

COMMENT

SARBANES–OXLEY: PROGRESSIVE PUNISHMENT FOR REGRESSIVE VICTIMIZATION*

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I. INTRODUCTION

In the mid to late 1990s, the exploding technology sector put economic growth into overdrive.¹ The period's exponential technological advances resulted in the popularization of interconnected computer networks such as the Internet.² Enabling infrastructure was in hyper-demand, and the telecommunications sector was booming.³ The promise of wealth quickly attracted millions of new investors, many of whom lacked substantial business acumen.⁴ In the spring of 2000, the "hallucinations of the late 1990s," most famously characterized by Alan Greenspan as "irrational exuberance," subsided.⁵ In March of that year, the "tech bubble" burst⁶ and market indices took a nosedive.⁷ "Irrational exuberance ha[d] unduly escalated asset values."⁸

Eighteen months later terrorists attacked.⁹ Within two months of those attacks, the United States invaded Afghanistan and expanded its "war on terror."¹⁰ Shortly thereafter, Enron restated its financial position.¹¹ Nevertheless, despite mounting pressure from the exploded tech bubble, terrorist attacks, military expenditures abroad, and the unfolding Enron scandal,

1. See, e.g., Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 923 (2003).

2. *Id.*

3. *Id.*

4. *Id.*

5. *Id.*; Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks at the Annual Dinner and Francis Boyer Lecture of the American Enterprise Institute for Public Policy Research: The Challenge of Central Banking in a Democratic Society (Dec. 5, 1996), available at <http://www.federalreserve.gov/BOARDDOCS/SPEECHES/19961205.htm>.

6. John M. Griffin, et al., Who Drove and Burst the Tech Bubble? 4 (Aug. 16, 2005) (unpublished manuscript, available at <http://ssrn.com/abstract=459803>) (discussing the forces behind the rise and subsequent burst of the "tech bubble").

7. See Greg Ip & Gregory Zuckerman, *Global Sell-Off Gives Nasdaq a Frightening Jolt*, WALL ST. J., Mar. 14, 2000, at C1 (reporting a 141.38 point drop, the fourth-worst point drop in Nasdaq history); see also Cunningham, *supra* note 1, at 923 (describing the subsequent stagnation of stock market indices in the spring of 2000).

8. Greenspan, *supra* note 5.

9. N.R. Kleinfeld, *U.S. Attacked: Hijacked Jets Destroy Twin Towers and Hit Pentagon in Day of Terror*, N.Y. TIMES, Sept. 12, 2001, at A1.

10. See Michael Powell, *Across America, Voices of Support; Concern About New Attacks on U.S., Deaths in Afghanistan Also Expressed*, WASH. POST, Oct. 9, 2001, at A3 (reporting on the "war on terror" and concerns about the war in Afghanistan).

11. See, e.g., WILLIAM C. POWERS, JR., RAYMOND S. TROUBH, & HERBERT S. WINOKUR, JR., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 2-3 (2002) [hereinafter POWERS REPORT], available at <http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf>.

the markets held sideways.¹² In April 2002, however, the markets finally buckled.¹³ Reports and investigations of fraud at, financial restatements by, and bankruptcies of some of the largest and best-known public companies imposed pressures the market failed to withstand.¹⁴ It hit bottom three months later, several days after WorldCom filed for bankruptcy, and one day before the House Financial Services Committee released a responsive bill.¹⁵

The Sarbanes–Oxley Act of 2002¹⁶ (Sarbanes–Oxley or the Act) materialized under circumstances that forced Congress to rush to the aid of the American public.¹⁷ Spectacular business failures resulted from accounting scandals and fraud at numerous large and well-regarded companies.¹⁸ U.S. market values declined tremendously.¹⁹ Each new day brought new fraud, job cuts, worthless pension funds, and a louder cry for a strong legislative solution.²⁰ Close watch by the American public in the run up to the midterm congressional elections invariably forced emergency legislation.²¹ Finally, in July 2002, on the coattails of more than a 30% drop in total market value, Congress enacted Sarbanes–Oxley.²²

Determined to deliver a swift legislative response, Congress imposed new obligations on executives, directors, accountants,

12. Cunningham, *supra* note 1, at 924.

13. Roberta Romano, *The Sarbanes–Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1546–47 (2005).

14. *See id.* (discussing the collapse of several large corporations such as Enron and WorldCom); *see also infra* Part II.A (describing the numerous corporate scandals involving AOL, Enron, WorldCom, Time Warner, Qwest Communications, and others).

15. *See Romano, supra* note 13, at 1546 (noting that the S & P 500 composite index lost more than one-third of its April 2002 value and other major indices sustained similar declines and losses).

16. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

17. *See Romano, supra* note 13, at 1528–29 (criticizing the Act’s enactment as being rushed and “ill conceived”).

18. *See infra* Part II.A (chronicling the continual failures among the largest U.S. corporations).

19. *See* Floyd Norris, *Adding to Loss of Investments, A Loss of Faith*, N.Y. TIMES, July 20, 2002, at A1 (discussing financial markets’ rapid losses over the course of nine weeks); *see also Romano, supra* note 13, at 1528.

20. *Cf.* Senator Tom Daschle & Representative Richard Gephardt, News Conference on Corporate Scandal and Pension Reform (July 26, 2002), *available at* 2002 WL 1730009 (discussing the impact that frauds, layoffs, and pension fund collapses at WorldCom, Tyco, Rite-Aid and other large companies had on the passage of Sarbaes–Oxley).

21. *See Romano, supra* note 13, at 1528–29 (discussing the political climate surrounding the passage of Sarbanes–Oxley).

22. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.); Norris, *supra* note 19 (noting that the Dow Jones Industrial Average had lost over 30% of its peak value and other markets displayed similar drops).

lawyers, and numerous other entities,²³ but gave little consideration to the Act's possibly adverse effects.²⁴ A result of its circumstances, Sarbanes–Oxley put forth numerous provisions targeting existing governance and financial reporting weaknesses. The Act purported “[t]o protect investors by improving the accuracy and reliability of corporate disclosures.”²⁵ Its provisions addressed numerous conflicts of interest, mandated director independence, channeled supervisory responsibilities to the most disinterested parties, improved the dissemination and disclosure of material financial and organizational information, and sought to deter future fraud with stiffer criminal sanctions and greater senior executive responsibility.²⁶ These mandates, though well suited for safeguarding against exposed weaknesses, completely ignored the differences between large and small companies.²⁷

This Comment addresses the disproportionate burden Sarbanes–Oxley places on small public companies. Part II examines the key events and circumstances surrounding and influencing the Act's enactment. Part III dissects Sarbanes–Oxley, presenting evidence that numerous provisions are disproportionately burdensome on small public companies. Part IV analyzes several recently recommended changes aimed at decreasing compliance costs for small public companies and encouraging their participation in the public markets. Moreover, Part IV suggests that the market is well prepared to handle corporate fraud, concluding that Sarbanes–Oxley is an overinclusive regulation punishing smaller firms for their

23. See, e.g., Robert C. Brighton, Jr., *Sarbanes–Oxley: A Primer for Public Companies, and Their Officers and Directors, and Audit Firms*, 28 NOVA L. REV. 605, 606 (2004) (listing individuals and entities affected by the Act); Cunningham, *supra* note 1, at 920–21 (identifying groups “designated for study or regulation” under the Act); Robert W. Hamilton, Address, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 56–69 (2003) (discussing the ten titles of Sarbanes–Oxley and the obligations they placed on corporate entities); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes–Oxley Act of 2002*, 28 J. CORP. L. 1, 11–18 (2002) (analyzing the requirements of Sarbanes–Oxley and how they affect directors, auditors, executives, and securities analysts).

24. See, e.g., Romano, *supra* note 13, at 1585 (noting that Congress did not evaluate the Act's efficacy but rather adopted it for its “symbolic benefit”); Neal L. Wolkoff, *Sarbanes–Oxley Is a Curse for Small-Cap Companies*, WALL ST. J., Aug. 15, 2005, at A13 (describing the competitive difficulties faced by smaller companies since the passage of Sarbanes–Oxley).

25. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

26. See *id.*; Brighton, *supra* note 23, at 608–25.

27. See Wolkoff, *supra* note 24 (examining the Act's provisions that are especially costly for smaller companies to follow).

association in the “business” club. Overall, this Comment aims to demonstrate that Sarbanes–Oxley was a direct response to the overwhelming drop in investor confidence due to fraud among the largest U.S. public corporations and suggests that only very large public companies wield substantial market capital to affect the markets in the same way as Enron and WorldCom. Therefore, applying the most burdensome Sarbanes–Oxley provisions only to public corporations whose fraud has devastating potential would protect investors and improve small-firm competitiveness in the public markets without seriously threatening investor confidence.

II. BACKGROUND

A. Monumental Fraud(s)

In early 2001, Enron, with its total assets reportedly worth over \$65.5 billion and nearly \$100.8 billion in revenues,²⁸ was the seventh-largest public corporation in the United States.²⁹ Enron’s success was soon to be revealed as a sham, consisting of deceptive conspiracies committed by some of the most trusted business institutions.³⁰ On November 8, 2001, Enron announced its intent to “restate its financial statements for the years ended December 31, 1997 through 2000 and the quarters ended March 31 and June 30, 2001.”³¹ In the end, Enron reduced its earnings by over \$1 billion, increased its debt by over \$2.5 billion, and squeezed shareholders’ equity by over \$3.3 billion.³² In addition, Enron restated its reported earnings from the third quarter of 2000 to the third quarter of 2001 by nearly \$1 billion.³³ Consequently, Enron’s stock quickly collapsed, and Enron filed

28. Enron Corp., Annual Report (Form 10-K), at 27 (Apr. 2, 2001). In 2000, Enron controlled four times as many total assets as in 1996. *Id.* (valuing Enron’s 1996 total asset holdings at \$16.137 billion). In those same four years, Enron’s total revenues grew over 750%. *Id.* (noting that Enron’s 1996 total revenues were roughly \$13.3 billion).

29. *The 500 Largest U.S. Corporations*, FORTUNE, Apr. 15, 2002, at F-1 [hereinafter FORTUNE 500] (ranking public corporations with the highest gross revenue in 2001).

30. See, e.g., POWERS REPORT, *supra* note 11, at 3–5 (identifying fraudulent transactions between Enron and several partnerships entered into in order to conceal financial difficulties); see also William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1305–20 (2002) (detailing further the self-dealing transactions between Enron and other partnerships under Chief Financial Officer Andrew Fastow’s management).

31. Enron Corp., Current Report (Form 8-K), at 2 (Nov. 8, 2001).

32. POWERS REPORT, *supra* note 11, at 2–3 (summarizing numerous adjustments to Enron’s 1997, 1998, 1999, and 2000 financial statements).

33. *Id.* at 4.

for bankruptcy.³⁴ In Spring 2002, Enron informed the Securities and Exchange Commission (SEC or the Commission) that a \$14 billion asset write-down was inevitable.³⁵

What was hoped to be a case of a “few rotten apples,”³⁶ became a catalyst for the widespread publicizing of accounting deception at the largest public corporations. Reports of fraud became front-page news.³⁷ Kmart, a Fortune 500 retailer with 2,114 stores, 234,000 workers, and over \$36 billion in revenues in 2001,³⁸ filed for Chapter 11 protection after an official investigation of accounting practices, allegedly intending to artificially boost the company’s overall health and to deceive investors, was publicized.³⁹ Global Crossing, a promising telecommunications provider with peak market capitalization of \$75 billion, plunged into bankruptcy shortly after investigations into sweetheart loan write-offs and questionable accounting techniques which artificially inflated profits were publicized.⁴⁰ Qwest Communications, a Fortune 500 darling with over \$19.5 billion in revenues and market capitalization of over \$13.5 billion in 2001,⁴¹ was investigated for fraudulently inflating revenues and admitted that it improperly accounted for \$1.16 billion in sales.⁴² Investigations into accounting fraud at WorldCom, once the nation’s second-largest telecommunications firm with over \$35 billion in revenues, peak market capitalization of \$115

34. *Id.* at 3. On December 2, 2001, Enron petitioned for relief under Chapter 11 of the United States Bankruptcy Code. *Id.* at 32.

35. *See* Enron Corp., Current Report (Form 8-K), exhibit 99, at 2 (Apr. 22, 2002). Enron’s management refused to conduct a comprehensive review of accounting adjustments or prepare a consolidated balance sheet but speculated that, if conducted, such a write-down would be required. *Id.*

36. Cunningham, *supra* note 1, at 924; *see also* President George W. Bush, Remarks on Corporate Responsibility (July 9, 2002), available at <http://www.whitehouse.gov/news/releases/2002/07/20020709-4.html> (“[T]he American system of enterprise has not failed us. Some dishonest individuals have failed our system. Now comes the urgent work of enforcement and reform, driven by a new ethic of responsibility.”).

37. *See, e.g.,* Kurt Eichenwald, *Enron Inquiry Is Now Examining Whether Company Inflated Assets*, N.Y. TIMES, Dec. 26, 2002, at A1; Andrew Ross Sorkin & Alex Berenson, *Tyco Admits Using Accounting to Inflate Earnings*, N.Y. TIMES, Dec. 31, 2002, at A1; *see also* Romano, *supra* note 13, at 1528 & n.17 (commenting on the effect the 2001–2002 “media frenzy” had on legislators).

38. *See* FORTUNE 500, *supra* note 29, at F-1 (ranking Kmart the 40th largest U.S. corporation); Kmart Corp., Annual Report (Form 10-K), at 6, 9, 22 (May 15, 2002).

39. Penelope Patsuris, *The Corporate Scandal Sheet*, FORBES, Aug. 26, 2002, <http://www.forbes.com/management/2002/07/25/accountingtracker.html>.

40. *FBI Launches Global Crossing Probe*, BBC NEWS, Feb. 8, 2002, <http://news.bbc.co.uk/1/hi/business/1809602.stm>.

41. *See* FORTUNE 500, *supra* note 29, at F-5 (ranking Qwest Communications the 102nd largest U.S. corporation).

42. Patsuris, *supra* note 39.

billion, and the fifth most widely held stock in the country,⁴³ resulted in a total restatement of \$7.2 billion and bankruptcy.⁴⁴ Adelphia Communications, at one point the sixth-largest cable-television company in the United States, filed for bankruptcy protection after an SEC investigation into the company's accounting practices uncovered \$2.3 billion in unreported debt; Adelphia had funded over \$2 billion in loans to the chief executive's family.⁴⁵

Official inquiries into accounting practices at well-known companies, previously reserved for the back pages of daily newspapers, became front-page news and headlined radio and television programs.⁴⁶ AOL Time Warner, a Fortune 500 internet service giant with over \$38 billion in revenues and market capitalization of almost \$114 billion in 2001,⁴⁷ was scrutinized for questionable accounting techniques used to hide hundreds of millions in expenses.⁴⁸ Resulting from fraudulent accounting schemes conducted by top executives, Rite Aid, a Fortune 500 retailer and pharmacy chain with over \$15 billion in revenues, market capitalization of almost \$2 billion,⁴⁹ and more than 70,000 employees,⁵⁰ restated its pre-tax income by \$2.3 billion and net income by \$1.6 billion.⁵¹ In the weeks leading up to the enactment of the Sarbanes–Oxley Act, underway were probes into Bristol–

43. See FORTUNE 500, *supra* note 29, at F-1 (ranking WorldCom the 42nd largest U.S. corporation); Charles Haddad, Dean Foust & Steve Rosenbush, *WorldCom's Sorry Legacy: Its Downfall May Hurt Rivals and Kill Telecom Competition*, BUS. WK., July 8, 2002, at 38, 38, 40.

44. See Patsuris, *supra* note 39; see also Shawn Young et al., *WorldCom Files for Bankruptcy*, WALL ST. J., July 22, 2002, at A3 (detailing WorldCom's bankruptcy filing).

45. *Adelphia Communication Milestones*, WASH. POST, Sept. 30, 2004, <http://www.washingtonpost.com/wp-dyn/articles/A45896-2002Oct18.html>. In 2001, Adelphia Communications was the 456th largest U.S. corporation, with nearly \$3.5 billion in gross revenues. See FORTUNE 500, *supra* note 29, at F-19.

46. Cunningham, *supra* note 1, at 925.

47. See FORTUNE 500, *supra* note 29, at F-1 (ranking AOL Time Warner the 37th largest U.S. corporation).

48. See Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Time Warner with Fraud, Aiding and Abetting Frauds by Others, and Violating a Prior Cease-and-Desist Order; CFO, Controller, and Deputy Controller Charged with Causing Reporting Violations (Mar. 21, 2005), available at <http://www.sec.gov/news/press/2005-38.htm> (charging Time Warner with overstating revenues and other frauds); see also Carrie Johnson, *Time Warner, SEC Settle AOL Fraud Charges*, WASH. POST, Mar. 22, 2005, at E1 (announcing the settlement of fraud charges between the company and the SEC).

49. See FORTUNE 500, *supra* note 29, at F-5 (ranking Rite Aid the 132nd largest U.S. corporation).

50. Rite Aid: About Us, <http://www.riteaid.com/company/about> (last visited Mar. 3, 2007).

51. Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Fraud Charges Against Former Rite Aid Senior Management (June 21, 2002), available at <http://www.sec.gov/news/press/2002-92.htm>.

Myers Squibb for inflating its 2001 revenues by \$1.5 billion, Merck for recording \$12.4 billion in payments that were never received, and Mirant for inflating its revenues by nearly \$1.1 billion.⁵² Each company topped the 2001 Fortune 500 list with revenues and market capitalization of roughly \$22 billion and \$96 billion, \$48 billion and \$144 billion, and \$32 billion and \$5 billion, respectively.⁵³

B. The Media and the Public

The World Trade Center and Pentagon bombings, combined with the Enron debacle, created a “perfect storm.” Americans were glued to their televisions, allowing the media to capitalize on anything “sexy,” including the recently popularized corporate-scandal hotbed.⁵⁴ On the coattails of this drama, the media kept the public’s attention with various uncertainties: possible war in Iraq, terrorist threat levels, and the unraveling Enron scandal.⁵⁵ But for business, the 2001 media coverage revealed itself as only the “eye of the storm.”⁵⁶

The 2002 election year welcomed “[a] flurry of congressional hearings . . . on the [Enron] collapse, its causes, and potential legislative solutions.”⁵⁷ With dozens of giant corporate frauds and some of the largest bankruptcies in history publicized, business could no longer avoid the media spotlight. During a seven-month period in 2001, starting in January, the major networks’ evening news covered a total of 489 business related stories.⁵⁸ Only 11% of these reports were about corporate scandals.⁵⁹ However, during

52. Patsuris, *supra* note 39.

53. See FORTUNE 500, *supra* note 29, at F-1 to -4. In 2001, Merck, Mirant, and Bristol-Myers Squibb were the 24th, 52nd, and 96th largest U.S. corporations respectively. *Id.*

54. See Romano, *supra* note 13, at 1559 (noting the increase in media focus on corporate scandals from 2001 to 2002).

55. See Cunningham, *supra* note 1, at 923–24; David Lieberman, *Attacks Alter Priorities Across Media Industry*, USA TODAY, Sept. 25, 2001, <http://www.usatoday.com/money/perfi/columnist/lieber/2001-09-25-lieber.htm> (reporting that over 80% of Americans kept a TV or radio tuned into news on the terror attacks and predicting continued attentiveness resulting from “anxiety about terrorism, economic instability and possibly war”).

56. See Romano, *supra* note 13, at 1559.

57. *Id.* at 1544.

58. See *id.* at 1559 (citing to Videoclip: Karlyn H. Bowman, *Sarbanes-Oxley: A Review* (American Enterprise Institute 2004) [hereinafter *Bowman Review*], available at http://app2.capitalreach.com/esp1204/servlet/tc?cn=aei&c=10162&s=20271&e=2830&es_pmt=2 (speaking about data from the Media Research Center)).

59. See *id.* (citing *Bowman Review*, *supra* note 58) (counting fifty-two news reports addressing corporate scandals).

the same period in 2002, business segments increased by 25%.⁶⁰ Moreover, major news networks addressed corporate scandals 471 times, nearly as many times as general business issues were addressed during the seven-month period in 2001.⁶¹ Amazingly, corporate scandal coverage leaped by almost 800% and made up 77% of all business news coverage.⁶²

This giant increase in media coverage can be partially attributed to the public's demand for answers.⁶³ During a nine-month period beginning in February 2002, over 60% of Americans followed news coverage of stories about recent business scandals "fairly closely" or closer.⁶⁴ Nearly twice as many Americans paid closer attention to business than in the preceding year.⁶⁵ It was clear, the unfolding drama in late 2001 and midway through 2002 changed American perceptions.⁶⁶ In June 2002, 64% of Americans felt that "[a]side from the terrorist attack on September 11th," fallouts from recent business scandals and accounting frauds "made the biggest impression on [them] personally."⁶⁷ That same year, 38% of Americans, nearly twice as many as in 2000, believed that *big business* "[would] be the biggest threat to the country in the future."⁶⁸ Undoubtedly,

60. *Id.* (citing Bowman Review, *supra* note 58). The major network evening news ran 613 business stories between January 2002 and July 2002, compared to 489 in total during the identical time period a year earlier. *Id.* (citing Bowman Review, *supra* note 58).

61. *Id.* (citing Bowman Review, *supra* note 58). There were only eighteen more general business stories during the 2001 period than there were corporate scandal stories during the same period in 2002. *See id.* (citing Bowman Review, *supra* note 58) (reporting 489 general business stories during the first seven months of 2001, compared to the 471 media stories focusing primarily on corporate scandals during the same time period in 2002).

62. *Id.* (citing Bowman Review, *supra* note 58). General business issues were addressed 613 times during the 2002 period. *Id.* (citing Bowman Review, *supra* note 58).

63. *Id.* (citing Bowman Review, *supra* note 58). The need for government action was addressed in 80% of the stories covering corporate scandals. *Id.* (citing Bowman Review, *supra* note 58).

64. AM. ENTER. INST. FOR PUB. POLICY RESEARCH, TAKING STOCK OF BUSINESS: PUBLIC OPINION AFTER THE CORPORATE SCANDALS 14 (2006), http://www.aei.org/publications/pubID.19507/pub_detail.asp. This is a report compiled by the American Enterprise Institute on the effect of corporate scandals on perceptions of business as reflected by numerous polls conducted by various public opinion research institutes. *Id.* at 2.

65. *Id.* at 14 (revealing an average of 63% between February and October 2002, compared to only 34% in December 2001).

66. *See id.* at 2 (reporting a steep decline in ordinary Americans' confidence in business).

67. *See id.* at 14–15 (noting a survey by Public Opinion Strategies (R) and Greenberg Quinlan, and Rosner Research (D) for National Public Radio).

68. *Id.* at 21 (listing data from Gallup surveys asking the people polled what, in their opinion, constituted the biggest threat to the country). From 1995 to 2000, only 22–24% of Americans had similar feelings about big business, with most Americans—64–65%—concentrating on the threats posed by big government. *Id.*

the American public paid close attention as legislators scrambled to deliver an appropriate response.⁶⁹

C. *Leaps to Enactment*

Investigations into Enron began to uncover a contrived scandal to inflate the company's stock price,⁷⁰ creating what seemed to be a perfect opportunity for legislative action. In December 2001, legislators began holding congressional hearings on the scandal and the appropriate legislative response.⁷¹ In February 2002, the House Financial Services Committee introduced a bill, which the House passed in late April 2002.⁷² Despite this surge of activity, legislators delayed final action until late July 2002.⁷³ Giant losses in the preceding three months, coupled with an explosion in the number of investigations into large public corporations and impending bankruptcies, all made public in unprecedented ways, forced Congress to act.⁷⁴ On July 26, 2002, the Public Company Accounting Reform and Investor Protection Act of 2002, short titled the Sarbanes–Oxley Act, passed both the House and the Senate with “virtually unanimous approval.”⁷⁵ On July 30th, President George W. Bush signed into law the Sarbanes–Oxley Act of 2002,⁷⁶ emphasizing that

69. See Romano, *supra* note 13, at 1543–68 (setting out the political environment surrounding the Act and extensively scrutinizing the legislative process leading up to its enactment).

70. See, e.g., POWERS REPORT, *supra* note 11, at 3–4 (detailing the fraudulent transactions and rampant self-dealing that caused the scandal).

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

72. See Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, H.R. 3763, 107th Cong. (2002); see also Romano, *supra* note 13, at 1545 n.65 (chronicling the bill's progress from its referral to committee in February 2002 until its passage in the House in April 2002).

73. See Romano, *supra* note 13, at 1549 (suggesting that the market decline and a “looming election” may have led to the bill finally getting House and Senate approval in late July).

74. See *supra* Part II.A (describing the massive frauds by numerous Fortune 500 companies and the SEC's investigations of those companies).

75. Hamilton, *supra* note 23, at 46 (describing the unusual speed and lack of vetting the bill underwent in Congress—all in the interest of getting the Act passed rapidly to address the perceived public pressure); see also Stephen Labaton, *New Rules on Accountants, but Also Questions*, N.Y. TIMES, July 26, 2002, at C1 (reporting “a vote of 423 to 3 in the House . . . and 99 to 0 in the Senate” in favor of the Act).

76. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.); see also Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1 (characterizing President Bush's approval as an attempt to “cast himself . . . as the protector of the small investor and the rank-and-file worker”).

[f]ree markets are not a jungle in which only the unscrupulous survive, or a financial free-for-all guided only by greed For the sake of our free economy, those who break the law—break the rules of fairness, those who are dishonest, however wealthy or successful they may be—must pay a price.⁷⁷

III. SARBANES–OXLEY ACT OF 2002

Congress enacted Sarbanes–Oxley in response to an explosion in large business fraud and bankruptcies coupled with unprecedented public exposure through the media.⁷⁸ A result of this hostile environment, the Sarbanes–Oxley Act embodied a weapon to be used against corporate criminals and a shield intended to protect American investors.⁷⁹ The three months preceding the Act's enactment saw an incredible downturn in the markets, attributed mainly to decreasing investor confidence.⁸⁰ Newspapers, radio broadcasts, and television shows devoured every opportunity to scrutinize big business and its investors, demanding prompt action from government to curb fraudulent behavior.⁸¹ Under this pressure, Sarbanes–Oxley came to the rescue.⁸² At its very core, the Act functioned to place the costs associated with all of the Act's provisions, both offensive and defensive, on business.⁸³ This sent the clear message that business would bear the brunt of reinstilling confidence back into the markets.⁸⁴ The character of these costs, however, greatly depends on perspective. While large public corporations can absorb Sarbanes–Oxley costs relatively easily,⁸⁵ to small companies, these costs have a much stronger punitive feel.

77. See Bumiller, *supra* note 76 (quoting President Bush's statement accompanying the signing of the bill).

78. See *supra* Part II.

79. See Statement by President George W. Bush upon Signing H.R. 3763, 38 WEEKLY COMP. PRES. DOC. 1286 (July 30, 2002) (commenting on the purposes of Sarbanes–Oxley).

80. See Norris, *supra* note 19 (noting an average 20% loss across financial markets in just nine weeks).

81. See *supra* Part II.B (discussing the media frenzy around corporate scandals).

82. See *supra* Part II.C (detailing the passage of the Act and the circumstances under which it was passed).

83. See Kathleen A. Lacey et al., *Assessing the Deterrent Effect of the Sarbanes–Oxley Act's Certification Provisions: A Comparative Analysis Using the Foreign Corrupt Practices Act*, 38 VAND. J. TRANSNAT'L L. 397, 436 (2005).

84. *Id.*

85. See Joseph A. Castelluccio III, *Sarbanes–Oxley and Small Business: Section 404 and the Case for a Small Business Exemption*, 71 BROOK. L. REV. 429, 455 (2005).

After all, Enron and other large companies were the source of this steep market downturn.⁸⁶ Poor accounting practices at large public firms caused investors to lose confidence.⁸⁷ Sarbanes–Oxley is merely making companies pay for the damages that resulted from their wrongful acts.⁸⁸ When viewed from this angle, the retributive nature of Sarbanes–Oxley is clear.⁸⁹ Hopefully, the overinclusive character of this pronouncement is equally transparent. Enron, WorldCom, Qwest, Kmart, AOL Time Warner, Xerox, Adelphia, Global Crossing, Merck, Bristol–Myers Squibb, and numerous other large corporations, not “business in general,” were covered by the media, and ultimately were responsible for the large losses sustained by huge numbers of investors: they were the catalysts for Sarbanes–Oxley.⁹⁰ Yet the Act mandates that business in general bear the brunt of reinstilling the confidence that was lost as a result of these huge frauds.⁹¹ Only companies with market capitalization below \$75 million have received extensions, whereas all others were forced to comply by 2004.⁹² If large corporations caused the damages to be remedied by Sarbanes–

86. See *supra* Part II.A (discussing high-profile business collapses and the effects of such monumental frauds on investors).

87. See *supra* notes 13–15 and accompanying text (describing reports of fraud and bankruptcy filings in 2002 that culminated in a market crash).

88. See Lacey et al., *supra* note 83, at 436.

89. “Retribution” is defined as “punishment imposed as repayment or revenge for the offense committed.” BLACK’S LAW DICTIONARY 1343 (8th ed. 2004).

90. See *supra* Part II.A (explaining the questionable accounting practices used by each of these companies).

91. See *Sarbanes–Oxley: A Price Worth Paying?*, ECONOMIST, May 21, 2005, at 71, 71–72 (discussing the lack of “confidence in American capitalism” and the aim of the bill to “improve the accountability of managers to shareholders”).

92. See Management’s Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068, 68 Fed. Reg. 36,636, 36,657 (June 18, 2003) (codified in scattered sections of 17 C.F.R.) (setting out the guidelines for Sarbanes–Oxley’s section 404 compliance); see also Management’s Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8392, Exchange Act Release No. 49,313, Investment Company Act Release No. 26,357, 69 Fed. Reg. 9,721, 9,722 (Mar. 1, 2004) (codified in scattered sections of 17 C.F.R.) (extending the compliance date). *But see* Management’s Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies That Are Not Accelerated Filers, Securities Act Release No. 8618, Exchange Act Release No. 52,492, 70 Fed. Reg. 56,825, 56,825 (Sept. 29, 2005) (codified in scattered sections of 17 C.F.R.) (exempting nonaccelerated filers from compliance with section 404 until fiscal year end on or before July 2007); Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, Securities Act Release No. 8731, Exchange Act Release No. 54,295, 71 Fed. Reg. 47,060, 47,060 (proposed Aug. 15, 2006) (proposing to further extend exemption until fiscal year ending on or after December 15, 2007).

Oxley, forcing small companies to participate in the remuneration may be fairly characterized as punishment for being members of the same “business” club in which big corporations are members. Small firms are nowhere near being free from the type of fraud that Sarbanes–Oxley intends to curb.⁹³ Sarbanes–Oxley, however, was not the “immediate, direct, and proximate result” of small-company fraud.⁹⁴

A. Section 404

Sarbanes–Oxley imposed new duties on “[e]xecutives, outside directors, lawyers, accountants, analysts and others.”⁹⁵ But, of all the duties arising from the Act, the obligations dealing with internal controls, especially those emanating from section 404, have received the most attention.⁹⁶ Referenced as “[t]he most notorious mandate introduced” by Sarbanes–Oxley,⁹⁷ the Act’s internal control framework is most controversial because of the attached implementation and compliance costs, mostly unquantifiable benefits, unclear standards and guidelines, and the SEC’s mixed signals regarding the extent of the mandate’s application.⁹⁸

93. See *infra* note 182 and accompanying text (noting that small companies are susceptible to fraud, particularly by senior management).

94. BLACK’S LAW DICTIONARY 417 (8th ed. 2004) (defining “general damages”); see also *supra* Part II (discussing the fraudulent accounting practices of large companies that led to the enactment of Sarbanes–Oxley). The Author does not argue that legislation should always be reactive. It is often necessary and in the best interest to proactively regulate. Nevertheless, proactive legislation must be well advised, refusing to succumb to reactionary pressures.

95. Donald C. Langevoort, *Internal Controls After Sarbanes–Oxley: Revisiting Corporate Law’s “Duty of Care as Responsibility for Systems,”* 31 J. CORP. L. 949, 949 (2006).

96. *Id.* at 950 (“[T]he internal controls requirement found in section 404 . . . in some circles has become almost synonymous with [Sarbanes–Oxley] itself.”).

97. Ehud Kamar et al., *Going-Private Decisions and the Sarbanes–Oxley Act of 2002: A Cross-Country Analysis* 6 (RAND Inst. for Civil Justice, Working Paper No. WR-300-1-ICJ, 2006), available at http://www.rand.org/pubs/working_papers/WR300.

Although section 404 is the focus of most attention, . . . section 302[] is actually the more elaborate, requiring CEO and CFO certification of the issuer’s 10-K’s and 10-Q’s . . . [T]he officers must also affirm that they are responsible for internal controls; have designed such controls to ensure that material information is brought to their attention; have evaluated its effectiveness in the last 90 days; have presented in their report their conclusions about its effectiveness; and have discussed in the report any changes in internal controls during the period under review, including corrective actions.

Langevoort, *supra* note 95, at 954. Section 404, on the other hand, “simply insists that each 10-K contain management’s assessment of internal controls, and—crucially—requires the independent auditor to attest to and report on that assessment.” *Id.* at 954–55.

98. See Langevoort, *supra* note 95, at 950, 971–72 (examining the various costs and

“Section 404 of [Sarbanes–Oxley] requires the SEC to set rules that accomplish two Congressional objectives”:⁹⁹ (1) to have management acknowledge “its responsibility for internal controls over financi[al] reporting” and report on “its assessment of the effectiveness of these internal controls”;¹⁰⁰ and (2) to “require the firm’s independent auditors to attest to management’s internal control assessment as part of the annual audit engagement.”¹⁰¹ Subsequent to the Act’s enactment, the SEC approved final rules for implementing section 404¹⁰² and made compliance mandatory for “accelerated filers” for the first fiscal year ending on or after November 15, 2004.¹⁰³

In large part, the extensive attention accorded section 404 stems from its requirement that external auditors attest to the quality of an issuer’s internal controls.¹⁰⁴ A recent study of “firms . . . required to comply with [section 404’s] internal control documentation, evaluation, and attestation requirements” reported an “average increase in audit fees of \$2.3 million from 2003 to 2004.”¹⁰⁵ These increases in audit-related expenses are

benefits of internal control mandates and postulating that a clearer frame of reference as to the appropriate goals of such mandates will help stabilize current inequalities resulting from compliance, including curbing “rent-seeking”); *see also* Kamar et al., *supra* note 97, at 7–8 (chronicling the SEC’s promulgation of various regulations which set standards for proper compliance and which was followed by rulings postponing compliance deadlines).

99. Susan W. Eldridge & Burch T. Kealey, SOX Costs: Auditor Attestation Under Section 404, at 3 (June 13, 2005) (unpublished manuscript, *available at* <http://ssrn.com/abstract=743285>).

100. *Id.*; *see also* Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, § 404(a), 116 Stat. 745, 789 (codified at 15 U.S.C. § 7262).

101. Eldridge & Kealey, *supra* note 99, at 3; *see also* Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, § 404(b), 116 Stat. 745, 789 (codified at 15 U.S.C. § 7262) (regarding assessment of internal controls).

102. *See* Management’s Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068, 68 Fed. Reg. 36,636, 36,636, 36,657 (June 18, 2003) (codified in scattered sections of 17 C.F.R.) (requiring compliance with reporting rules at the end of the “first fiscal year ending on or after June 15, 2004”).

103. *See* Management’s Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8392, Exchange Act Release No. 49,313, Investment Company Act Release No. 26,357, 69 Fed. Reg. 9,722, 9,722 (Mar. 1, 2004) (codified in scattered sections of 17 C.F.R.) (extending the June 15, 2004 deadline mandated by the earlier release). Accelerated filers are defined as issuers not in their first year of being public with over \$75 million in market capitalization. Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports, Securities Act Release No. 8644, Exchange Act Release No. 52,989, 70 Fed. Reg. 76,626, 76,626 (Dec. 27, 2005) (codified in scattered sections of 17 C.F.R.).

104. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, § 404(b), 116 Stat. 745, 789 (codified at 15 U.S.C. § 7262).

105. Eldridge & Kealey, *supra* note 99, at 2. The SEC modified the rules pertaining

almost entirely attributable to the costs of section 404-mandated attestations.¹⁰⁶ The strong positive correlation between section 404 compliance and audit cost increases lends itself well to observations about the burdens section 404 creates, and most importantly, who carries the heaviest load.

It should come as no surprise that smaller companies find it more difficult to comply with section 404. With fewer resources, smaller companies must devote a greater portion of their revenues to finance implementation and compliance expenses.¹⁰⁷ Certainly, larger companies must also finance these expenses, which are much larger than those at smaller firms, but find the

to “disclosure of audit and non-audit service fees paid to a firm’s principal independent accountant,” resulting in “more detailed fees disclosure.” *Id.* at 8 (citing Strengthening the Commission’s Requirements Regarding Auditor Independence, Securities Act Release No. 8183, Exchange Act Release No. 47,265, Investment Company Act Release No. 25,915, 67 Fed Reg. 76,780 (Dec. 13, 2002)). Firms are now required to provide proxy statements and Form 10-K disclosures of four categories of fees paid to the firm’s principal accountants: audit fees, audit-related fees, tax fees, and all other fees. *See* Strengthening the Commission’s Requirements Regarding Auditor Independence, Securities Act Release No. 8154, Exchange Act Release No. 46,934, Investment Company Act Release No. 25,838, 67 Fed. Reg. 76,780, 76,798–99 (Dec. 13, 2002) (codified in scattered sections of 17 C.F.R.). Fees associated with services performed to comply with Generally Accepted Auditing Standards must be reported in the audit fees category. *Id.* at 76,798. Fees associated with services such as “employee benefit plan audits, due diligence related to mergers and acquisitions, accounting assistance and audits in connection with proposed or consummated acquisitions, internal control reviews, [and] consultation concerning financial accounting and reporting standards,” must be reported in the audit-related fees category. *Id.* “Based on this guidance, . . . Section 404 attestation fees [are expected] to be included in the Audit Fees category.” Eldridge & Kealey, *supra* note 99, at 8. In 2004, only one out of 648 Fortune 1000 companies categorized section 404 attestation fees as audit-related. *Id.* at 7, 22 n.3.

106. *See* Eldridge & Kealey, *supra* note 99, at 11. “Although firms are not required to track and report on their actual compliance costs,” approximately 15% of firms disclosed details regarding their Sarbanes–Oxley audit fees. *Id.* at 1, 3. These firms reported an “average cost of \$2.4 million[,] [which] is essentially equal to the increase in audit fees from 2003 to 2004.” *Id.* at 2–3. “Because initial compliance with the SEC’s implementation rules for . . . Section 404 [was] required for fiscal years ending on or after November 15, 2004, there is currently very little evidence on compliance costs other than survey data.” *Id.* at 1 (citation omitted). It is therefore important to note that the reported “averages are at the upper extreme of the estimates [companies] have provided in surveys.” *Id.* at 3. A fairly recent survey of “217 public companies with average revenues of \$5 billion” revealed an average expected auditor attestation cost of \$1.3 million, close to half of what the actual reported costs turned out to be in 2004. Press Release, Fin. Executives Int’l, Sarbanes–Oxley Compliance Costs Exceed Estimates (Mar. 21, 2005), available at http://www.fei.org/download/404_pr_3_21_2005.pdf. Though no study has been conducted to help gauge other costs related with section 404 compliance, it is important to note that the companies surveyed expected average internal costs of \$1.34 million and average external costs of \$1.72 million. *Id.* If their estimating barometer is equally accurate for these costs as it was for auditor attestation costs, actual average total costs related to the implementation of section 404 will be close to \$8 million.

107. *See Sarbanes–Oxley: A Price Worth Paying?*, *supra* note 91, at 72 (charting section 404 compliance costs as a percentage of a company’s revenues).

costs to be less burdensome than their smaller counterparts.¹⁰⁸ Compare a firm with 2003 year-end total assets of just over \$1.1 billion and one with over \$100 billion in such assets.¹⁰⁹ While the small company's 2004 Sarbanes–Oxley audit costs are slightly above \$1 million, the larger firm must pay over \$4.5 million.¹¹⁰ Nevertheless, the weak positive correlation between audit fees and company size is obvious. The latter company is approximately 100 times bigger than its counterpart, yet the larger company expends only four and one-half times more than the smaller firm on external audits. Clearly, the larger the firm, the cheaper it is to audit its internal controls framework.¹¹¹ Further support is found by scaling the Sarbanes–Oxley audit costs by total assets, and using this “unit cost” measure to attain “a more unambiguous prediction for how . . . size . . . influence[s] internal control audit costs.”¹¹² The results, documented in Table 1 below, show that small firms pay as much as ten times the amount that big firms pay for section 404-mandated audits.

Mean 2003 Year-end Total Assets (\$ thousands)	Mean 2004 SOX Audit Cost (\$ thousands)	Mean 2004 SOX Audit Unit Cost (\$)
1,103,939	1,019	1.01
2,476,425	1,796	0.74
5,074,772	2,086	0.42
13,345,865	2,728	0.21
110,912,461	4,542	0.09

Although less quantifiable, a shift in labor expenditures is another direct result of section 404 implementation needs.¹¹⁴ Some small companies are substituting “revenue-developing employees, such as engineers, [with] monitors, such as lawyers and accountants.”¹¹⁵ While monitors may help ensure smoother

108. *See id.* (noting that smaller companies are given more flexibility with compliance dates and reporting requirements).

109. Eldridge & Kealey, *supra* note 99, at 27 tbl.3.

110. *Id.* at 15.

111. *See id.*

112. *Id.* at 13.

113. *Id.* at 27 tbl.3.

114. Paul Rose, *Balancing Public Market Benefits and Burdens for Smaller Companies Post Sarbanes–Oxley*, 41 WILLAMETTE L. REV. 707, 730 (2005).

115. *Id.*

implementation of internal controls,¹¹⁶ “opportunity costs will likely be significant.”¹¹⁷ With more limited human and financial capital, small companies are facing an uphill battle when it comes to section 404 implementation and compliance.¹¹⁸ Unlike large public corporations, small firms fail to absorb these costs, finding it less beneficial to trade on the open market.¹¹⁹

B. “Other” Sarbanes–Oxley Costs

The drama of 2002 in part resulted from “numerous conflicts of interest between management, shareholders, and the gatekeepers,” such as “audit committees, independent auditors, . . . and outside counsel.”¹²⁰ “Sarbanes–Oxley attempts to address the problem of gatekeeper failure by limiting or eliminating conflicts of interest and by increasing penalties for ignoring or facilitating illegal activities.”¹²¹ In-house and outside counsel must report “evidence of a material violation . . . to the issuer’s chief legal officer . . . or to both the issuer’s chief legal officer and its chief executive officer.”¹²²

Post-2002, it has become increasingly important that the majority of company directors be independent.¹²³ Hoping that

116. See Eldridge & Kealey, *supra* note 99, at 13–14 (expecting a positive correlation between company size and materially weak internal controls, which would result in a negative correlation between company size and Sarbanes–Oxley audit costs due). “Significant additional work by the auditors is needed when control exceptions, deficiencies, and weaknesses are identified, and this additional work increases the audit costs.” *Id.* at 12.

117. Rose, *supra* note 114, at 730.

118. See *Sarbanes–Oxley: A Price Worth Paying?*, *supra* note 91, at 72 (remarking that regulators have given smaller firms more time to comply with the law and that the SEC has set up a panel to review the impact on smaller firms).

119. *Id.* at 72–73 (noting that Sarbanes–Oxley has led smaller firms who cannot afford the increased costs to delist their stock or even to “go private” to avoid costs).

120. Rose, *supra* note 114, at 721. Gatekeepers “provide a check on management activity, constraining activities that do not serve the basic goal of return on investment or that otherwise serve the interests of management at the expense of shareholders.” *Id.*; see also John C. Coffee Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1404–05 (2002) (discussing the function and failures of professional gatekeepers).

121. Rose, *supra* note 114, at 722.

122. 17 C.F.R. § 205.3(b)(1) (2006). Unless the report results in “an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to” the audit committee, another independent committee, or the board of directors. 17 C.F.R. § 205.3(b)(3) (2006). “[A]n attorney [who] reasonably believes that it would be futile to report evidence of a material violation to the issuer’s chief legal officer and chief executive officer” may report directly to the above groups. 17 C.F.R. § 205.3(b)(4) (2006). Attorneys who fail to adhere to these regulations are subject to civil penalties and disciplinary action. See 17 C.F.R. § 205.6(a)–(b) (2006).

123. “Independent director majority” is a newly adopted NYSE and NASDAQ listing standard, directly resulting from the enactment of Sarbanes–Oxley. See Rose, *supra* note

“independence” will protect against conflicts of interest,¹²⁴ the Act delegates greater supervisory control to company directors, especially independent directors and members of the audit committee.¹²⁵ Audit committees, empowered to hire, oversee, and fund their firm’s outside auditor,¹²⁶ must consist of independent directors,¹²⁷ at least one of whom should be a financial expert.¹²⁸

The cumulative results of these Sarbanes–Oxley gatekeeper provisions are most clear when examined as costs. For example, director meetings are more frequent;¹²⁹ and, because director compensation generally depends on meeting frequency, public companies face increased expenditures resulting from directors’

114, at 727–28 (justifying the adopted standard on the basis “that independent directors are more reliable stewards than management or ‘interested’ directors”); *see also* NYSE GROUP, LISTED COMPANY MANUAL § 303A.01, http://www.nyse.com/lcm/lcm_manual.shtml (last visited Mar. 3, 2007) [hereinafter NYSE MANUAL]; NASDAQ, INC., NASDAQ MANUAL, § 4350(c) (2006), *available at* <http://nasdaq.complinet.com/nasdaq/display/index.html>. The NYSE deems “independent” only those directors with “no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).” NYSE MANUAL, *supra*, § 303A.02.

124. *See* NYSE MANUAL, *supra* note 123, § 303A.01 (“Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.”); NASDAQ MANUAL, *supra* note 123, § IM-4350-4 (“Independent directors . . . play an important role in assuring investor confidence [T]hey act on behalf of investors to maximize shareholder value . . . and guard against conflicts of interest. Requiring . . . a majority of independent directors empowers such directors to carry out more effectively these responsibilities.”).

125. Areas of increased supervisory control include regularly scheduled executive sessions of independent directors, independent director oversight of director nominations and executive officer compensation, adoption of a formal written audit committee charter setting out the scope of the committee’s responsibilities, including responsibilities relating to accounting problems, internal accounting controls or auditing matters, authority to engage advisors, and funding. *See* NYSE MANUAL, *supra* note 123, § 303A.03–.07; NASDAQ MANUAL, *supra* note 123, § 4350.

126. 15 U.S.C. § 78j-1(m)(2) (Supp. II 2004).

127. 15 U.S.C. § 78j-1(m)(3)(A) (Supp. II 2004).

128. *See* 17 C.F.R. § 229.401(h)(1)(ii) (2006) (requiring disclosure of the identity of the financial expert if one exists on the audit committee). Companies whose audit committees do not include a financial expert must detail the reasons for the absence. 17 C.F.R. § 229.401(h)(1)(iii) (2006). Although the financial expert requirement is put forward as a disclosure rule, its practical function is to force at least one such expert onto the audit committee because a failure to do so is likely to signal managerial bad faith. *See* Disclosure Required by Sections 406 and 407 of Sarbanes–Oxley Act of 2002, Securities Act Release No. 8177, Exchange Act Release No. 47,235, 68 Fed. Reg. 5,110, 5,110 (Jan. 31, 2003) (codified in scattered sections of 17 C.F.R.). Forcing adoption in the same way is a similar requirement that a company disclose its code of ethics for financial officers, another Sarbanes–Oxley offspring. *Id.*

129. James S. Linck et al., Effects and Unintended Consequences of the Sarbanes–Oxley Act on Corporate Boards 16–17 (May 16, 2006) (unpublished manuscript, *available at* <http://ssrn.com/abstract=687496>) (noting that firms of all sizes have seen an increase in the number of audit committee meetings).

travel costs and higher compensation.¹³⁰ Moreover, extra duties and stricter independence requirements have made recruitment of qualified directors more difficult.¹³¹ While director compensation at large firms has seen only a 28% increase from 2001 to 2004, small companies have hiked compensation by 36% over the same period.¹³² In proportion to company revenues, however, small companies spend almost ten times more than large firms to compensate directors.¹³³ As expected, Sarbanes–Oxley provisions targeting gatekeeper failure, and their offspring, are disproportionately more cumbersome on small companies.¹³⁴

Other Sarbanes–Oxley provisions regulate corporate behavior and the activities of corporate agents.¹³⁵ For example, firms are pressured to develop and disclose a code of ethics for financial officers.¹³⁶ Most “personal loan[s] to . . . any director or executive officer” are prohibited.¹³⁷ CEOs and CFOs must reimburse their companies for certain bonuses and profits if misconduct results in “an accounting restatement due to the material noncompliance . . . with *any* financial reporting requirement under the securities laws.”¹³⁸ Firms must disclose all off-balance sheet transactions.¹³⁹ Contractual obligations must be partitioned into five categories and disclosed by virtually all firms.¹⁴⁰ Material changes in financial condition or operations

130. See Rose, *supra* note 114, at 728 (noting that smaller companies face disproportionately larger costs because of the increase in meeting frequency).

131. *Id.*

132. See Linck et al., *supra* note 129, at 21–22. In 2004, large companies spent \$0.32 per \$1,000 in sales on director compensation, compared to \$0.25 in 2001, while small companies spent \$3.19 per \$1,000 in sales on director compensation, compared to \$2.35 in 2001. *Id.*

133. *Id.* at 22.

134. See, e.g., *id.* (“[I]t is relatively more expensive for small firms to hire qualified directors than for large firms.”).

135. Rose, *supra* note 114, at 724–25.

136. See Disclosure Required by Sections 406 and 407 of the Sarbanes–Oxley Act of 2002, Securities Act Release No. 8177, Exchange Act Release No. 47,235, 68 Fed. Reg. 5,110, 5,110, 5,117 (Jan. 31, 2003) (requiring disclosure of whether a company had adopted a code of ethics for financial officers, and if not, why a code has not been adopted).

137. 15 U.S.C. § 78m(k)(1) (Supp. III 2005). “[H]ome improvement and manufactured home loans . . . , consumer credit . . . , or any extension of credit under an open end credit plan . . . , or a charge card . . . , or any [permitted] extension of credit by a [registered] broker or dealer . . . to an employee . . . to buy, trade, or carry securities” are permitted. *Id.*

138. 15 U.S.C. § 7243(a) (Supp. III 2005) (emphasis added).

139. 15 U.S.C. § 78m(j) (Supp. III 2005); see also 17 C.F.R. § 229.303(a)(4)(i)–(ii) (2006) (requiring explanation of any material off-balance sheet agreements having, or likely to have, an impact on the firm’s financial situation).

140. See 15 U.S.C. § 78m(j) (Supp. III 2005); 17 C.F.R. § 229.303(a)(5) (2006).

must be disclosed “on a rapid and current basis.”¹⁴¹ These additional disclosure requirements have naturally resulted in higher reporting costs.¹⁴² Companies are spending more on information technology and document storage to adequately safeguard against obstruction of justice charges.¹⁴³

Some provisions strengthen the SEC’s ability to enforce compliance with the Act.¹⁴⁴ For example, the SEC may force CEOs and CFOs to forfeit certain bonuses and profits¹⁴⁵ and discipline attorneys for improper conduct.¹⁴⁶ In addition, Sarbanes–Oxley imposes stiffer criminal liability to better deter fraudulent acts.¹⁴⁷

The least quantifiable, yet especially harmful, cost of these provisions is “the chilling effect . . . on management’s willingness to take business risk.”¹⁴⁸ When making new investments and

Contractual obligations must be separated into long-term debt obligations, capital lease obligations, operating lease obligations, purchase obligations, and other long-term liabilities. *Id.*

141. 15 U.S.C. § 78m(l) (Supp. III 2005).

142. *See* Rose, *supra* note 114, at 729–30 (discussing the proportionately higher price that small companies must pay to satisfy internal control requirements).

143. *Id.* at 730–31. Increased spending is largely attributed to added liability for the destruction of important documents related to possible investigations, not just those related to ongoing investigations. *Id.* at 731. This is a direct result of 18 U.S.C. § 1519, which ensures that useful evidence is better preserved. 18 U.S.C. § 1519 (Supp. III 2005).

144. Rose, *supra* note 114, at 726–27.

145. 15 U.S.C. § 7243(a) (Supp. III 2005); *cf. supra* text accompanying note 138 (noting the prohibition on loans to executives).

146. 17 C.F.R. § 205.1 (2006). The SEC

sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, *this part shall govern*.

Id. (emphasis added).

147. 18 U.S.C. § 1519 (Supp. III 2005) (“Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States . . . shall be fined under this title, imprisoned not more than 20 years, or both.”).

148. Rose, *supra* note 114, at 732; *see also* Peter J. Wallison, *Capital Punishment*, WALL ST. J., Nov. 4–5, 2006, at A7 (“[T]he most far-reaching effect of [Sarbanes–Oxley] may be indirect and intangible. By placing a congressional imprimatur on the notion that corporate managements have to be supervised and controlled by independent boards, the act may have set up an adversarial relationship between managements and boards that will, over time, impair corporate risk-taking and thus economic growth . . . [B]oards are more focused on compliance with standards and regulations than they are on obtaining a competitive advantage.” (quoting an Ernst & Young survey of independent directors)).

introducing new products, management is encouraged to act conservatively because the consequences of failed decisions may include civil liability and stricter criminal sanctions.¹⁴⁹ Although these effects of Sarbanes–Oxley have received far less attention than the infamous section 404, research results indicating that section 404 and gatekeeper provisions are disproportionately more burdensome on small companies also provide a basis for observing these “other” Sarbanes–Oxley costs. If such an assumption is fair, and small companies find it more difficult than their much larger competition to absorb costs in general, then small companies are carrying a heavier load when it comes to new Sarbanes–Oxley obligations of rebuilding investor confidence.¹⁵⁰

149. See Ribstein, *supra* note 23, at 37–38 (discussing the costs of the Act and problems with using a regulatory approach).

150. See, e.g., *Sarbanes–Oxley: A Price Worth Paying?*, *supra* note 91, at 72. Ironically,

[o]f Enron’s [fourteen] directors, only two (Kenneth Lay and Jeffrey Skilling) were insiders. The directors reflected a wide range of business, finance, accounting, and government experience. The board had all the committees one would hope to see, including an executive committee, finance committee, audit and compliance committee, compensation committee, and nominating and corporate governance committee. Perhaps most important to the board’s monitoring role, the Enron audit committee had a model charter and was chaired by a former accounting professor who had served as the Dean of the Stanford Graduate School of Business. Finally, the board regularly met five times a year, with special meetings called as needed.

Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress*, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 495, 504–05 (Nancy B. Rapoport & Bala G. Dharan eds., 2004) (footnotes omitted). Having the board appear to be legitimate may have contributed to higher, undeserved stock prices, rather than decreasing the price due to greater transparency. See Ideoblog, http://busmovie.typepad.com/ideoblog/2006/04/the_us_as_the_n.html (Apr. 3, 2006, 9:54 EST) (summarizing a *Guardian* article, which shows a drop in foreign IPOs on the U.S. markets and the growth of such IPOs on the United Kingdom markets and comparing this trend with the passage of antitrust laws in New Jersey in the mid-1900s which debunked New Jersey as the premier incorporation state). In a recent paper, Professor Langevoort argues

that [Sarbanes–Oxley]’s most important effects on business may be less about investor protection per se and more about renegotiating the boundary between the public and private spaces in big corporations, a much deeper ideological issue. The legislation may reflect a political instinct that the incentive structure in the modern public corporation generates risks that require public (not just investor) accountability to be legitimate. [T]he “independent” director, currently seen largely as an investor advocate, is being pushed toward becoming a “public” director whose main assignment is risk management.

Donald C. Langevoort, *The Social Construction of Sarbanes–Oxley*, 105 MICH. L. REV. (forthcoming June 2007); see also Arthur Levitt, Jr., *Stocks Populi*, WALL ST. J., Oct. 27, 2006, at A14 (praising shareholders’ latest push for control of the corporate machinery that will allow investors to nominate directors). *But see* Ideoblog, http://busmovie.typepad.com/ideoblog/2006/10/the_shareholder.html (Oct. 27, 2006, 7:35 EST) (“While . . . Levitt and [others] want you to think that this is about some

C. *Disproportionate Burden on Small Public Companies:
More Evidence*

While many Sarbanes–Oxley costs are not quantifiable, or are quantifiable but not yet studied, recent trends in delisting behavior reflect the resulting burden from Sarbanes–Oxley on small companies.¹⁵¹ These companies are more frequently choosing to “go

fundamental American principle of ‘shareholder democracy,’ it’s really about two other issues. The first is whether we are going to abandon . . . the creative dynamism of state law on internal corporate governance—and install in its place control by the Congress, the SEC and federal courts. SOX was a major start in that direction, and the ‘reformers’ would like to finish the job. . . . The second principle is about who controls our modern corporations. The reformers like to shout about ‘shareholder democracy’ as if it meant anything. But the question is *which shareholders*. . . . Corporate elections are unions’ last opportunity to shore up their declining clout.”). Regardless of whether the Act’s partial purpose is to redraw these boundaries, it appears that the costs associated with such change are falling disproportionately on the small player in the capital markets. *See supra* note 130 and accompanying text (discussing the effect of increased director compensation on smaller companies).

151. *See* Langevoort, *supra* note 150, at 13–14 (“The problem, however, is that there is no good scientific mechanism for quantifying benefits or costs [In some cases] only post-[Sarbanes–Oxley] evidence can be of help”). Delisting trends, however, are not the only indicators that “the U.S. has passed the regulatory tipping point.” Wallison, *supra* note 148 (“Like taxes, economic regulations are burdens; and also like taxes, once regulatory burdens become heavy enough, they will drive business to jurisdictions where it can be transacted more cheaply and efficiently.”). Average annual non-U.S. listings on the NYSE have declined by more than 60% between the 1996–2001 average and 2005. *Id.* In 2005, the London Stock Exchange (LSE) and the Alternative Investment Market, LSE’s small company affiliate, attracted more than 700% more new listings than NASDAQ. *Id.* (noting that the London exchanges “gained 139 new listings while Nasdaq attracted 19”). In that same year, “only one out of the top 24 IPOs was registered in the U.S.” Charles E. Schumer & Michael R. Bloomberg, *To Save New York, Learn from London*, WALL ST. J., Nov. 1, 2006, at A18 (“[G]ross financial regulatory costs to U.S. companies are 15 times higher than in Britain.”); *see also* Ideoblog (Apr. 3, 2006, 9:54 EST), *supra* note 150 (relaying research stating that European exchanges attract more foreign companies than do the U.S. exchanges and concluding that increased expenses associated with Sarbanes–Oxley are a factor in “driving Russian and Chinese companies to London rather than [New York]”). *But see* Barbara Roper, Letter to the Editor, *Things Paulson Can Do to Boost U.S. Markets*, WALL ST. J., Nov. 10, 2006, at A17 (“[T]he decline in foreign listings on U.S. exchanges long predates the passage of Sarbanes–Oxley. A variety of factors contributed to the trend, not least U.S. economic policy over the past quarter century that actively encouraged globalization, technological advances that made globalization possible and investment-banking fees that are nearly twice as high for U.S. IPOs as they are on major European exchanges.”).

Furthermore, a recent study suggests that private companies are also hard hit by Sarbanes–Oxley mandates. *See* James A. DiGabriele & Aron A. Gottesman, *The Sarbanes–Oxley Act and the Private Company Discount: An Empirical Investigation* 3–4 (June 12, 2006) (unpublished manuscript, available at <http://ssrn.com/abstract=908061>) (“[A] private company target will be less attractive to a public acquirer than a public company target, as the private company target has not previously complied with [Sarbanes–Oxley] [Additionally,] compliance with [Sarbanes–Oxley] sends a positive signal to potential acquirers, as it signals that the potential target has overcome the hurdles associated with [Sarbanes–Oxley]. If this benefit of [Sarbanes–Oxley] outweighs its cost, then a private firm that has not previously complied with [Sarbanes–Oxley] will be at a disadvantage relative to an otherwise identical public firm.”).

private” or to “go dark.”¹⁵² To “go private” and shed the numerous requirements attached to participation in the public markets, including the costly obligations promulgated by Sarbanes–Oxley,¹⁵³ a company must ensure its stock is held “by less than 300 persons.”¹⁵⁴ Other companies, choosing to “go dark” instead, delist their shares,¹⁵⁵ but typically continue to trade in the “Pink Sheets,” a public-company exchange with far fewer disclosure burdens.¹⁵⁶ A recent study shows that there were nearly twice as many companies filing with the SEC to go private in 2004 as there were in 2002.¹⁵⁷ Another recent study reveals that firms filing to go private after Sarbanes–Oxley was enacted had mean market capitalization of just under \$74 million.¹⁵⁸ Post-enactment, the average company filing to go private is over two times smaller than the average company filing before enactment.¹⁵⁹ These studies conclude that the rising frequency of going-private filings and decrease in the size of companies filing indicate a disproportionate burden imposed on smaller firms by Sarbanes–Oxley.¹⁶⁰ Going dark trends are no different. Nearly three times as many companies delisted and went dark in 2003 as did in 2002.¹⁶¹ The average company going dark had

152. See Rose, *supra* note 114, at 733.

153. *Id.* at 727–30 (discussing the increased burden on directors and increased disclosure requirements).

154. 17 C.F.R. § 240.13e-3(a)(3)(ii)(A) (2006). In the alternative, a company may go private by “[c]ausing any class of [its] equity securities . . . either listed on a national securities exchange or authorized to be quoted in an inter-dealer quotation system of a registered national securities association to be neither listed . . . nor . . . quoted.” 17 C.F.R. § 240.13e-3(a)(3)(ii)(B) (2006).

155. The option to “go dark” is available only to companies who meet the requirements for going private. See Jannat C. Thompson, *Turning Off the Lights: “Going Dark” or “Going Private,”* WALL ST. LAW., Dec. 2005, at 9, 9–10.

156. See Rose, *supra* note 114, at 734. The “Pink Sheets,” primarily listing penny stocks, is “a web-based quotation service . . . considered [to be] the lowest rung of public company exchange status.” *Id.*

157. William J. Carney, *The Costs of Being Public After Sarbanes–Oxley: The Irony of “Going Private”* 14 tbl.3 (Emory Law & Econ. Research Paper Series, Working Paper No. 05-4, 2005), available at <http://papers.ssrn.com/abstract=672761> (calculating that in 2002, there were only 59 going-private filings, compared to 114 in 2004).

158. Ellen Engel et al., *The Sarbanes–Oxley Act and Firms’ Going-Private Decisions* 34 tbl.5 (May 6, 2004) (unpublished manuscript, available at <http://ssrn.com/abstract=546626>). Although mean market capitalization was \$73.79 million, the median market capitalization, which, because the studied sample consisted of only 46 companies, is a better indicator of the types of companies going private, was only \$21.34 million. *Id.*

159. *Id.* The average company filing to go private before Sarbanes–Oxley had market capitalization of \$185.79 million and \$307.18 million in assets. *Id.* After the Act, the average company filing had market capitalization of only \$73.79 million and \$161.88 million in assets. *Id.*

160. *Id.* at 23; see also Carney, *supra* note 157, at 16 (concluding that “smaller companies that went public in the late 1990s . . . may wish to rethink their decision”).

161. Christian Leuz et al., *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations* 42 tbl.1 (Robert H. Smith Sch. of Bus.,

market capitalization just under \$25.2 million and \$90.7 million in assets.¹⁶² The study reporting these results concluded that while “stronger performing firms appear to go private rather than go dark,” Sarbanes–Oxley “may be leading managers of poorly performing firms to go dark, having the perverse effect of decreasing transparency, and exacerbating agency problems.”¹⁶³ It is not surprising to see that small companies are fleeing the public markets. When costs of participation become prohibitive, there are few other options.¹⁶⁴

IV. RIGHTING A WRONG

A. SEC Advisory Committee on Smaller Public Companies: *The Final Report*

Is such a disproportionate burden just, given that the largest American corporations were mostly responsible for the market downturns which forced the enactment of Sarbanes–

Working Paper No. RHS-06-045, 2006), available at <http://ssrn.com/abstract=592421>.

162. *Id.* at 46 tbl.4. The median company’s market capitalization was \$3.96 million and owned assets worth \$16.44 million. *Id.*

163. Christian Leuz et al., Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations 32 (Nov. 2004) (unpublished manuscript, available at <http://fisher.osu.edu/fin/dice/seminars/Dereg%20SSRN.pdf>). The study suggests that while “many firms go dark as a response to bad news about future prospects, . . . for a subset of firms deregistration seems to be driven by less benign motivations.” *Id.* at 32–33. In some cases, management justified going dark by citing the high costs imposed by Sarbanes–Oxley in order to ensure low transparency and conceal ongoing fraud. *Id.* Pushing out entities most susceptible to corporate fraud results in a safer public market, clearly satisfying Sarbanes–Oxley’s goals. *Id.* Perversely, this rewards very large corporations, the entities that spawned the passage of the 2002 protective measures. *Id.* Ultimately, the measures push out small entities, reducing market competition and freeing up public investor dollars for reinvestment in the Enrons and WorldComs.

164. Many anticipated a substantial cost reduction for large and small firms alike for the second year of implementation.

A recent study by CRA International commissioned by the Big 4 accounting firms concluded that the cost of compliance with Section 404 of [Sarbanes–Oxley] will drop an average of approximately 40% in a company’s second year of implementation, citing first-year start-up costs, reduced documentation needed in year two, increased efficiency because of progress on the learning curve, and remediation efforts that should not recur in the second year. It was also stated that the auditors expect to rely more heavily on the work of others in the second year

Thomas A. Basilo, *An Open Memo to Officers and Directors of Smaller Public Companies: Watch What You Wish For!*, *SARBANES–OXLEY COMPLIANCE J.*, Mar. 24, 2006, <http://www.s-ox.com/Feature/detail.cfm?articleID=1702>. Unfortunately for the small corporations, second year costs did not drop as much as was expected. See CRA International, *Sarbanes–Oxley Section 404 Costs and Implementation Issues: Spring 2006 Survey Update 3–4* (Apr. 17, 2006), http://www.s-oxinternalcontrolinfo.com/pdfs/CRA_III.pdf (citing only a 30.7% decrease in second-year costs for small companies, as opposed to a 43.9% decrease for large companies).

Oxley? The compliance extensions granted to the smallest public companies¹⁶⁵ (those with market capitalization under \$75 million)¹⁶⁶ signal the SEC's acknowledgement of this "disproportionate compliance burden."¹⁶⁷ "[T]o assist the Commission in evaluating the current securities regulatory system relating to disclosure, financial reporting, internal controls, and offering exemptions for smaller public companies," the SEC established an Advisory Committee on Smaller Public Companies ("Advisory Committee").¹⁶⁸ Additionally, "at the request of Commission staff, a task force of the Committee of Sponsoring Organizations ('COSO') has been established to . . . provide more guidance on how the existing COSO [Internal Control] Framework can be applied to small companies."¹⁶⁹

165. In March 2005, the SEC extended the dates when nonaccelerated filers had to begin to comply with section 404 requirements to fiscal year ending on or after July 15, 2006. Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers, Securities Act Release No. 8545, Exchange Act Release No. 51,293, 70 Fed. Reg. 11,528, 11,528 (Mar. 8, 2005) (codified in scattered sections of 17 C.F.R.). Six months later, the SEC again extended compliance dates, this time to fiscal year ending on or after July 15, 2007. Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies That Are Not Accelerated Filers, Securities Act Release No. 8618, Exchange Act Release No. 52,492, 70 Fed. Reg. 56,825, 56,825 (Sept. 29, 2005) (codified in scattered sections of 17 C.F.R.). In August 2006, the SEC proposed to again extend compliance deadlines for nonaccelerated filers to fiscal year ending on or after December 15, 2008. Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, Securities Act Release No. 8731, Exchange Act Release No. 54,295, 71 Fed. Reg. 47,060, 47,060 (proposed Aug. 15, 2006).

166. Nonaccelerated filers must have market capitalization of less than \$75 million. *See* Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports, Securities Act Release No. 8644, Exchange Act Release No. 52,989, 70 Fed. Reg. 76,626, 76,627-28 (Dec. 27, 2005) (codified at 17 C.F.R. § 240.12b-2). All other filers are divided into two categories: accelerated filers and large accelerated filers. *Id.* Companies with market capitalization between \$75 and \$700 million are designated accelerated filers. *Id.* Companies with market capitalization of \$700 million or more are designated large accelerated filers. *Id.*

167. SEC. & EXCH. COMM'N, INTERNAL CONTROLS SUBCOMM., PRELIMINARY REPORT 30 (2005), <http://www.sec.gov/info/smallbus/acspc/pr-intcontrol.pdf> [hereinafter INTERNAL CONTROLS SUBCOMM. REPORT].

168. Advisory Committee on Smaller Public Companies, Securities Act Release No. 8514, Exchange Act Release No. 50,864, 69 Fed. Reg. 76,498, 76,498 (Dec. 21, 2004).

169. Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers, Securities Act Release No. 8545, Exchange Act Release No. 51,293, 70 Fed. Reg. 11,528, 11,529 (Mar. 8, 2005) (codified in scattered sections of 17 C.F.R.) (footnote omitted). The Committee of Sponsoring Organizations (COSO) of the Treadway Commission "is a voluntary private sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance." COSO Home Page, <http://www.coso.org> (last visited Mar. 3, 2007). The COSO Framework, released in 1992, has become the de facto official guide to section

The Advisory Committee was charged with recommending regulatory system changes that targeted provisions that are especially burdensome on smaller companies.¹⁷⁰ In April 2006, the Advisory Committee released its final findings and suggestions to the SEC.¹⁷¹ The Advisory Committee's primary recommendations addressed internal controls and section 404.¹⁷² Given the extensive attention accorded section 404, this should not come as a surprise.¹⁷³

The Advisory Committee recommended that nonaccelerated filers, the "smaller public companies," be split into two groups, "smallcap companies" and "microcap companies."¹⁷⁴ Smallcap companies would include those with market capitalization no greater than 6%, but more than 1%, of the total U.S. public market capitalization.¹⁷⁵ Companies with market capitalization no greater than 1% of the total U.S. public market capitalization would be further separated and designated as microcap companies.¹⁷⁶ Table 2 demonstrates the breakdown of U.S. public companies according to their market capitalization and annual revenues.

404 implementation. See Langevoort, *supra* note 95, at 954 (noting the Framework's "significant role under Sarbanes-Oxley"). COSO has recently released a guidance report outlining fundamental principles associated with key components of internal control and listing a variety of approaches smaller companies can use to incorporate these principles. See generally 1 COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, INTERNAL CONTROL OVER FINANCIAL REPORTING—GUIDANCE FOR SMALLER PUBLIC COMPANIES (2006), available at http://www.coso.org/Publications/SB_Executive_Summary.pdf.

170. See Advisory Committee on Smaller Public Companies, Securities Act Release No. 8514, Exchange Act Release No. 50,864, 69 Fed. Reg. 76,498, 76,498-99 (Dec. 21, 2004).

171. ADVISORY COMM. ON SMALLER PUB. COS., FINAL REPORT (2006) [hereinafter FINAL REPORT], available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>.

172. *Id.* at 3-8. In addition, the committee recommended that smaller public companies be permitted to report less historic financial information, an increase in efforts to promote non-Big Four accounting firms, the scaling back of regulations related to exiting the public market, increased registration thresholds, and requiring "smaller public companies" to file audited balance sheets and statements of income, cash flows, and changes in stockholders equity for the two preceding fiscal years. See *id.* app. D. Although these are not the only recommendations proposed by the committee, they are the most likely to directly affect the costs associated with being a publicly traded company.

173. See Langevoort, *supra* note 95, at 949-50 (remarking that "vocal criticism is largely reserved for" section 404).

174. See FINAL REPORT, *supra* note 171, at 4.

175. *Id.* at 5. A smallcap company's market capitalization would be below \$787.1 million. *Id.* at 5 tbl.1. Consequently, 2,444 firms, over 25% of all public companies, would be designated as smallcap companies. *Id.* at 7 n.13 tbl.2.

176. *Id.* at 5. A microcap's market capitalization would be below \$128.2 million. *Id.* at 5 tbl.1. As a result, 4,958 firms, over 52% of all public companies and nearly 70% of all smaller public companies, would be designated as microcaps. *Id.* at 7 n.13 tbl.2.

Revenue (\$ million)	Market Capitalization (\$ million)				
	0–125	125–250	250–500	500–750	750+
0–125	5,252	534	343	75	74
125–250	152	94	178	97	119
250–500	79	76	118	102	248
500–750	24	33	53	53	197
750–1,000	8	18	29	27	149
1,000+	16	12	43	64	1,161

The Advisory Committee recommended that “[s]mallcap companies with less than \$250 million in annual revenues but more than \$10 million in annual product revenue[,] and [m]icrocap companies with between \$125 and \$250 million in annual revenue” be exempt from the external audit requirements of section 404 of Sarbanes–Oxley.¹⁷⁸ Moreover, the Subcommittee recommended that “microcap companies with less than \$125 million in annual revenue, and . . . smallcap companies with less than \$10 million in annual product revenue, that have or add [certain] corporate governance controls” be completely exempt from section 404 of Sarbanes–Oxley.¹⁷⁹ The group acknowledged the unexpectedly high costs imposed by section 404, speculating that the especially dynamic nature of smaller companies will cause section 404 costs to remain very high.¹⁸⁰ The disproportionately higher regulatory burden, the committee argued, is adversely affecting smaller companies’ ability to compete and discouraging them from becoming public issuers, which, in effect, is weakening U.S. capital markets.¹⁸¹ The

177. INTERNAL CONTROLS SUBCOMM. REPORT, *supra* note 167, at 34 (footnote omitted).

178. FINAL REPORT, *supra* note 171, at 6–7.

179. *Id.* at 6 (footnote omitted).

180. *See id.* at 36–39; *see also* Management’s Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068, 68 Fed. Reg. 36,636, 36,657 (June 18, 2003) (estimating that “the aggregate annual costs of implementing Section 404” would be about \$91,000 per company).

181. *See* FINAL REPORT, *supra* note 171, at 24; *see also supra* notes 132–34, 150–64 and accompanying text (outlining additional costs small companies are incurring in order to comply with section 404).

Advisory Committee concluded that, in smaller companies, senior managers pose the highest risk of fraud, and internal controls over financial reporting were one of the least effective methods for detecting and preventing such acts.¹⁸² Moreover, because investors perceive risk relative to company size, and, therefore, recognize that smaller companies carry greater investment risk, the Advisory Committee concluded that scaling section 404 compliance relative to company size is appropriate.¹⁸³ These recommendations were presented to the SEC in April 2006.¹⁸⁴ SEC Chairman Christopher Cox found the suggestions inappropriate, and the SEC rejected the recommendations.¹⁸⁵ Nevertheless, it appears that a change is near. Chairman Cox recently urged the Public Company Accounting Oversight Board “to include in its [coming] changes some of the recommendations made by the [Advisory Committee], including one that the auditing rule [associated with section 404 attestations] be tailored to companies based on their size.”¹⁸⁶ Other key members of the Bush Administration have made public their view that Sarbanes–Oxley “may have gone ‘too far.’”¹⁸⁷

182. See FINAL REPORT, *supra* note 171, at 35 (noting that a smaller company’s management has a “wider span of control and more direct channels of communication,” which results in the increased fraud risk). While internal controls help detect over 18% of all cases of fraud, only about 6% of fraud by senior executives is detected by this method. ASS’N OF CERTIFIED FRAUD EXAM’RS, 2004 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE 20 (2004), <http://www.acfe.com/documents/2004RttN.pdf>; see also Alok Ghosh & Martien Lubberink, Timeliness and Mandated Disclosures on Internal Controls Under Section 404, at 29 (Sept. 2006) (unpublished manuscript, available at <http://ssrn.com/abstract=931896>) (concluding that disclosures under Sarbanes–Oxley do not timely identify internal control problems).

183. See FINAL REPORT, *supra* note 171, at 4–5 (illustrating that although approximately 80% of all U.S. public companies are smaller public companies, or microcaps, they comprise only 6% of U.S. public market capitalization).

184. *Id.*

185. Floyd Norris, *S.E.C. Eases Audit Rules but Rejects Exemptions*, N.Y. TIMES, May 18, 2006, at C2 (quoting Chairman Cox as saying that “there is no ultimate postponement for smaller companies . . . [and] all companies will be required to comply” with section 404). Instead, the SEC announced that it would issue a “guidance” for section 404 compliance and work with the Public Company Accounting Oversight Board (PCAOB) to revise and improve current auditing standards. Ideoblog, *The SEC’s Pathetic Response to Problems with SOX*, http://busmovie.typepad.com/ideoblog/2006/05/the_secs_pathet.html (May 17, 2006, 18:59 EST). The SEC, nevertheless, “conceded . . . that [section 404] wasn’t working as intended, . . . sa[ying] it hoped to tailor the rule to companies of all sizes, so that small businesses, in particular, weren’t overburdened.” Kara Scannell & Deborah Solomon, *Business Wins Its Battle to Ease a Costly Sarbanes–Oxley Rule*, WALL ST. J., Nov. 10, 2006, at A1.

186. Scannell & Solomon, *supra* note 185.

187. *Cheney Echoes Recent Concerns on Sarbanes–Oxley*, WALL ST. J., Oct. 31, 2006, at C6. “President Bush told CNBC . . . that he would like to fine-tune Sarbanes–Oxley to retain good corporate governance but relax some rules that could put U.S. capital markets at a disadvantage to their global competition.” *Id.* Vice President Dick Cheney said, “We

B. Not Good Enough

In effect, the committee's recommendations proposed that smaller companies be allowed to scale section 404 costs, especially costs associated with the required auditor attestation.¹⁸⁸ This approach, however, fails to address several key issues.¹⁸⁹ First, although these changes would result in

have to be very careful about slapping on new regulations or trying to respond to the political pressures of the moment by making life even more burdensome than we have. . . . [W]e have to be very careful here not to choke off the creativity and the entrepreneurial spirit of the American economy." *Id.* (quoting Dick Cheney from a CNBC interview). Treasury Secretary Henry Paulson expressed his belief that the "regulatory pendulum 'may have swung too far,'" indicating his intent to examine the negative effects of Sarbanes–Oxley on U.S. capital markets. *Id.*

188. See FINAL REPORT, *supra* note 171, at 4–8.

189. Nevertheless, others are arguing that the growing constituency pushing for these changes is not considering the effects of the recommended scaling:

A factor being overlooked by the CEO's and CFO's of smaller public companies that are calling for massive exemptions from [Sarbanes–Oxley] requirements is that Sections 302 and 906 certifications will still be required. Without auditor attestation of the effectiveness of the internal controls over financial reporting, the CEO's and CFO's will be the sole attesters to the effectiveness of internal control.

This could shift the financial burden for fraud from the Corporation to the individuals. Director and officer insurance will not protect the officers as coverage will be denied under breach of warranty provisions of the policy. One of the "bones" the Advisory Committee threw to the SEC was to call for an increased threat of criminal penalties for subsequent discovery of material weaknesses not previously reported by the company. Using the statistics generated by the proxy research firm of Glass, Lewis & Co. as of May 2005, among the 366 companies that received a qualified opinion, 94 percent had previously certified their controls as effective as recently as the quarterly finding previous to the [Sarbanes–Oxley] 404 report.

This result is with the larger public companies that supposedly had the resources to assess their controls. Obviously, the threat of criminal penalties has not deterred companies from improperly and inaccurately reporting on the effectiveness of their internal controls. If the Advisory Committee recommendations are adopted, the CEO and CFO could be facing criminal charges, which, up to now, the SEC has chosen not to pursue.

Basilo, *supra* note 164. Others argue against scaling specifically because small companies represent 80% of U.S. public business. *E.g.*, Robert C. Pozen, Op-Ed, *Why Sweat the Small Stuff?*, WALL ST. J., Apr. 5, 2006, at A20. Mr. Pozen, chairman of MFS Investment Management, argues for a middle ground. *Id.* He proposes that:

[T]he SEC and the PCAOB should apply to all public companies narrower rules of internal controls. Management's assessment of internal controls should focus on the material information contained in the company's reports to the SEC, and the auditors should attest to management's assessment by reviewing its process and sample testing. Both should apply the traditional concept of materiality—financial significance relative to the whole company.

Id. Auditors should attest to the internal control's assurance that "a problem is 'unlikely to actually happen'" rather than that there is a "remote likelihood" of such problems happening. *Id.* (quoting Auditing Standard No. 2 and arguing that its "remote likelihood" standard leads auditors to ponder unlikely hypothetical situations).

significant reductions in Sarbanes–Oxley costs,¹⁹⁰ they are only marginally on target when addressing the “disproportionate compliance burden.” Take for example a fictional microcap company, Micro Co., which would be permanently exempt from section 404 requirements had the Committee’s recommended changes been implemented.¹⁹¹ In 2004, Micro Co. had market capitalization of \$20 million and \$65 million in revenues. To ensure that Micro Co. remains a listed public company, the SEC extends indefinitely the exemption from section 404 that the company is currently enjoying.¹⁹² After all, investors are already aware of the risks associated with such a small company.¹⁹³ Moreover, the internal controls required by section 404 are not very effective when it comes to ensuring that companies like Micro Co. honestly report their financial positions.¹⁹⁴ More importantly, in addition to reducing the costs of being public, the exemption would promote competition among small companies, making it more profitable for them to remain listed.¹⁹⁵ However, even assuming that all of these conclusions are correct, the inference that the means—permanent exemption¹⁹⁶—would necessarily ensure the end—discouragement of deregistration¹⁹⁷—is weak. To hold true, the mere prospect of section 404 compliance must almost entirely account for recent deregistration trends.¹⁹⁸ After all, most microcap companies are exempt from section 404 until their 2007 fiscal year.¹⁹⁹ Yet, most companies choosing to go private or to go dark were microcap firms.²⁰⁰ Essentially then, the only difference between the regulatory system advanced by the Committee and the current one is a mandate ensuring that microcap companies will always

190. See FINAL REPORT, *supra* note 171, at 3.

191. *Id.* at 6–7.

192. See *id.*

193. See *supra* text accompanying note 183 (noting that investors understand the increased risk associated with smaller companies).

194. See ASS’N OF CERTIFIED FRAUD EXAM’RS, *supra* note 182, at 20 (observing that roughly 6% of fraud by senior executives is detected by internal controls, which are the least effective method of detection).

195. See *supra* note 181 and accompanying text (suggesting that the higher costs associated with implementing section 404 discourage small companies from going public).

196. See INTERNAL CONTROLS SUBCOMM. REPORT, *supra* note 167, at 35.

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

198. See *supra* Part III.C (examining the trends of going private and going dark among small companies in 2004).

199. See Management’s Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies That Are Not Accelerated Filers, Securities Act Release No. 8618, Exchange Act Release No. 52,492, 70 Fed. Reg. 56,825, 56,825 (Sept. 29, 2005) (codified in scattered sections of 17 C.F.R.).

200. See Leuz et al., *supra* note 161, at 46 tbl.1.

be free from section 404 costs. There is no denying that this mandate has potential to somewhat curb the deregistration trend. Management, for example, will be assured that expenditures associated with section 404 are not on the horizon. They will be free to use the revenues set aside for compliance on revenue-producing assets. The fact remains, microcap companies like Micro Co., who are fully exempt from section 404 at least until fiscal year 2007,²⁰¹ have seen their audit costs jump approximately 250% since 2000.²⁰² These companies spend close to 1.5% of their revenues on audit fees, while large public companies, which are not exempt from section 404, today's Enrons and WorldComs, spend under 0.15% of their revenues on audit fees.²⁰³ Therefore, while the recommended changes would help alleviate the pressure on microcap companies from the disproportionate section 404 compliance burden, the suggested regulatory changes would largely fail to help microcaps with the disproportionate Sarbanes–Oxley compliance burden.²⁰⁴

The proffered regulatory changes designed to assist smallcap companies is similarly futile in addressing the overall burden imposed by the Act. The change would relieve these companies from the very high costs associated with section 404's requirement that internal controls over financial reporting be attested by an external auditor.²⁰⁵ Nevertheless, smallcap companies would still be responsible for developing internal controls over financial reporting.²⁰⁶ Moreover, senior officers at these companies would need to certify that the internal controls framework is efficient.²⁰⁷ While the overall effects of Sarbanes–

201. Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies That Are Not Accelerated Filers, Securities Act Release No. 8618, Exchange Act Release No. 52,492, 70 Fed. Reg. 56,825, 56,825 (Sept. 29, 2005) (codified in scattered sections of 17 C.F.R.). This exemption could possibly extend until the end of fiscal year 2008. See Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, Securities Act Release No. 8731, Exchange Act Release No. 54,295, 71 Fed. Reg. 47,060, 47,060 (proposed Aug. 15, 2006).

202. See INTERNAL CONTROLS SUBCOMM. REPORT, *supra* note 167, at 20 (charting the increase in external audit fees from 2000 to 2004 based on market capitalization).

203. *Id.*

204. See *supra* Part III; see also INTERNAL CONTROLS SUBCOMM. REPORT, *supra* note 167, at 30.

205. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, § 404(b), 116 Stat. 745 (codified at 15 U.S.C. § 7262) (“[E]ach 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.”).

206. *Id.* § 404(a).

207. *Id.* § 302; Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068,

Oxley on smallcap companies are not evidenced by deregistration trends,²⁰⁸ documented conclusions that the section 404 auditor attestation burden has a weak positive correlation to company size lend themselves well to conclusions regarding the overall Sarbanes–Oxley burden and its correlation with company size.²⁰⁹ For many of the same reasons why larger companies are better able to comply with section 404,²¹⁰ the bigger the firm the lighter the burden of Sarbanes–Oxley. The Committee’s proposal would definitely assist in strengthening this correlation. But it is only a small step in that direction; because, the Act’s flavor in the mouths of companies which are smaller than the largest public corporations is a punitive one.

Perhaps, it would be more efficient to use contract and market-based approaches to address fraud among smaller public companies.²¹¹ This approach would address not only the problems associated with section 404, but also the adverse effects of the Act as a whole.²¹² The conclusion by the Committee that investors are well aware of the higher risks associated with smaller sized public companies²¹³ supports a market approach. If choosing to invest in smaller public companies exposes the investor to certain risks, some associated with possible financial fraud, should not the choice associated with such an investment, to a certain extent, counterbalance the need for legislation and regulation ensuring reduced fraud risk?²¹⁴

68 Fed. Reg. 36,636, 36,657 (June 18, 2003).

208. *Cf. supra* note 200 and accompanying text (noting that the companies delisting are microcaps, not smallcap companies).

209. *See supra* notes 107–13 and accompanying text.

210. *See supra* Part III.C (recognizing that auditing costs are disproportionately larger for small corporations).

211. *See Ribstein, supra* note 23, at 3 (arguing that “[t]he only effective antidotes to fraud are active and vigilant markets and professionals with strong incentives to investigate corporate managers and dig up corporate information”). *But see* Wolkoff, *supra* note 24 (advancing a mixed approach consisting of both market-based and regulatory elements); *see also* Jaclyne Badal & Phred Dvorak, *Sarbanes–Oxley Gains Adherents*, WALL ST. J., Aug. 14, 2006, at B3 (“[A]n increasing number of closely held companies are complying with parts of the corporate-reform law—even though they don’t have to. Some of these private-sector companies have investors who hope the company will one day go public, or will be acquired. Others think adhering to the law’s requirements will make their businesses more efficient. Still others face pressure from lenders or customers, including government agencies, who value the strong internal controls required by Sarbanes–Oxley.”).

212. *See Ribstein, supra* note 23, at 18–61 (identifying major problems stemming from regulatory responses and illustrating the benefits associated with market-based alternatives).

213. *See FINAL REPORT, supra* note 171, at 5 (describing the amount of investment in small companies).

214. *See Ribstein, supra* note 23, at 48 (predicting the success of a market-based

A study of fraudulent financial reporting conducted during a ten-year period starting in 1987 reveals that most such fraud is committed by small public companies.²¹⁵ This leads to two immediate observations. First, with financial reporting fraud being prevalent in small business settings,²¹⁶ exempting small companies from legislation and regulations targeting such fraud is illogical. The second observation, however, is more encompassing. An equally important goal of Sarbanes–Oxley was to rebuild the investor confidence which was lost in 2002 as a result of large corporate fraud.²¹⁷ During the above-mentioned decade study, markets boomed and investor confidence soared.²¹⁸ Significant market growth in the face of frequent small company fraud supports the notion that investors were aware of the higher risks associated with smaller firms.²¹⁹ Moreover, sustained market strength during this period signals small firms’ inability to hurt the market the way large public corporations can.²²⁰ To exempt smaller public companies from Sarbanes–Oxley²²¹ seems

approach because “the risks of defective accounting have become as obvious to investors as they have become to politicians and regulators”.

215. MARK S. BEASLEY ET AL., COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, *FRAUDULENT FINANCIAL REPORTING: 1987–1997, AN ANALYSIS OF U.S. PUBLIC COMPANIES 15–17* (1999), http://www.coso.org/publications/FFR_1987_1997.PDF (observing that companies committing financial statement fraud typically controlled well below \$100 million in total assets and were not listed on the New York or American Stock Exchanges); see also FINAL REPORT, *supra* note 171, at 139 (“[S]mall firms . . . make up the bulk of accounting fraud cases under review by regulators and the courts (one study puts it at 75 percent of the cases from 1998–2003).”).

216. FINAL REPORT, *supra* note 171, at 139 (reporting a prevalence of fraud in small corporations). “The small-cap and microcap companies that the SEC’s advisory panel wants to exempt from all or part of [s]ection 404 accounted for 59% of restatements of financial results by public companies in 2005, according to a report from proxy-advisory and research firm Glass Lewis & Co.” Kara Scannell & David Reilly, *Small Firms’ Sarbanes Suffering?*, WALL ST. J., Apr. 6, 2006, at C1.

217. See Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 745 (codified in scattered sections 11, 15, 18, 28, and 29 U.S.C.) (purporting “[t]o protect investors by improving the accuracy and reliability of corporate disclosures”); Bumiller, *supra* note 76 (quoting President George W. Bush proclaiming after he signed into law the Sarbanes–Oxley Act that “those who break the law—break the rules of fairness, those who are dishonest, however wealthy or successful they may be—must pay a price”).

218. See, e.g., Larry E. Ribstein, Commentary, *Bubble Laws*, 40 HOUS. L. REV. 77, 77–78 (2003) (contending that the 2001–2002 frauds and the subsequent enactment of Sarbanes–Oxley are normal events in “a centuries-old cycle of capital market booms followed by busts and regulation”).

219. See *id.* (describing the pattern of investment in small companies); see also BEASLEY ET AL., *supra* note 215, at 5–9 (summarizing the results of a study of 200 financial statement frauds).

220. See *supra* note 183 and accompanying text (suggesting that small companies’ limited market capital prevents damage to the market).

221. See *supra* notes 178–83 and accompanying text (describing a committee’s recommendation to except smaller public companies from Sarbanes–Oxley).

to go against the Act's goal of reducing fraud. This impression, however, is partially incorrect. The Act's goal is to reduce the likelihood of fraud which has potential to move the public market.²²² Concentrating on the 20% of U.S. public companies that wield 94% of the market's capital²²³ would diminish the Act's overinclusive nature²²⁴ without hurting the prospects of preventing another Enron or WorldCom.²²⁵

V. CONCLUSION

The costs of Sarbanes–Oxley compliance are causing smaller companies to reevaluate the benefits of being a public company, and in many instances are driving them out of the highly regulated public market.²²⁶ Small companies, however, are a vital

222. See *supra* note 217 and accompanying text.

223. See *supra* notes 175–77 and accompanying text (identifying the breakdown of market capitalization by company size).

224. See *supra* Part III (describing how the Act covers business in general, not just large companies).

225. See Ribstein, *supra* note 23, at 47–61 (arguing for a market based approach that will be less costly for small companies); FINAL REPORT, *supra* note 171, at 16 (“[One hundred] bankruptcies [of] companies with \$10 million total market capitalization would be required to equal the potential loss of the bankruptcy of a company with \$1 billion of market capitalization.”).

226. See *supra* Part III.C (describing the privatization of many public companies following Sarbanes–Oxley); see also R. Glenn Hubbard & John L. Thornton, *Is the U.S. Losing Ground?*, WALL ST. J., Oct. 30, 2006, at A12 (“The efficiency and competitiveness of our public capital markets as well as the safeguards for investors in these markets are essential to the vibrancy and resiliency of the U.S. economy. Issuers gain access to a lower cost of capital for growth. Investors benefit from liquidity and efficiency in pricing of securities. And well-developed capital markets are directly related to growth in productivity and greater employment opportunities across the whole of our economic spectrum. It is a virtuous cycle that attracts more capital to the U.S. public capital markets. . . . Sarbanes–Oxley offers enhanced benefits of transparency, accountability and investor protection, and thus strengthens our capital markets. . . . Since the new regulatory mechanisms have been put in place, developments in the U.S. capital markets have not been positive. In 2000, 90% of the funds raised by foreign companies through new stock offerings were raised in the U.S. The ‘90% rule’ held in 2005, too, but in reverse—90% of the funds raised by foreign firms through new listings occurred in Europe and other non-U.S. markets. . . . [T]he fraction of non-U.S. IPOs listed in the U.S. has fallen to under 10% so far in 2006 from 37% in 2000 [T]he declines in foreign firms’ U.S. listings by number and value are similar. Concerns about listings in the U.S. relate to domestic firms too, as U.S. firms contemplate ‘going private’ or do not ‘go public’ for regulatory and legal reasons.”). *But see* Reynolds Holding, *Plugging the IPO Drain*, TIME, Feb. 19, 2007, at 50, 50 (“U.S. stock markets still attract more money and investors than any in the world, mostly because of a reputation for operating fairly. The strict rules ‘give companies the opportunity to tell investors, ‘Look at the scrutiny we undergo. That’s why you should invest with us,’” says Andrew Karolyi, an Ohio State University finance professor. Thanks in part to this reputation for clean dealing, foreign firms can get as much as 37% more for their stock on U.S. markets than they can elsewhere, including on the London Stock Exchange, according to an article co-authored by Karolyi. That’s a big reason why, per dollar raised, U.S. stock offerings are the cheapest in the world.”).

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component of the American economy.²²⁷ They represent more than 99.7% of all employers, and generate 60% to 80% of new jobs annually.²²⁸ It is crucial to a healthy economy that small businesses have the opportunity to grow and prosper.²²⁹ It is imperative that legislators reexamine the Sarbanes–Oxley Act. The entities most like those responsible for the damages directly resulting from the debacles of 2002, public companies wielding significant market capital, should bear the primary burden of rebuilding and then sustaining investor confidence in public markets. Insuring against their possible misdeeds should not force innocent smaller parties out.

Oleg Rezzy

227. *See generally* Cynthia A. Glassman, Comm’r, Sec. & Exch. Comm’n, Remarks Before Government-Business Forum on Small Business Capital Formation (Sept. 22, 2003), available at <http://www.sec.gov/news/speech/spch092203cag.htm> (discussing the economics of small business and the importance small business has to the American economy).

228. *Id.* (quoting numbers that demonstrate the role of small business in the economy).

229. *Id.* (advocating that small businesses take advantage of the comment process).