yet extensively and justly exercised its authority to assist small public companies in regards to the Sarbanes-Oxley Act.\(^{152}\) An SEC spokesman “confirmed that the agency has no plans at this time to exempt small companies from Sarbanes-Oxley’s reach.”\(^{153}\)

In proposing a small public companies exemption, proponents have suggested considering the “revenue, current procedures, and estimated costs” as the measurements for determining whether or not to grant exemption.\(^{154}\) To begin, the exemption would only be available to microcap companies with less than $125 million in annual revenue and to smallcap companies with less than $10 million in annual product revenue, as measured on the last day of the company’s most recent fiscal year.\(^{155}\) Additionally, exemptive relief from certain provisions, such as external auditor involvement, may be allowed for smallcap companies with less than $250 million in annual revenues but greater than $10 million in product revenue.\(^{156}\) In addition, in considering the current procedures of the small public company, the SEC could allow exemption only to such small public companies that currently maintain sufficient financial and corporate governance procedures within the company.\(^{157}\) Further, the small public company requesting exemption would have to establish that the estimated costs of compliance would overly burden the company.\(^{158}\)

The proposal of an exemption for smaller public companies has been met by both support and opposition. Proponents of the exemption for small public companies have stated that the underlying rationale for the exemption relates to the fact that the costs of compliance outweigh the benefits. In support of an exemption, many commentators have stated that having the

\(^{151}\) Loomis, supra note 10.
\(^{152}\) Id.
\(^{153}\) Id.
\(^{154}\) Wilda, supra note 4, at 690.
\(^{156}\) Id. at 7.
\(^{157}\) Wilda, supra note 4, at 690.
\(^{158}\) Id.
same regulations for all public companies results in immense and disproportionate burdens; therefore, the exemption would eliminate some of the costs inherent in complying with the provisions of the Sarbanes-Oxley Act that are burdening small public companies.\footnote{Castelluccio, supra note 15, at 472.} The costs of compliance not only affect small companies’ ability to operate in their current condition but also restrict access to capital for further growth.\footnote{Id. at 467-69.} Additionally, in response to the Advisory Committee’s request for public input, one commentator stated, after surveying numerous companies in his area, that the companies supported the notion of exempting small public companies from Section 404 of the Sarbanes-Oxley Act.\footnote{Letter via Fax to Jonathan G. Katz, Comm. Mgmt. Officer, U.S. Sec. & Exch. Comm’n (Aug. 31, 2005), http://www.sec.gov/rules/other/265-23/2652372.pdf.} These companies stated that the exemption would benefit small companies but would not negatively impact on investors because, due to the small size of the companies, other means of ensuring proper behavior by the companies, such as auditing, would ensure accountability of management and the finances.\footnote{Id.} Since the exemption would exempt only small public companies from compliance with Sarbanes-Oxley, corporate managers would still have to comply with the antifraud regulations of the SEC; therefore, the exemption would likely not weaken the SEC’s ability to enforce the regulations, and companies would still have the motivation to be accountable for their actions of management.\footnote{Castelluccio, supra note 15, at 473.} Therefore, the purpose of guaranteeing accountability in order to promote investor confidence would still be viable even if the small public companies were exempt.\footnote{Id.} Further, the necessity and feasibility of this exemption is supported by the reasoning and concepts behind other securities law exemptions, including Regulation D, which would apply to a Section 404 exemption as well.\footnote{See Letter via Fax to Jonathan G. Katz, supra note 161.}

On the other hand, opponents contend that the SEC does not have the authority to grant such an exemption, exemptions would lead to a lack of investor confidence, and exemptions would have a negative impact on the entirety of the U.S. economy. To begin, in a recent letter, twenty law professors asserted that the SEC “lacks the power to exempt ‘micropub’ companies”\footnote{Castelluccio, supra note 15, at 473.} from the provisions of the Sarbanes-Oxley Act since the SEC does not have “total exemptive authority.”\footnote{Id. at 540 (quoting Sen. Sarbanes’s discussion of the letter).} As noted by Senator Sarbanes, the Advisory Committee on Smaller Public Companies did not have a statutory basis upon which to rely in proposing the exemption for smaller public companies from the provisions of the Sarbanes-Oxley Act; therefore, the SEC would not have the requisite authority to allow exemptions from the

\begin{footnotes}
\item[159] Castelluccio, supra note 15, at 472.
\item[160] Id. at 467-69.
\item[162] Id.
\item[163] Castelluccio, supra note 15, at 473.
\item[164] See Letter via Fax to Jonathan G. Katz, supra note 161.
\item[165] Castelluccio, supra note 15, at 469.
\item[166] Sarbanes Defends SOX, supra note 147, at 539.
\item[167] Id. at 540 (quoting Sen. Sarbanes’s discussion of the letter).
\end{footnotes}
Act for small public companies. \textsuperscript{168} In addition, opponents reason that “exemptions would ‘remove an estimated 80\% of all public companies’ from the law’s requirements,” which would negatively impact investor confidence and the market. \textsuperscript{169} Although the small public companies that qualify for the exemption would still be subject to other regulatory actions, the SEC would not have as much control over the disclosures of the company and might not have the resources to patrol these companies as effectively. \textsuperscript{170} Allowing an exemption for small public companies would also completely ignore a study which indicated that “the typical company in an SEC . . . enforcement case [is] very small.” \textsuperscript{171} Therefore, if the SEC adopts an exemption for small public companies, it would “fail to target [the] companies with greater risk of financial statement fraud activities,” which would lead to a negative impact on both investor confidence and the market. \textsuperscript{172}

While the SEC was “taking more of a wait-and-see approach” in regards to the exemption for smaller public companies in order “to see whether the concerns they’re hearing now are still an issue down the road,” the SEC has decided not to grant an exemption for small public companies in regards to Section 404 of the Sarbanes-Oxley Act. \textsuperscript{173} Although the refusal to grant an exemption from Section 404 of the Act does not necessarily indicate whether small public companies ever may be exempted from other aspects of the Act, this decision does imply that the SEC is reluctant to grant small public companies an exemption from the regulations. Thus, even though an exemption from compliance may be beneficial to the small public companies, the U.S. economy may suffer as a result; therefore, the recommendation to exempt all small public companies may go too far.

\textbf{D. Different Rules for Different Sized Companies}

Although the SEC was, arguably, granted the flexibility to go as far as exempting small public companies from compliance with the Sarbanes-Oxley Act, a better solution to reducing the costs of compliance is to tailor the regulations to fit the needs of companies based on their various sizes. \textsuperscript{174} Since small public companies seem to be bearing a greater burden than

\begin{footnotes}
\item 168. See id. at 540 (outlining Sen. Sarbanes’s views on SEC exemptive authority).
\item 169. SEC Advisory Panel, supra note 146, at 341 (quoting Paul Volcker, former Chairman of the Federal Reserve, in a letter to SEC Chairman Christopher Cox).
\item 170. See Wilda, supra note 4, at 690.
\item 171. Sarbanes Defends SOX, supra note 147, at 540 (quoting Sen. Sarbanes’s comments on the Treadway Commission study of 1999) (internal quotation marks omitted).
\item 172. Id.
\item 173. Loomis, supra note 10.
\item 174. See Advisory Committee on Smaller Public Companies, 69 Fed. Reg. 76, 498, 76,499 (Dec. 21, 2004) (explaining the SEC created the Advisory Committee on Smaller Public Companies with the expectation that “the Committee will provide recommendations as to where and how the Commission would draw lines to demarcate companies that warrant tailored regulatory treatment based on size”).
\end{footnotes}
large companies, it appears that “[o]ne size does not fit all in any regula-
tion.” 175

“Even Oxley himself has begun backpedaling. . . . If he could do it over
again, Oxley said, he would permit ‘a bit more flexibility for small and me-
edium-size companies.’” 176 As Congressman Oxley has suggested, the Sar-
banes-Oxley Act could be clarified to have “one set of standards for large
companies and another set for small companies.” 177 SEC Chairman Chris-
topher Cox has also pointed out that “the costs of implementation of Section
404 of the Sarbanes-Oxley Act . . . are a function of the way the law has
been implemented.” 178

The rationale for tailoring the regulation to fit the needs of varying sized
companies is based on the facts that companies of varying sizes differ in
terms of their characteristics and that the SEC has previously recognized the
need to scale regulation based on a company’s size. Critical characteristics
of small companies, such as the investment in the companies’ stock, the
varying types of advisors relied on by the companies, and the focus of man-
agement, make them different to regulate than large corporate entities. 179 In
addition, numerous federal securities regulations already contain specific
lighter provisions for small public companies; therefore, creating different
provisions under the Sarbanes-Oxley Act for smaller public companies
would not be an unprecedented happening. 180 Therefore, it is in the public’s
interest, and within the SEC’s authority, to promulgate different rules for
different sized companies in order to alleviate the burden of the Sarbanes-
Oxley Act on small public companies.

In order to achieve the law’s objective of sound internal controls and
accurate financial statements, while at the same time making compliance
consistent with the sound management of shareholder dollars, the SEC
should adopt “a new system of scaled or proportional securities regulation
for smaller public companies.” 181 In order to implement these scaled or pro-
portional regulations, significant changes to the provisions—found in the
Sarbanes-Oxley regulatory regime—for smaller public companies are re-

175. Feldman, supra note 112, at 138 (quoting Bruce Aust, Executive Vice President of the Corpo-
rate Client Group at Nasdaq) (internal quotation marks omitted).
177. Id. at 138.
178. SEC’s New Leader Shares His Views on a Range of Issues, WALL. ST. J., Sept. 19, 2005, at A13,
available at http://online.wsj.com/article/SB112709328603244514.html?mod=todays_us_page_one
(quoting from the full transcript of an interview with SEC Chairman Christopher Cox).
179. Letter from John C. Malone, Managing Partner, Malone & Bailey, PLLC, to Jonathan G. Katz,
/jcmalone1.htm.
180. See 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); see also Exposure Draft of
Final Report of Advisory Committee on Smaller Public Companies, 71 Fed. Reg. 11,090, 11,096-97
(Mar. 3, 2006) (discussing the long history of tailoring regulation to varying sized companies by the
SEC, such as Regulation S-B, which limited the coverage of the Exchange Act of 1934 to companies
with more than $10 million in net assets).
181. FINAL REPORT, supra note 155, at 14.
required in the areas of internal control, corporate governance and disclosure, and auditing.\textsuperscript{182}

To begin, proportional regulations would be beneficial in the area of internal controls. While exemptive relief from external auditor requirements could be beneficial to small public companies, the audit promotes investor and market confidence; therefore, as opposed to granting a full exemption, the SEC should alter the current regulatory regime and make the requirements lighter for smaller public companies.\textsuperscript{183} For example, in order to affect a more cost-effective standard for small public companies, modifications should be made to the external auditor requirement, providing for an external audit that is narrowly conformed to meet the requirements of the Sarbanes-Oxley Act.\textsuperscript{184} The Advisory Committee has suggested that the SEC take steps to implement a new audit standard for smaller public companies that “provides guidance for the external audit of only the design and implementation of internal controls to make the work performed by auditors on internal controls more efficient for these companies.”\textsuperscript{185} While the rationale for internal controls is understandable because the SEC wants to make certain that it is doing everything in its means to prevent corporate scandals resulting from companies cooking the books, the same goal can be achieved in an alternative less costly manner; therefore, the internal control requirements should be scaled to better fit the needs of small public companies.

In addition to the internal control requirements, the corporate governance and disclosure requirements should also be tailored to better fit the needs of small public companies. With regard to corporate governance, a variance in the regulatory provision requiring independent directors for small public companies would help serve this purpose. According to a response from a survey sent out by the Advisory Committee on Smaller Public Companies, it would be advantageous to the business of small public companies if they were required only “to have at least one-third of their boards composed of independent directors and/or a majority of each committee composed of independent directors.”\textsuperscript{186} By scaling down the requirement for independent board members, small public companies would benefit not only in terms of a reduction in costs, such as director and officer insurance, but would also benefit from not having to expend resources on attempting to find qualified independent directors.\textsuperscript{187} Therefore, the small public companies could focus on finding members of the board to best further their business strategy instead of merely trying to find a sufficient number of members to meet the requirements of the Sarbanes-Oxley Act.

\textsuperscript{182.} \textit{Id.} at 20, 42.
\textsuperscript{183.} \textit{See id.} at 42-44.
\textsuperscript{184.} \textit{Id.} at 44.
\textsuperscript{185.} \textit{Id.} at 50.
\textsuperscript{186.} Letter via Fax to Jonathan G. Katz, \textit{supra} note 75.
\textsuperscript{187.} \textit{See id.}
Also, other meaningful regulatory relief from the impact of Sarbanes-Oxley could come in the form of allowing the corporate governance committee to be an option for smaller public companies rather than a mandatory provision, if the company’s board—or a part thereof—assumed the functions of the corporate governance committee. In order to ensure that the underlying rationale behind the creation of a corporate governance committee—preventing fraud and other criminal activity—and to assure the market and investors that they have complied with the requisite corporate governance standards under this more flexible structure, small public companies should “be required to explain clearly their particular implementation of corporate governance relief in . . . their proxy statement” or other disclosures.

In regard to disclosure, small public companies should be allowed to “[i]ncorporate the scaled disclosure accommodations currently available to small business issuers under Regulation S-B” and, correspondingly, the SEC should stop requiring separate specialized disclosure forms for smaller companies. For example, small public companies should be permitted “to provide a less detailed description of their business and to disclose business development activities for only three years, instead of the five years required of larger companies” and should be permitted to provide a “more streamlined disclosure for management’s discussion and analysis of financial condition and results of operations.” Along with the reduction of costs from less disclosure, another reason for allowing less disclosure for small public companies is due to the fact that their business strategy may change more quickly than that of a large public company, so it would not be necessary for such companies to provide a full five years worth of disclosure that may no longer be relevant. Another possible solution with regard to disclosure would be “a system [requiring] semi-annual reporting with limited revenue information to be provided in other quarters.” “Such a system would provide investors with relevant information about the registrant, but not repetitive information,” which would alleviate costs from the duplicative nature of some required disclosure. The limited quarterly revenue information . . . would provide investors with continuous and timely information about the registrant.” By allowing a more proportional regulatory regime for small public companies in corporate governance and disclosure, the SEC would still be able to oversee the actions of the companies and ensure that they are not disclosing fraudulent information while

189. Letter via Fax to Jonathan G. Katz, supra note 75.
190. See FINAL REPORT, supra note 155, at 59.
191. Id. at 61-62.
192. See id. at 64-66.
194. Id.
195. Id.
allowing the companies a break from the extensive costs of compliance with the Sarbanes-Oxley Act.

In order to provide a scaled regulatory regime, less stringent accounting regulations may also be appropriate for smaller public companies. For example, beneficial distinctions in regulations regarding the auditing provisions for smaller public companies would include permitting such companies to choose to have their audit committee also handle other matters, such as compensation, reducing the need for stand-alone committees in these areas.\footnote{See Letter of Supplemental Material to Jonathan G. Katz, supra note 67; see also Letter from John C. Malone to Jonathan G. Katz, supra note 179.} Also, a “safe-harbor” rule may be enacted, which would protect good faith “preparers from regulatory or legal action when a prescribed process is appropriately followed and results in an accounting conclusion that has a reasonable basis.”\footnote{FINAL REPORT, supra note 155, at 102.} Further, it may be beneficial for the SEC to establish a “provision that provides relief for certain types of violations that are de minimis in nature as long as these are discussed with and approved by the company’s audit committee.”\footnote{Id. at 109-10.}

In varying the rules for small public companies, the SEC could clarify the Sarbanes-Oxley Act so as to provide one set of standards for large companies and another set for small companies. Since the scaled provisions directed towards small public companies would still have the same basic scope of the broad provisions that govern large public companies, the SEC would not be forced to incur substantial additional costs, and enforcement of these provisions would not be drastically different because the same basic structure of regulations would be in place for all sizes of public companies. In addition, the underlying rationale for the enactment of the Sarbanes-Oxley Act, to “protect investors by improving the accuracy and reliability of corporate disclosures,”\footnote{Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 745.} would still be promoted with the proportional regulations. Since the scaled regulations would merely be a better regulatory fit for the varying sizes of companies, the same purpose would still be promoted through the securities laws. Thus, perhaps more rules, ironically, would be the best solution.

VII. CONCLUSION

Even though the U.S. economy is built on the entrepreneurial aspect inherent in the operation of small firms, the enormous compliance costs required by the Sarbanes-Oxley Act currently outweigh the benefits of operating in the public market for many of these companies. Thus, since small public companies are exiting the public market, these compliance costs affect not only the companies who incur the direct costs of compliance but also investors, the job market, and the economy in general.
To help reduce these burdens that cause small public companies to go private or go dark, the SEC should grant regulatory relief to prevent these companies from exiting the public market. While commentators have suggested solutions, such as the creation of an alternative market solely for small public companies, the most beneficial approach would be for the SEC to create a regulatory scheme that is scaled in proportion to the size of the company. Scaling down the provisions of the Sarbanes-Oxley Act would allow the SEC to better meet the needs of small companies, and by reformulating the corporate governance, disclosure, internal controls, and auditing requirements, the SEC would help retain small public companies in the public market. Since it would be relatively uncomplicated to tailor the Sarbanes-Oxley Act to the needs of small public companies, this solution is perhaps the most preferable and would avoid the creation of significant additional costs in implementing or in enforcing the resulting proportional rules.

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