



Summer 6-1-2006

Take It Slow: A Novel Concept in the Life of Sarbanes-Oxley

D. Skylar Rosenbloom

Follow this and additional works at: <https://scholarlycommons.law.wlu.edu/wlulr>



Part of the [Business Organizations Law Commons](#), and the [Securities Law Commons](#)

Recommended Citation

D. Skylar Rosenbloom, *Take It Slow: A Novel Concept in the Life of Sarbanes-Oxley*, 63 Wash. & Lee L. Rev. 1185 (2006).

Available at: <https://scholarlycommons.law.wlu.edu/wlulr/vol63/iss3/8>

This Note is brought to you for free and open access by the Washington and Lee Law Review at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington and Lee University School of Law Scholarly Commons. For more information, please contact christensena@wlu.edu.

Take It Slow: A Novel Concept in the Life of Sarbanes-Oxley

D. Skylar Rosenbloom*

Table of Contents

I. Introduction	1186
II. The Background of the Sarbanes-Oxley Act	1187
A. The Stock Market Bubbles and Bursts	1187
B. The Birth of the Sarbanes-Oxley Act.....	1191
C. The Sarbanes-Oxley Act.....	1194
1. The Act at a Glance.....	1194
2. Section 404	1196
III. The Aftermath of Section 404	1197
A. Unexpected Costs	1198
B. The SEC Responds to the Small Business Community.....	1199
IV. The Small Business Question: To Comply or Not to Comply?	1200
A. The Small Business Argument	1201
1. Voluntary Compliance	1203
2. Exemptions from Compliance.....	1206
3. Tailor the Requirements of Section 404.....	1209
B. Saving Small Businesses from Themselves.....	1210
1. Rapidly Declining Costs of Compliance	1211
2. Regulation Will Not Destroy the Benefits of Being Public.....	1214
3. Strong Internal Controls Achieve Their Purposes	1215

* Candidate for J.D., Washington and Lee University School of Law, May 2007; B.S., Georgetown University, 2001. I would like to thank the editors of the *Washington and Lee Law Review*, particularly Laura Chernitsky and Travis Barham, for their indispensable aid and unending patience. I would also like to thank Professor Lyman Johnson whose insightful comments and watchful eye ensured that I stayed on the right path. Finally, I would like to thank my family, friends, and dogs for their understanding and for not filing a missing persons report.

V. Conclusion.....	1216
--------------------	------

I. Introduction

In the late 1990s American equity markets surged to new heights. Investors, enjoying an unprecedented period of economic growth, flooded the markets with capital. However, this dream would quickly turn into a nightmare. In a matter of months many individual investors found their portfolios and retirement accounts decimated as the market collapsed. Dismayed investors lost trillions of dollars of net worth, seemingly overnight.

This dismay turned quickly to anger as the deceptions of company executives and their advisors proved to be the root of the market collapse. An overwhelming public outcry for reform, or vengeance, arose from the ashes of these scandals. Congress reacted swiftly, instituting sweeping corporate reforms, drastically changing the corporate regulatory environment with the passage of the Sarbanes-Oxley Act of 2002.¹

Critics quickly denounced the Sarbanes-Oxley Act as "a nightmare for company executives," truly "a telling example of the law of unintended consequences."² Immediately commentators recommended repealing or modifying the Sarbanes-Oxley Act. Critics have since focused their attacks upon Section 404 of the Sarbanes-Oxley Act (Section 404), the section which requires reports on a company's internal controls by management and their external auditors.³ However, these critics still call for relief from this misunderstood and much maligned reform.

This Note argues that while Congress passed the Sarbanes-Oxley Act without the proper study and contemplation typically given to such sweeping legislation, current efforts to exempt smaller companies from Section 404 are similarly misguided. Instead, this Note proposes a staggered implementation process for smaller companies that have yet to comply with Section 404. In addition, this proposal provides temporary relief from the onerous requirement of auditing internal controls to smaller companies already in compliance with Section 404. The "take it slow" approach of this proposal would ease the burdens of compliance for companies, while providing the necessary protection to investors. This slower approach would also allow regulators and companies

1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 16 Stat. 745 (2002) [hereinafter Sarbanes-Oxley Act].

2. Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 Hous. L. Rev. 1, 49 (2003).

3. Sarbanes-Oxley Act § 404.

to understand both the drawbacks and benefits of the Sarbanes-Oxley Act better. Only when these parties fully understand all of the ramifications of the Sarbanes-Oxley Act can constructive dialogue about reform and relief begin.

Part II of this Note examines the factors in the equity markets that led to the broad public support for regulatory action and briefly looks at the Sarbanes-Oxley Act. Part III highlights the unexpected negative effects arising from implementing the Sarbanes-Oxley Act and briefly describes the actions the Securities and Exchange Commission (SEC) took to address the small business community's concerns about these negative effects. Part IV details the issues the small business community utilizes in arguing for relief from Section 404 and examines recent evidence suggesting that complying with the Sarbanes-Oxley Act yields unexpected benefits. This recent evidence shows that the issues presented by the small business community are not as significant as many believe. This Note then provides a specific staggered approach to mandating compliance with Section 404, which balances the concerns and needs of smaller public companies and the public.

II. The Background of the Sarbanes-Oxley Act

Understanding Congress's motivation for passing the Sarbanes-Oxley Act in mere months requires a clear picture of the business environment near the turn of the century. This Part will explain how a handful of scandals could adversely affect such a large portion of the American population. This widespread harm provided Congress with sufficient political capital to allow quick passage of the Sarbanes-Oxley Act. With such limited time to react, the interested parties provided little input in shaping the legislation. This hasty action by Congress provoked an equally hasty, widespread condemnation by the business community.

A. The Stock Market Bubbles and Bursts

A variety of factors contributed to the increasing number of individual investors in the stock market during the two decades before the scandals that changed the regulatory world of public companies. Many investors, lured by visions of wealth, chased a skyrocketing bull market, as they salivated over a Dow Jones industrial average that exploded from a 1982 low of less than 800⁴

4. See Arthur M. Louis, *Individual Investors Gaining Status*, S.F. CHRON., Dec. 28, 1999, at D1 (discussing the fundamental reasons for the increased "flow of individuals into stocks . . . since the early 1980s").

to almost 12,000 in early 2000.⁵ In addition to the willing investor, corporate cost-cutting introduced many Americans to the stock market as defined-contribution pension plans, such as 401(k)s and Individual Retirement Accounts (IRAs), replaced their traditional defined-benefit pension plans.⁶ The rapid development of technology led to the proliferation of discount brokers, who provided ordinary Americans with the power to research, buy, and sell stock with the click of a button. As a result of these factors, the percentage of Americans invested in the stock market mushroomed during the 1980s and 1990s from twenty percent to approximately fifty percent of all households by 2002.⁷

While the profile of the average investor was changing, the equity markets were transforming. During the 1990s, the longest economic boom in U.S. history began,⁸ fueled by unprecedented development of technology and growth of the telecommunications industry.⁹ As a result, countless "dot com" companies were appearing on major exchanges on a seemingly daily basis,¹⁰ while typically steady telecom stocks experienced surges in their share prices.¹¹ However, these "new economy" companies had a corporate structure that

5. Dow Jones & Co., Dow Jones Industrials History 2000–2009, <http://www.djindexes.com/mdsidx/index.cfm?event=showAverages> (last visited Aug. 17, 2006) (on file with the Washington and Lee Law Review).

6. See Louis, *supra* note 4, at D1 (stating that "the great corporate cost cutting movement of recent decades has revolutionized pensions"). A defined-benefit pension is a pension plan that guarantees the participant a specific, or defined, annual benefit upon retirement. *Id.* A defined-contribution plan guarantees the participant a defined annual contribution. However, the benefit realized by the participant depends upon the performance of their investment choices. *Id.* Companies found the risk and expense of maintaining defined-benefit plans too great and have shifted that burden to their employees. *Id.*

7. See Liz Marlantes, *Stock Slide Dons New Meaning*, CHRISTIAN SCIENCE MONITOR, July 15, 2002, at 1 (discussing the political ramifications of the recent increase in public ownership of stock). A 2002 poll found that forty percent of Americans had at least \$10,000 invested in the stock market. *Id.*

8. See Dow Jones & Co., *supra* note 5, at 1990–99 (showing the performance of the Dow Jones Industrial Average in relation to historic world events).

9. See Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 923 (2003) (discussing the "economic expansion and technological innovation" of the 1990s).

10. See *id.* (discussing the large number of companies eager to take advantage of a market flush with capital); see also Stephen Labaton, *S.E.C. Is Suffering from Nonbenign Neglect*, N.Y. TIMES, July 20, 2002, at C1 (examining the heavy burden the increased number of public companies placed on the SEC). According to an investigation by the General Accounting Office, the number of corporate filings received by the SEC increased from 61,925 in 1991 to 98,745 in 2000, a 59% increase. *Id.*

11. See Hamilton, *supra* note 2, at 14–15 (discussing the rise of the telecommunications industry during the late 1990s).

differed greatly from traditional companies and that investors understood poorly.¹² "Dot com" companies began to experience phenomenal success in the equity markets, not as a result of concrete results, but based on rumor, speculation, and market momentum.¹³ While the rapid growth of the telecommunications industry is likely a product of the same "irrational exuberance,"¹⁴ it fell victim to the more traditional economic concept of supply and demand.¹⁵ The mantra for these telecom and "dot com" companies appears to have been "spend your way to success."¹⁶ This approach was sound while investors poured capital into the markets,¹⁷ but in 2000, as profits failed to materialize quarter after quarter, the cash flow began to dry up.¹⁸

By the spring of 2000, the general investing public recognized that the market was severely overvalued. A massive sell off ensued as investors tried to withdraw before the bubble burst, causing the depression of every major American market.¹⁹ Over the next year and a half, the market began to clean house with most nonviable "dot coms" quietly exiting the marketplace²⁰ and the

12. See Cunningham, *supra* note 9, at 923 (discussing the unconventional business models used by most "dot coms"); see also J. William Gurley, *In This Wild Market, Startups Face a Very Tough Call*, FORTUNE, Apr. 13, 1998, at 152 (discussing the irrational market response to internet related company actions).

13. See Louis, *supra* note 4, at D1 (discussing the speculative nature of the stock market in prosperous economic times); see also Gurley, *supra* note 12 (explaining how surges in an internet related company's stock price were typically the result of speculation). To highlight this point, consider "dot com" darling Yahoo. At the end of 1999, Yahoo's market capitalization was roughly equal to that of Disney, General Motors, and Johnson & Johnson combined. Meanwhile, the three traditional companies had net income of approximately 180 times that of Yahoo's. *Id.*

14. Hamilton, *supra* note 2, at 13

15. *Id.* at 14-15. In the late 1990s, the telecommunications industry began to lay millions of miles of fiber optic cable to be prepared to meet tremendous demand for electronic communication. *Id.* at 14. However, the industry estimates that Internet traffic was to experience annual growth of more than 1000% failed to materialize. *Id.* at 14-15. This fanciful period of expansion never occurred, as actual growth was approximately ten percent of industry estimates. *Id.* at 14. This resulted in an excessive supply of transmission capabilities which caused bandwidth prices to drop an average of sixty-five percent a year. *Id.* at 15. Couple this excessive transmission capability with rapidly improving transmission technology, and the overcapacity issues become exponentially worse. *Id.*

16. Gurley, *supra* note 12, at 152 (discussing the aggressive spending used by companies to seize market share).

17. *Id.*

18. See Hamilton, *supra* note 2, at 14-15 (discussing the rapid decline of the "dot com" and telecommunications industries).

19. See Cunningham, *supra* note 9, at 923-24 (recounting the events leading to the downturn of the markets prior to 2002).

20. See Hamilton, *supra* note 2, at 14 (discussing the end of the "dot com" boom).

more stalwart telecom companies tightening their belts.²¹ The markets seemed to be heading in the right direction, but the terrorist attacks of September 11, 2001, brought new uncertainties to the political and economic landscape.²² As the country was attempting to cope with this tragedy, few were aware that one more storm was about to be unleashed on the economy.

In October of 2001, Enron began its spectacular fall²³ from a "darling on Wall Street"²⁴ to the second largest bankruptcy in U.S. history, two short months later.²⁵ As Enron's accounting irregularities came to light, investors (and the public) initially viewed the case as a result of the actions of a few unscrupulous executives at Enron and Arthur Anderson, not as a sign of a broken regulatory system.²⁶ The murmurs of disgust would turn to cries for reform over the next eight months as allegations of fraud surfaced in the wake of a handful of bankruptcies at major companies, including WorldCom, Global

21. See *id.* at 16–17 (noting that over 500,000 telecom workers were laid off by early 2001).

22. See Cunningham, *supra* note 9, at 923–24 (discussing the events leading to the downturn of the markets prior to 2002). The New York Stock Exchange closed for a week following the attacks as the country attempted to process what had occurred. *Id.* When trading resumed, the markets responded strongly, a seemingly patriotic response to the acts of terrorism on American soil. *Id.* However, even the patriotic fervor that gripped the nation could not settle the anxiety and uncertainty resulting from that day and the resulting war on terror. *Id.* Within weeks a sell-off began and progressed steadily into the following year. *Id.*

23. See Floyd Norris, *Where Did the Value Go at Enron?*, N.Y. TIMES, Oct. 23, 2001, at C1 (noting the rapidly declining stock price of Enron). On October 16, 2001, Enron revealed a \$1.2 billion reduction in shareholders' equity in their quarterly earnings statements. *Id.* Enron's share price plummeted forty percent in the week following this release. *Id.* This plummet proved to be the beginning of the end of Enron's meteoric rise to fame. *Id.*

24. Julia King & Gary H. Anthers, *Juiced*, COMPUTERWORLD, Nov. 20, 2000, at 44 (discussing how Enron's use of internet technology transformed the company from an Old Economy company to a "New Economy pioneer"); see also David Ivanovich, *Everybody Knows Enron's Name*, HOUSTON CHRON., Oct. 21, 2002, at A1 (noting that "Fortune magazine named Enron the nation's most innovative company five years running and . . . ranked Enron among its '10 Stocks to Last the Decade'").

25. A bankruptcy is measured by the pre-bankruptcy assets of a company. When Enron filed bankruptcy on December 2, 2001, its total pre-bankruptcy assets were \$63.4 billion. Enron currently ranks as the second largest bankruptcy in U.S. history after WorldCom, Inc.'s July 2002 bankruptcy of \$103.9 billion. Bankruptcydata.com, *The 15 Largest Bankruptcies 1980–Present*, http://www.bankruptcydata.com/research/15_largest.htm (last visited Aug. 17, 2006) (on file with the Washington and Lee Law Review).

26. See Cunningham, *supra* note 9, at 924 (discussing the initial political and public response to the Enron bankruptcy). Despite the bankruptcy of the seventh largest company in the U.S., the markets held steady and Congressional action, including action on over forty reform bills, was "put on the back burner." *Id.* For a more in-depth discussion of the transactions and accounting practices that led to Enron's rise and fall, see Cunningham, *supra* note 9, at 928–29 (explaining Enron's ethical and accounting irregularities).

Crossing, and Adelphia Communications.²⁷ During the first half of 2002, every new day seemed to bring forth another company that had restated its financial statements.²⁸ Underlying each of these restatements was another story of profiteering by the executives of these troubled companies or of the failure of an external accounting firm or investment analyst to provide honest and unbiased information.²⁹ With the extensive level of participation in the equity markets, these bankruptcies and scandals further decimated the net worth of millions of Americans.³⁰

B. The Birth of the Sarbanes-Oxley Act

Knowing that legislative action was almost guaranteed, the presidents of the Securities Industry Association and the American Institute of Certified Public Accountants urged Congress not to overreact in responding to these scandals.³¹ They warned that a rush to provide legislative remedies could create extraordinarily negative unintended consequences that could further harm the economy. Even policymakers, such as Federal Reserve Board Chairman Alan Greenspan, pressed for legislative restraint.³² However, following WorldCom's June 25th earnings restatement, Congress could not ignore the mounting political pressure for action, particularly in the face of the upcoming mid-term elections.³³

27. See Jennifer S. Recine, Note, *Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act*, 39 AM. CRIM. L. REV. 1535, 1537 (2002) (recounting the major bankruptcies that "cause[d] market upheaval and public outrage").

28. See Hamilton, *supra* note 2, at 17 (stating that in the first six months of 2002, 112 telecom companies restated prior earnings).

29. See Neil H. Aronson, *Preventing Future Enrons: Implementing The Sarbanes-Oxley Act of 2002*, 8 STAN. J.L. BUS. & FIN. 127, 127 (2002) (discussing the causes of the decline of public confidence in the market).

30. See *id.* at 127 (stating that from March 2000 through September 2002, investors' net worth decreased by almost \$8.5 trillion).

31. See Joseph A. Castelluccio III, Note, *Sarbanes-Oxley and Small Business: Section 404 and the Case for a Small Business Exemption*, 71 BROOK. L. REV. 429, 450 (2005) (reviewing events that led to the passage of the Sarbanes-Oxley Act).

32. See Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks at the Stern School of Business, New York University (Mar. 26, 2002), <http://www.federalreserve.gov/boarddocs/speeches/2002/200203262/default.htm> (discussing corporate governance in the wake of the Enron bankruptcy) (on file with the Washington and Lee Law Review). Greenspan stated: "We have to be careful . . . not to look to a significant expansion of regulation as the solution to current problems Regulation has, over the years, proven only partially successful in dissuading individuals from playing with the rules of accounting." *Id.*

33. See Marlantes, *supra* note 7, at 1 (discussing the political ramifications of the recent increase in public ownership of stock). According to Marlantes, individuals that own shares are

At the time, the Sarbanes-Oxley bill was the only piece of legislation pending before Congress.³⁴ While Congress had discussed many of the bill's ideas and proposals prior to the current crisis, it had never seriously considered enacting these reforms.³⁵ As a result, the majority of politicians, publicly held corporations, and interested organizations had never studied these ideas.³⁶ However, reform-minded legislators capitalized on the high level of public support for reform and pushed the bill to a vote in the Senate.³⁷ The political pressure for action was so great that the bill passed unanimously.³⁸ The House of Representatives also offered little in the way of resistance, with only three dissenting votes.³⁹ These votes do not really reflect congressional support for the bill but are more a product of the circumstances. One Congressman noted that, given "the environment that we're in, virtually anything could have passed the Congress."⁴⁰ President Bush echoed these sentiments as he signed the Sarbanes-Oxley Act into law due to the "public outrage" over the business scandals.⁴¹

more likely to vote in political elections. *Id.* Furthermore, about half of those with investments say that the market decline has had a significant impact upon their retirement planning, a major source of concern. *Id.* As people tend to vote pocketbook issues, both parties needed to take an aggressive stance in combating corporate scandals in the face of upcoming mid-term elections. *Id.*

34. See Hamilton, *supra* note 2, at 46 (reviewing the legislative actions that produced the Sarbanes-Oxley Act). In fact, many politicians still believed that the bill could be defeated less than a month before its passage. David S. Hilzenrath, *How Congress Rode a 'Storm' to Corporate Reform*, WASH. POST, July 28, 2002, at A1 (detailing the events that lead to the passage of the Sarbanes-Oxley Act).

35. See Hamilton, *supra* note 2, at 46 (discussing prior legislative attempts at corporate reform).

36. See *id.* (revealing that few people considered a regulatory response likely, even after the Enron scandal).

37. See Cunningham, *supra* note 9, at 924 (discussing the effect that public support had upon getting the Sarbanes-Oxley Act passed).

38. See Hilzenrath, *supra* note 34, at A1 (detailing the surge of public support for reform prior to the passage of the Sarbanes-Oxley Act). Senators were so concerned with appearing soft on corporate reform that not a single amendment of the seven prepared by the American Institute of Certified Public Accountants for the Senate debate was sponsored. *Id.*

39. See 148 CONG. REC. H5462.02 (daily ed. July 25, 2002) (showing that the bill passed the house by a vote of 423-3).

40. See Hilzenrath, *supra* note 34, at A1 (quoting Senator Phil Gramm).

41. Hamilton, *supra* note 2, at 46-47 (discussing President Bush's disappointment in needing to sign the Sarbanes-Oxley Act). However, the President's disappointment did not result in any delay in signing the bill. The President signed the bill into law the day it was presented to him. *Id.*; see also Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1 (stating that "President Bush signed a sweeping corporate-fraud bill . . . with central provisions that he opposed just three weeks ago").

The criticism mounted quickly following the passage of the Sarbanes-Oxley Act.⁴² While critics agreed that the current state of corporate governance needed the government's focus, they took exception to the method used to address the issue.⁴³ The Sarbanes-Oxley Act, hailed as "the most far-reaching reform[] of American business practice[s] since the time of Franklin Delano Roosevelt,"⁴⁴ passed into law a mere eight months after Enron's bankruptcy.⁴⁵ In contrast the last time this country saw such sweeping corporate reform, President Roosevelt signed the Securities Act of 1933 into law over three and a half years following the stock market crash of 1929.⁴⁶ Aware of this discrepancy, critics called the Sarbanes-Oxley Act "a hasty, panicked reaction of an electorate looking for an easy fix to the apparent 'problem' that stock prices go down as well as up."⁴⁷ They further charged that by acting "quickly and without a lot of study," Congress has created a law that will have serious

42. See Hamilton, *supra* note 2, at 49–52 (relating the immediate reactions of executives, corporate lawyers, and scholars).

43. See Anthony Lin, *One Year After Sarbanes-Oxley Act, Many Officers See Need, but Grumble Nonetheless*, N.Y. L.J., July 31, 2003, at 1 (discussing the attitudes of top executives and corporate lawyers towards the Sarbanes-Oxley Act).

44. Bumiller, *supra* note 41, at A1 (quoting President Bush).

45. See *id.* at A1 (stating that the signing of the Sarbanes-Oxley bill in July 2002 was the end of a process begun by Enron's bankruptcy in December 2001).

46. See Castelluccio, *supra* note 31, at 434–37 (discussing the history of the Securities Act of 1933 and the Securities Exchange Act of 1934).

47. Hamilton, *supra* note 2, at 49 (quoting Professor Larry Ribstein). This discrepancy may not be as significant as critics think. The Securities Act of 1933 was passed only after a lengthy investigation and significant hearings. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 1 (3d ed. 2003) (stating that legislation was enacted after more than two years of hearings and investigations). These hearings were required to "galvanize[] broad public support for direct federal regulation of the stock markets." *Id.* at 2. Other commentators have noted that these hearings "were orchestrated to develop an explanation of the market crash as having been caused by market manipulation, fraud, and abuse by financial firms, in order to implement an agenda for market regulation." Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1592 (2005). Some have even suggested that Congress exaggerated the issues that led to the stock market crash in 1929 to galvanize sufficient public support to enact regulatory legislation. See Castelluccio, *supra* note 31, at 435 (claiming that these hearings were able to achieve remedial legislation after "diminish[ing] the public's faith in the nation's financial institutions"). These claims make it appear that the long delay between the stock market crash of 1929 and reform resulted not from careful study, but from a planned manipulation of public sentiment. Yet, in the case of the Sarbanes-Oxley Act, Congress "resisted [acting] until they saw a tidal wave" of public demand for reform. Hamilton, *supra* note 2, at 46 (quoting Professor John Coffee). Under these circumstances it appears that the Sarbanes-Oxley Act is a much more legitimate representation of the will of the people than the Securities Act of 1933.

"unintended consequences."⁴⁸ Primarily, they warned that formal compliance with the Sarbanes-Oxley Act—especially Section 404—would impose potentially onerous costs on companies.⁴⁹

C. The Sarbanes-Oxley Act

Section 404 is often confused as synonymous with, instead of a part of, the Sarbanes-Oxley Act. This confusion results from the significant exposure given to Section 404 in the media. This section provides a brief overview of these often ignored provisions of the Sarbanes-Oxley Act, then discusses Section 404 in greater detail.

1. The Act at a Glance

The purpose of the Sarbanes-Oxley Act is "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."⁵⁰ To achieve this goal and prevent the reoccurrences of the problems that surfaced at the recently disgraced companies, the Sarbanes-Oxley Act prohibits corporate loans to officers, places further limitations on insider transactions, enhances auditor independence by removing undue influences, and increases the criminal penalties for violators.⁵¹

To improve the integrity of audits of public companies, the Sarbanes-Oxley Act seeks to remove the undue influences on auditors. First, independent directors must hold all positions on a company's audit committee.⁵² This requirement attempts to prevent audit boards from being controlled by, or simply deferring to, chief officers within the company.⁵³ Second, the Sarbanes-Oxley Act prohibits accounting firms from providing

48. Lin, *supra* note 43, at 1.

49. *See id.* (discussing the concerns of the business community with the Sarbanes-Oxley Act).

50. Introduction to the Sarbanes-Oxley Act.

51. *See* Aronson, *supra* note 29, at 132 (explaining some of the Sarbanes-Oxley Act's key provisions).

52. Sarbanes-Oxley Act § 301(m)(3). To be considered independent, audit committee members cannot, other than in their capacity as an audit committee member, "accept any consulting, advisory, or other compensatory fee from the issuer; or . . . be an affiliated person of the issuer or any subsidiary thereof." Sarbanes-Oxley Act § 301(m)(3)(B).

53. *See* Aronson, *supra* note 29, at 139–41 (explaining that corporate boards were often aware of and ignored accounting improprieties).

both audit and non-audit services contemporaneously.⁵⁴ This prohibition prevents companies from holding out lucrative consulting engagements as an incentive for their auditors to provide more favorable audit treatment.⁵⁵

To address the loss of public confidence in financial statements, audited and unaudited, the Sarbanes-Oxley Act requires that the chief executive officer and the principal financial officer must certify each annual and quarterly report.⁵⁶ These certifications provide that the officers have reviewed the report, that the report has no untrue statements of material facts, and that the financial statements fairly reflect the financial conditions and results of the company's operations.⁵⁷ In addition to these assertions, the officers must provide substantial disclosures regarding the company's internal controls.⁵⁸ To enhance the seriousness of these certifications, Congress provided the Sarbanes-Oxley Act with some teeth. Any officer who knowingly certifies a report that does not meet these requirements may be fined up to \$1,000,000 and be imprisoned up to ten years.⁵⁹ Any officer who willingly certifies a report that does not meet these requirements may be fined up to \$5,000,000 and be imprisoned up to twenty years.⁶⁰ These provisions force the chief officers of a company to be more directly involved in the accounting and financial practices of the company.

These regulations provide just a cursory look at the Sarbanes-Oxley Act's extensive reach. This reform restructured every aspect of a public company, from the board room to the field accounting office. However, the majority of these revolutionary changes are outside the scope of this Note. This Note focuses on the current crisis facing small businesses across the country as a result of the pending implementation of Section 404.⁶¹

54. Sarbanes-Oxley Act § 201(g). Non-audit services encompass a wide array of activities from bookkeeping to management consulting. *Id.* This section was the main impetus behind the major accounting firms divesting their more profitable consulting branches.

55. See Aronson, *supra* note 29, at 138–39 (stating Congress's concerns that consulting engagements generated three times more revenue than audits).

56. Sarbanes-Oxley Act § 302(a)(1), (2).

57. *Id.*

58. *Id.* § 302(a)(4).

59. *Id.* § 906(c)(1).

60. *Id.* § 906(c)(2).

61. Currently, accelerated filers have been required to comply with the requirements of Section 404 since their first fiscal years ending on or after November 15, 2004. Internal Control Over Financial Reporting, 17 C.F.R. §§ 228.308, 229.308 (2004). The term "accelerated filer" has recently been redefined, but is essentially any domestic company with more than \$75 million in public equity. Definitions, 17 C.F.R. § 240.12b-2 (2005). The companies that are not accelerated filers, including foreign issuers, must comply with Section 404 for fiscal years

2. Section 404

The most widely known and despised regulations mandated by the Sarbanes-Oxley Act are those found in Section 404. The rules in Section 404⁶² require a company's annual report to include a management assessment of the effectiveness of the internal control structure and procedures.⁶³ In addition, Section 404 requires the company's external auditor to "attest to, and report on" this assessment made by management.⁶⁴ This language requires that the auditor report on management's assertions as well as opine upon an audit of the company's internal controls.⁶⁵

The management assertion report must contain a statement in which management acknowledges responsibility for "establishing and maintaining an adequate internal control structure" as well as providing an assertion as to the effectiveness of this control structure.⁶⁶ In order to be able to provide an honest assessment of the effectiveness of internal controls, management must "document, evaluate, and test controls that are deemed significant to the financial reporting process."⁶⁷ During this process most

ending after July 15, 2006. Postponement of Reports on Internal Control over Financial Reporting for Non-Accelerated Filers and Foreign Issuers, 70 Fed. Reg. 11,528 (2005) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249). At this time the SEC is considering a final rule that would extend this deadline one more year. Management's Report on Internal Control Over Financial Reporting and Certification Disclosure in Exchange Act Periodic Reports of Companies that Are Not Accelerated Filers, 70 Fed. Reg. 56,825 (2005).

62. As is often the case, Congress has provided only a sketch of the big picture and left the details to be filled in by someone else. Congress gave the job of filling in these details to the Public Company Accounting Oversight Board (PCAOB), a private non-profit company created to "oversee the audit of public companies that are subject to the securities law . . . in order to protect the interests of investors. . . ." Sarbanes-Oxley Act § 101(a). To accomplish this purpose Congress directed PCAOB to establish standards and rules to be followed by applicable companies and accounting firms. Sarbanes-Oxley Act § 103(a)(1). However, any standard that PCAOB adopts is not effective unless it is approved by the SEC. See Public Company Accounting Oversight Board, Standards-setting, <http://www.pcaobus.org/Standard/s/Standardssetting.aspx> (last visited Aug. 17, 2006) (providing a detailed outline of the organization's standard setting process) (on file with the Washington and Lee Law Review). PCAOB established Audit Standard 2 as the guidance for Section 404 of the Sarbanes-Oxley Act. PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD AUDITING STANDARD NO. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements ¶ 3 (2005). For convenience and simplicity, Auditing Standard No. 2 and its effects will be attributed directly to Section 404 of the Sarbanes-Oxley Act.

63. Sarbanes-Oxley Act § 404(a)(2).

64. *Id.* § 404(b).

65. See John C. Coffee, Jr., *Sarbanes-Oxley Section 404 and Auditing Standard No. 2*, N.Y. L.J., May 20, 2004, at 5 (providing an overview of the major requirements of Section 404).

66. Sarbanes-Oxley Act § 404(a).

67. CRA INT'L, SARBANES-OXLEY SECTION 404 COSTS AND IMPLEMENTATION ISSUES:

companies identify and correct internal deficiencies or redesign their current internal controls altogether.⁶⁸ While the burden of an extra report does not seem insurmountable, a company's internal controls touch every aspect of the business.⁶⁹ This expansive reach of internal controls in a company means that the effective documentation of controls will require participation of employees from every department at every level of the hierarchy.⁷⁰ In addition, the external auditors will essentially duplicate this work so that they may report on management's assessment, as well as provide the basis for their own opinion on controls.⁷¹

III. The Aftermath of Section 404

This Part explains how the law of unintended consequences manifested itself in the requirements of Section 404. This rather innocuous Section of a wide-reaching Act would prove to present the largest burden for formal compliance. Even worse, the circumstances surrounding the new legislation proved particularly onerous for smaller companies. These issues elicited a quick response from the SEC, an attempt to address the fears of smaller companies.

SURVEY UPDATE (2005), available at http://www.crai.com/pubs/pub_4896.pdf (describing the requirements of Section 404).

68. See Comment on Section 404 from PricewaterhouseCoopers LLP, to Jonathan G. Katz, Secretary, Sec. & Exch. Comm'n (Apr. 1, 2005), available at <http://www.sec.gov/spotlight/soxcomp/soxcomp-stauffer.pdf> (commenting on corporate actions during the initial year of Section 404 implementation) [hereinafter PricewaterhouseCoopers Comment]; see also *Learning to Love Sarbanes-Oxley*, BUSINESSWEEK ONLINE, Nov. 21, 2005, http://www.businessweek.com/magazine/content/05_47/b3960113.htm (discussing the benefits companies have experienced as a result of Section 404) (on file with the Washington and Lee Law Review).

69. See JAMES HAMILTON & N. PETER RASMUSSEN, GUIDE TO INTERNAL CONTROLS UNDER SECTION 404 OF THE SARBANES-OXLEY ACT 17-19 (2004) (defining internal controls). The authors state: "[T]he scope of internal control extends to policies, plans, procedures, processes, systems, activities, functions, projects, initiatives, and endeavors of all types at all levels of a company." *Id.* at 19.

70. See *id.* at 18 (explaining that internal control is "effected by an entities board of directors, management, and other personnel").

71. See PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD AUDITING STANDARD NO. 2, AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS ¶¶ 4-6 (2005), available at http://pcaobus.org/Rules/Rules_of_the_Board/Auditing-Standard_2.pdf (establishing the auditor's objective in an audit of internal controls).

A. Unexpected Costs

The SEC immediately recognized that Section 404 would impose a significant burden upon companies.⁷² In the subsequent months, however, estimated costs continued to rise.⁷³ One report estimated that the costs of compliance were likely to be twenty times that of the SEC's initial estimate.⁷⁴ These skyrocketing estimates have caused an increasing number of executives to question whether the benefits from compliance are worth such costs.⁷⁵

These compliance costs can effectively be separated into two major categories: internal compliance costs and external auditor expenses.⁷⁶ The internal costs are the costs of the company designing, documenting, and testing internal controls.⁷⁷ Most companies experienced significantly more expenses than they anticipated, as a result of significant documentation and remediation efforts for their internal control structures.⁷⁸

More importantly, companies incur these costs disproportionately to their size. One study showed that larger companies expended \$7.3 million in their first year of compliance, while smaller companies expended \$1.5 million.⁷⁹

72. See Securities Act Release No. 33-8238, Exchange Act Release No. 34-47986, Investment Company Act Release No. IC-26068, [2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,023 (June 5, 2003) (estimating the annual cost of compliance with Section 404(a) to be \$1.24 billion).

73. See ALEX DAVERN ET AL., AM. ELECTRONICS ASS'N, *SARBANES-OXLEY SECTION 404: THE 'SECTION' OF UNINTENDED CONSEQUENCES AND ITS IMPACT ON SMALL BUSINESS 6* (William T. Archey ed., 2004), available at <http://www.aeanet.org/soxreport> (charting the increase in estimated costs from June 2003 through December 2004).

74. See *id.* at 6 (estimating total costs of Section 404 to be \$35 billion).

75. See, e.g., J. Hodges, *Sarbanes-Oxley: After the Honeymoon*, INTERNAL AUDITOR, Oct. 2003, http://findarticles.com/p/articles/mi_m4153/is_5_60/ai_110221996 (documenting that only thirty percent of executives surveyed had a favorable opinion of the act).

76. See CRA INT'L, *supra* note 67, at 11 (explaining the costs involved in Section 404 implementation). "Internal compliance costs" include the cost of hours expended by issuer personnel, fees paid to providers other than the independent auditor. *Id.* This term also includes expenses related to the training and hiring of new staff, and additional acquisitions, such as software. *Id.* "External auditor expenses" represent only the portion of the audit fee attributed to the incremental audit procedures required to audit the issuer's internal controls in compliance with Section 404. *Id.* at 12.

77. See PricewaterhouseCoopers Comment, *supra* note 68, at 6 (commenting on Section 404 after one year of implementation).

78. *Id.* at 5. PricewaterhouseCoopers estimates that these two activities accounted for approximately forty percent of all time spent on Section 404 compliance. *Id.*

79. See CRA INT'L, *supra* note 67, at 5-6 (investigating the first and second year costs of implementing Section 404). The survey defined companies with a market capitalization greater than \$700 million as large companies and companies with a market capitalization of \$75 million to \$700 million as small companies. *Id.*

While these figures show that larger companies bear a heavier burden, the costs as a percentage of revenue are significantly higher for smaller companies.⁸⁰ One study estimates that these costs as a percentage of revenue increase exponentially as the company's market capitalization decreases.⁸¹ Advocates for smaller companies assert that this discrepancy is the result of a one-size-fits-all approach to compliance, in that the same standard of compliance a \$5 billion company uses is applied to an \$80 million company.⁸² These advocates have denounced Section 404 as a "regressive tax on small and medium companies."⁸³

B. The SEC Responds to the Small Business Community

Proponents of smaller companies quickly made these disproportionate costs known to the SEC.⁸⁴ Within one month of the initial stage of compliance with Section 404, the SEC had established a taskforce to make recommendations on tailoring the current rules to be more compatible with smaller companies.⁸⁵ The SEC specifically directed this taskforce, the Securities and Exchange Commission Advisory Committee on Smaller Public Companies (the Advisory Committee), to assess the effects of the current regulatory system upon smaller companies and recommend changes that may be needed.⁸⁶ The Advisory Committee's main objective is to consider the cost-benefit relationship between investor protection, the current regulatory system, and capital formation by smaller companies.⁸⁷

80. *Id.* The survey found that small companies' implementation costs as a percentage of revenue were 0.46%, while for large companies that figure was only 0.09%. *Id.*

81. *See* DAVERN, *supra* note 73, at 5 (estimating that a company with less than \$100 million in market capitalization will expend 2.55% of their revenues on Section 404 compliance).

82. *See id.* (describing the inequitable nature of holding small and large companies to the same standards).

83. *Id.* (discussing the inverse relationship between a company's size and the percentage of their revenue dedicated to Section 404 costs).

84. *See* Andrew Parker, *SEC to Consider Rules for Small Companies*, FIN. TIMES (LONDON), Dec. 17, 2004, at 27 (stating that the SEC acted upon a wave of complaints in considering specialized rules for smaller companies).

85. *Id.*

86. Sec. & Exch. Comm'n Advisory Committee on Smaller Pub. Cos. Charter art. B (Mar. 23, 2005), available at <http://sec.gov/rules/other/acspc-charter.pdf>. The Advisory Committee's final report is due to be submitted to the SEC by April 23, 2006. Press Release, U. S. Sec. & Exch. Comm'n, SEC's Advisory Committee on Smaller Public Companies Solicits Comments on Draft Final Report (Mar. 3, 2003), <http://www.sec.gov/news/press/2006-32.htm> (on file with the Washington and Lee Law Review).

87. Sec. & Exch. Comm'n Advisory Committee on Smaller Pub. Cos. Charter art. B, Mar.

In a further gesture of good faith towards smaller companies, the SEC twice postponed the compliance date by one year.⁸⁸ Stressing the importance of Section 404, the SEC provided these extensions to allow smaller "companies to devote the necessary resources to make sure those requirements are implemented effectively."⁸⁹ To allow the Advisory Committee to complete its work and to gather additional market information, the SEC provided another one-year extension to these smaller companies.⁹⁰ Emboldened by a third extension, advocates for smaller businesses increased their assault on Section 404.

IV. The Small Business Question: To Comply or Not to Comply?

This Part outlines the three consequences of Section 404 that small businesses view as most crippling. These factors provide the basis of the small business argument for substantial relief from Section 404. However, this Part provides recent evidence showing that these factors are much more manageable than companies have anticipated. As a result, the small business community does not need the drastic measures they have hastily proposed. Ultimately, this section proposes a staggered implementation approach that allows small businesses to comply with Section 404 in a manageable fashion.

23, 2005, <http://sec.gov/rules/other/acspc-charter.pdf>. The Advisory Committee released some preliminary recommendations in December of 2005. SEC. & EXCH. COMM'N ADVISORY COMM. ON SMALLER PUB. COS., PRELIMINARY REPORT OF THE INTERNAL CONTROLS SUBCOMMITTEE (2005) (on file with the Washington and Lee Law Review). The Advisory Committee recommended companies with market capitalization of less than \$700 million should be exempted from the external audit requirements of Section 404. *Id.* Much of the basis of these recommendations appears to come directly from the American Electronics Association (AEA) report. *Id.* Many of the assumptions and conclusions in this AEA report are becoming questionable as more data becomes available. See *infra* Part IV.B (providing evidence that compliance costs are not as significant as many believe).

88. See Securities Act Release No. 33-8545, Exchange Act Release No. 34-51293, 84 S.E.C. Docket 3226 (Mar. 2, 2005) (extending the compliance date for non-accelerated and foreign filers to the fiscal year ending on or after July 15, 2006); Securities Act Release No. 33-8392, Exchange Act Release No. 34-49313, Investment Company Act Release No. IC-26357, S.E.C. Docket 673 (Feb. 24, 2004) (extending the compliance date for non-accelerated and foreign filers to the fiscal year ending on or after July 15, 2005).

89. Press Release, U. S. Sec. & Exch. Comm'n, Extension of Compliance Dates for Non-Accelerated Filers and Foreign Private Issuers Regarding Internal Control Over Financial Reporting Requirements (Mar. 2, 2005), available at <http://www.sec.gov/news/press/2005-25.htm> (on file with the Washington and Lee Law Review).

90. See Securities Act Release No. 33-8618, Exchange Act Release No. 34-52492 (Sept. 22, 2005), <http://www.sec.gov/rules/final/fr33-8618.pdf> (extending the compliance date for non-accelerated and foreign filers to the fiscal year ending on or after July 15, 2007).

A. The Small Business Argument

Small businesses are the backbone of the American economy.⁹¹ They employ more than half of all private sector employees and create the majority of the nonfarm private gross domestic product.⁹² Representing over ninety-nine percent of all employers, they are responsible for sixty to eighty percent of net new jobs each year.⁹³ These contributions show how vital small businesses are to the well being of the economy; any overbearing or restrictive policies could potentially have devastating effects.⁹⁴

Small businesses claim that forcing them to adhere to Section 404 would have a chilling effect on the economy.⁹⁵ This chilling effect results not just from the extensive resources utilized in formal compliance with the provision, but also from a significant disincentive for small companies to become or to remain public.⁹⁶ One survey of mid-sized companies found that the average cost of being a public company has nearly doubled in the wake of Sarbanes-Oxley.⁹⁷ Advocates for small business believe these increased costs are the impetus behind the increase in companies opting to delist their shares instead of accepting the burdens and costs of Sarbanes-Oxley.⁹⁸ In 2003, 198 companies chose to delist their shares, approximately three times the amount of companies that delisted in the previous year.⁹⁹ In 2004, the number of companies delisting remained high with another 134 deregistering.¹⁰⁰ Most companies that have

91. See Cynthia A. Glassman, Comm'r, Sec. Exch. Comm'n, Remarks before Government-Business Forum on Small Business Capital Formation (Sept. 23, 2003), <http://www.sec.gov/news/speech/spch092203cag.htm> (discussing the importance of small business to the American economy) (on file with the Washington and Lee Law Review).

92. See *id.* (providing statistics regarding the contributions of small businesses).

93. *Id.*

94. See *id.* (discussing why the SEC considers the repercussions of expansive regulation carefully).

95. See Nathan Wilda, Comment, *David Pays for Goliath's Mistake: The Costly Effect Sarbanes-Oxley Has on Small Companies*, 38 J. MARSHALL L. REV. 671, 684-85 (2004) (positing possible results of Sarbanes-Oxley Act on the economy).

96. See Glassman, *supra* note 91 (relating complaints that these compliance costs are acting as a disincentive to become public).

97. See Tamara Loomis, *Cost of Compliance Soars After Sarbanes-Oxley*, N.Y. L.J., May 1, 2003, at 1 (citing a Foley & Lardner study that showed the average cost of being public increased from \$1.3 million to \$2.5 million).

98. See *Study: Scrutiny, Costs Fuel Rise in Delistings*, CHI. TRIB., Dec. 14, 2004, at C3. (citing a Wharton School of Business study on the increase of delistings following Sarbanes-Oxley).

99. *Id.*

100. See Amy Feldman, *What Does Sarbanes-Oxley Mean for Companies That Want to Go Public?*, INC. MAGAZINE, Sept. 2005, at 138 (describing the results of a Wharton School of

delisted claimed to have done so to avoid the significant costs of regulation.¹⁰¹ The inability of small companies to access the public markets presents a major problem for both the job market and the economy in general.¹⁰² The inability to access cheaper capital severely impacts the prospects of a small company attempting to expand.¹⁰³ Small business advocates claim that all of these unintended consequences are proving that the one-size-fits-all approach of Sarbanes-Oxley and, more specifically, that Section 404 does not properly balance the costs of compliance against the benefits gained by investors.¹⁰⁴

Advocates for small business have even advanced the argument that any benefits gained by the investing public are not worth the cost of compliance. They claim that the investing public is already aware of the added risk that is inherent in an investment in small business. Therefore, Section 404's additional protections, involving more reliable financial statements, would not benefit the type of person that typically would invest in smaller companies. Advocates for small business also argue that complying with Section 404 would give investors a false sense of security in small companies.¹⁰⁵ This false sense of security would attract investors that are not prepared for the inherently more risky nature of these companies to small companies.

This false sense of security comes directly from the failure of Section 404 to accomplish its purpose. Small businesses point to a study by the Association of Certified Fraud Examiners that shows internal controls are less likely to discover a million-dollar fraud than discovery by accident.¹⁰⁶ Executives of smaller companies are significantly more involved in daily operations than in larger companies, which further exacerbates the problem.¹⁰⁷ This significant

Business study).

101. See *Study, supra* note 98, at C3 (citing a Wharton School of Business study on the reasons for the increase of delistings in the wake of Sarbanes-Oxley). These claims must be viewed skeptically, as the study also found evidence that companies delisted to "evade the outside monitoring and additional scrutiny." *Id.*

102. See Glassman, *supra* note 91 (discussing the expansive effects of hindering small business growth).

103. *Id.*

104. See, e.g., J. Hodges, *Sarbanes-Oxley: After the Honeymoon*, INTERNAL AUDITOR, Oct. 2003, http://findarticles.com/p/articles/mi_m4153/is_5_60/ai_110221996 (documenting that only thirty percent of executives surveyed had a favorable opinion of the act) (on file with the Washington and Lee Law Review).

105. See DAVERN, *supra* note 73, at 2 (stating that one of Section 404's main problems is that it will provide "investors a false sense of security").

106. See *id.* at 4 (showing that in million dollar fraud schemes internal controls uncovered eight percent while eighteen percent were discovered by accident).

107. See *id.* at 5 (claiming that internal controls can easily be circumvented by executives at small companies).

level of involvement by executives provides them with a greater ability to circumvent internal controls and perpetrate a devastating fraud.¹⁰⁸ Small businesses contend that the other provisions of the Sarbanes-Oxley Act can protect investors against these issues more efficiently.¹⁰⁹

To remedy the perceived injustices done to small companies through this reform, proponents of small business have offered three major categories of reforms: (1) Make compliance voluntary for smaller companies,¹¹⁰ (2) exempt smaller companies,¹¹¹ or (3) tailor the regulations to provide a more cost effective approach for smaller companies.¹¹² Each of these proposals has significant advantages but comes at an extraordinary expense to investors.

1. Voluntary Compliance

Proponents of providing companies with the option of voluntarily complying with Sarbanes-Oxley claim that this approach will ease the burden on these companies at no expense to the investing public.¹¹³ The simplest method of voluntary compliance follows the "check-the-box" method of taxation.¹¹⁴ The "check-the-box" method of taxation allows unincorporated entities to choose to be taxed as a pass-through entity or as a corporate entity by checking the appropriate box on their tax form.¹¹⁵ The goal of the "check-the-box" method is to end the uncertainty experienced by unincorporated entities in determining their taxation structure.¹¹⁶ This simplified approach to taxation has

108. *Id.*

109. *See id.* at 14 (identifying the Sarbanes-Oxley Act's cost effective provisions).

110. *See* J. Brent Wilkins, Comment, *The Sarbanes-Oxley Act of 2002: The Ripple Effects of Restoring Shareholder Confidence*, 29 S. ILL. U. L.J. 339, 355-56 (2004) (proposing that smaller companies be allowed to voluntarily adopt Sarbanes-Oxley reforms if they so choose).

111. *See* Castelluccio, *supra* note 31, at 470 (proposing an exemption from Section 404 for small companies).

112. *See* DAVERN, *supra* note 73, at 8 (urging the SEC to adjust Section 404 to make it more equitable to smaller companies).

113. *See* Wilkins, *supra* note 110, at 356 ("[G]iving public companies the election option regarding Sarbanes-Oxley will not harm the investing public.").

114. *See* 26 C.F.R. § 301.7701-3 (2004) (allowing an unincorporated entity the ability to elect pass-through or corporate taxation by checking a box on the tax form).

115. *Id.*

116. *See* Victor E. Fleischer, "If It Looks Like A Duck": *Corporate Resemblance and Check-The-Box Elective Tax Classification*, 96 COLUM. L. REV. 518, 531 (1996) (discussing the expected benefits of the "check-the-box" approach). Prior to adoption of the "check-the-box" method, unincorporated entities were required to invest significant resources to have lawyers determine if the entity's structure required partnership or corporate tax treatment. *Id.* Many smaller entities were unable to afford these services, "subjecting them to uncertain tax

eased the burden these entities have experienced in requiring outside counsel under the prior rules.¹¹⁷ Proponents feel this approach would have a similar effect on companies if utilized as an approach to relief from Sarbanes-Oxley reforms.¹¹⁸ Under this method, companies could pick and choose which, if any, portions of Sarbanes-Oxley they will comply with after significant analysis.¹¹⁹ This voluntary compliance approach to Sarbanes-Oxley will allow companies to expend resources on government regulations when such expenditures would not interfere with business objectives.¹²⁰ In doing so, smaller companies will not delist, and private companies will not be scared from venturing into the capital markets, as they are likely to do under mandatory compliance with the Sarbanes-Oxley Act.¹²¹ Maintaining the attractiveness of the capital markets will allow smaller companies to continue to utilize the markets to raise capital effectively.¹²² By retaining the attractiveness of the capital markets for smaller public and private companies, this elective approach will protect investors from being harmed by a loss of information. Although these companies will not comply with the Sarbanes-Oxley Act, they will still be subject to the SEC's other reporting requirements.¹²³ These other reporting requirements would provide investors with significantly more information than if these companies were to delist.

treatment." *Id.* "Check-the-box" taxation has limited these burdensome legal expenses for larger companies and removed uncertainty from smaller companies. *Id.* at 531-32.

117. *See id.* at 531 (discussing the reasoning behind adopting the "check-the-box" approach).

118. *See Wilkins, supra* note 110, at 356 (stating that a "check-the-box" approach would allow companies to apply a cost-benefit analysis prior to complying with any provisions of Sarbanes-Oxley).

119. *See id.* at 356 (advocating that the "check-the-box" approach allows companies to make the compliance "decision at the business level").

120. *See id.* (advocating the "check-the-box" approach to allow companies the ability to escape overly burdensome regulations).

121. *See id.* (proposing that an elective approach to Sarbanes-Oxley would not bar companies with insufficient resources to dedicate to compliance from the capital markets). Some commentators have begun to question how many companies will actually leave the public markets in order to "avoid[] regulatory compliance costs because being a public company is so advantageous." Andrew Skouvakis, Comment, *Exiting the Public Markets: A Difficult Choice for Small Public Companies Struggling with Sarbanes-Oxley*, 109 PENN ST. L. REV. 1279, 1296 (2005).

122. *Wilkins, supra* note 110, at 356.

123. *See id.* at 356-57 (hypothesizing that a mandatory approach to compliance would result in companies delisting in significant numbers to avoid the costs of compliance). Those companies would no longer be subject to the SEC's other requirements. *Id.* This would harm investors by reducing the transparency of these companies' financial health. *Id.* By keeping these companies under SEC regulation, investors will still have significant assurances concerning the information provided by these companies. *Id.* at 356-57.

This argument also contends, however, that companies that choose not to comply with Sarbanes-Oxley will suffer at the hands of the marketplace. Investors will have knowledge of which companies have chosen not to comply with the provisions of Sarbanes-Oxley and will accordingly alter the stock prices of these companies.¹²⁴ As a result, regulation will eventually occur within the marketplace itself, at a more efficient level than when regulated by the SEC.¹²⁵

Despite the perceived advantages of this proposal, small business will not experience these suggested benefits because of three fundamental flaws. First, by allowing companies to comply electively with the regulations of Sarbanes-Oxley, confusion would reign supreme, as investors would have no easy method to determine which companies have complied with Sarbanes-Oxley and which have not. The resulting uncertainty would force investors to follow each of their investments intensely so they could act appropriately on any change in a company's compliance position. This uncertainty would also greatly affect small investors that typically invest in mutual funds. Unless a mutual fund was established as a "compliance only" fund, investors would be unable to ensure that they were investing in compliant companies without devoting significant study to the complex prospectus for that particular fund. This intense level of dedication would frighten casual and long term investors from participating in the markets, removing significant amounts of capital in the process.

Second, this approach assumes that sufficient information is available for the marketplace to reflect appropriately a company's compliance stance in the share price. This proposal also assumes that larger investors will be able to apply pressure on companies, forcing them to comply. These assumptions may be correct for larger companies, but smaller companies garner little in the way of attention from institutional investors, analysts, or the media.¹²⁶ Without sufficient information a market cannot efficiently adjust a company's stock price. This removes the key motivation for self-regulation in the marketplace. Further, as institutional investors do not follow smaller companies,¹²⁷ the

124. See Wilkins, *supra* note 110, at 357 (hypothesizing that an efficient marketplace will utilize a company's decision to comply with Sarbanes-Oxley in calculating the share price).

125. See *id.* at 357-58 (predicting that self-regulation by the marketplace is preferable "because 'market actors' will be informed and motivated to ensure the propriety of financial disclosures"). Wilkins provides an example of this by highlighting the actions of the Vanguard Group, the second largest mutual fund company in the United States. *Id.* at 358. The Vanguard Group is using its financial might to force companies to comply with the new regulations. *Id.*

126. Arthur Levitt, Jr., Commentary, *A Misguided Exemption*, WALL ST. J., Jan. 27, 2006, at A8.

127. See *id.* (stating that most institutional investors avoid smaller companies because of the increased financial risk).

pressure for a company to change its stance on compliance would have to come from an individual investor. That any individual investor acting alone would have sufficient clout to exert sufficient pressure on a company for it to opt to self-regulate is very unlikely.

Finally, assuming that sufficient information is available to regulate the marketplace efficiently, then this proposal would fail to provide small businesses with any relief. The central purpose of allowing companies to comply voluntarily with Sarbanes-Oxley is to prevent regulation from inhibiting access to capital markets in order to allow companies to raise capital inexpensively.¹²⁸ However, if a company that does not comply with Sarbanes-Oxley experiences a drop in stock price, the cost of raising capital in the equity markets for that company will be significantly increased. Therefore, raising capital through the stock market is no more attractive for companies that choose not to comply than for companies under a mandatory compliance scheme.

Voluntary compliance would likely have a drastic effect on the marketplace by causing mass confusion among investors or permitting smaller companies to escape retribution for not complying with Sarbanes-Oxley. If the markets could effectively deal with these issues, small companies would be unable to utilize the equity markets as a source of cheap capital without complying with the reforms of Sarbanes-Oxley. As a result, this proposal is unlikely to provide small business with an effective source of relief.

2. Exemptions from Compliance

Two alternative proposals could also help exempt smaller companies from compliance. One recommends a complete exemption.¹²⁹ The other recommends an application process, granting an exemption upon a showing that compliance would impose a significant hardship.¹³⁰ These proposals also center on the overly burdensome costs of compliance effectively barring smaller companies from participation in capital markets.¹³¹ However, these

128. See Wilkins, *supra* note 110, at 356 (proposing an elective approach to Sarbanes-Oxley so that companies would not lose easy access to capital markets, an important source of cheap capital).

129. See Castelluccio, *supra* note 31, at 470 (suggesting an exemption from Section 404 for small companies).

130. See Wilda, *supra* note 95, at 690 (maintaining that companies should be allowed to apply for an annual exemption from compliance with Sarbanes-Oxley). Although this is a separate proposal, it will be discussed with the outright exemption argument because the end result is the same for exempted companies.

131. See Castelluccio, *supra* note 31, at 464 ("[T]he immense and disproportionate

proposals typically only demand an exemption from Section 404, claiming that the other provisions of the Sarbanes-Oxley Act are cost-effective substitutes.¹³² By removing the burdens of Section 404, small companies would still have free access to the capital markets and would continue to be an integral part of the American economy. In addition, the other sections of the Sarbanes-Oxley Act protect investors from the threat of fraud and improper financial reporting.

Despite noble intentions, these proposals do not effectively address the concerns of investors in their attempt to solve the problems perceived by the small business community. As a result, these proposals will also fail to protect small business access to cheap capital in the equity markets because exemptions for small companies would wreak havoc on the capital markets. Two major issues in the capital markets would arise from any exemption for small businesses. First, small businesses would be relegated to a "second-class" status in the marketplace.¹³³ Second, the marketplace likely would need to establish new exchanges or sub-exchanges to handle the companies not subject to Section 404 compliance to ease the confusion on investors.

Small businesses are already at a disadvantage in the marketplace. An exemption from Section 404 would cement small businesses into a "second-class" status. Currently many investors do not invest in smaller companies because of the significantly increased risk associated with investing in a smaller company, such as an increased sensitivity to economic downturns.¹³⁴ If these companies were further removed from oversight through relief from internal controls regulations, the risk associated with smaller companies would increase.¹³⁵ An increase in the risk of the investment would require a risk premium¹³⁶ from these companies.¹³⁷ This risk premium would greatly increase

burden . . . impose[d] on small companies has restricted their access to capital.").

132. *See id.* at 472–73 (proposing that the SEC has other measures that would sufficiently control wrongdoing without the additional costs of Section 404).

133. Levitt, *supra* note 126, at A8.

134. *See id.* (stating that most institutional investors avoid smaller companies because of the increased financial risk). Smaller companies have significantly less resources and less diverse product offerings than larger companies. As a result, these smaller companies have a difficult time weathering economic downturns. At the same time, smaller companies provide almost limitless upside for investors looking to get in to the next Microsoft on the ground floor. This greater sensitivity to economic forces and incredible potential, however, causes the stock prices of smaller companies to be highly volatile. This volatility is one reason why risk averse investors typically do not invest in smaller companies. These risk averse investors do not believe that the potential gains outweigh the possibility of losing their investment.

135. *Id.*

136. A risk premium may be considered as a form of compensation to the investor for tolerating the additional risk of an investment compared to other investments. The riskier an investment is, the higher rate of return an investor will require, such as through a lower initial

their cost of raising capital, significantly decreasing the number of companies that would access the markets as a source of equity.¹³⁸ Additionally, companies that have already tapped the capital markets would find obtaining additional funding less profitable.¹³⁹ This higher cost of capital would "hinder [the] growth [of small businesses] as much as any onerous regulation."¹⁴⁰

The second major problem of holding smaller companies to a different standard than the rest of public companies would be the further stratification of the capital markets. The major exchanges, such as the New York Stock Exchange, have very strict requirements for companies listed with them.¹⁴¹ To accommodate the varying levels of compliance that would apply to companies, either "sub-exchanges"¹⁴² or new exchanges would need to emerge.¹⁴³ The creation of these additional exchanges would impose significant costs on the marketplace. The SEC would have to establish new regulatory schemes in order to follow these less regulated companies properly, increasing the burden on that agency. This increased burden likely would reduce the agency's effectiveness or increase the burden on individual taxpayers to fund the new schemes. The main benefit to the investing public of this expanded stratification is that it would highlight those companies that do not comply with regulation. However, this benefit would increase awareness of the risk of small businesses as an investment vehicle. This increased awareness of risk would raise the cost of raising capital for small business significantly. The additional burden on the SEC and this increased cost of capital is too high a price to pay for simply easing unnecessary confusion in the marketplace.

As a result, providing an exemption from Section 404 does not protect a small company's ability to inexpensively raise capital in the equity markets. In addition, given the costs of the subsequent restructuring of the markets and regulatory environments, an exemption is not a cost-effective method of providing investors with the protections that Congress intended.

stock price or a higher interest rate on a bond issue. Consequently, risky companies raise less capital because they must offer a risk premium.

137. Levitt, *supra* note 126, at A8.

138. *Id.*

139. *Id.*

140. *Id.*

141. See N.Y. Stock Exchange, Listing Standards, <http://www.nyse.com/about/listed/1022221392369.html> (last visited Aug. 17, 2006) ("The Exchange's listing standards ensure the quality and integrity of the NYSE list.") (on file with the Washington and Lee Law Review).

142. A "sub-exchange" would be a secondary listing system on a currently existing exchange.

143. See Wilkins, *supra* note 110, at 355 (discussing a stratified market as an alternative to mandatory compliance with Section 404).

3. Tailor the Requirements of Section 404

The third proposal also centers on the seemingly prohibitive costs of compliance for small businesses. Advocates of tailoring the requirements of Section 404 recommend eliminating significant steps of compliance to ease the burden on small business.¹⁴⁴ This proposal recommends suspending all Section 404 requirements for a significant portion of the capital markets until this section can be tailored properly to the needs of smaller businesses.¹⁴⁵ The ultimate goal of tailoring the requirements of Section 404 is to allow small businesses to comply at a price that is easily digestible by their executives.¹⁴⁶

This proposal, while the most reasonable approach suggested, would not adequately provide consumers with the protections of Section 404 and would not deliver any real value for small businesses. Tailoring the requirements of Section 404 and holding smaller businesses to a different standard than the remaining marketplace raises the same market confusion and stratification problems raised under the other two proposals.¹⁴⁷ In addition, holding smaller businesses to a lesser standard will harm, not help, investors. While eliminating or easing the costs of compliance will potentially provide investors with a more immediate return on their investment, the costs of non-compliance are too great. In the five years before 2004, nearly three-quarters of all financial restatements were from smaller companies.¹⁴⁸ This evidence shows that smaller companies are in need of just as much, if not greater, regulation than larger companies.

While these three proposals appear to be very different, they diverge from each other only in the degree of relief from compliance that they offer. Each of the proposals intends to relieve the direct and indirect cost burdens of Section 404. These proposals, however, are nothing more than a "hasty, panicked reaction,"¹⁴⁹ similar to the actions of Congress that brought about the Sarbanes-Oxley Act.

144. See DAVERN, *supra* note 73, at 9–12 (proposing ten cost-saving changes to current Section 404 compliance requirements).

145. See *id.* at 12–13 (recommending that Section 404 compliance be suspended for all companies with a market capitalization of less than \$1 billion).

146. See *id.* at 12 (recommending that Section 404 be tailored so that annual compliance costs are approximately \$91,000).

147. See *supra* Part IV.A.1–2 (illustrating negative effects from providing small companies with relief from Section 404 compliance).

148. Levitt, *supra* note 126, at A8 ("[N]early three-quarters of financial restatements were reported by companies with annual revenues of less than \$500 million.").

149. Hamilton, *supra* note 2, at 49 (quoting Professor Larry Ribstein).

The initial problems for large companies complying with Section 404 have scared small business executives. These executives feel that the overly burdensome costs of formal compliance will produce a ripple effect that magnifies the harm of Section 404. This fear has pushed the small business community to demand significant relief from Section 404. However, President Bush has already declared that "we won't let fear undermine our economy,"¹⁵⁰ certainly not when these fears are unfounded to a great extent.

B. Saving Small Businesses from Themselves

The efforts of the proposals described in Part IV.A to reverse or prevent the perceived damage of the Sarbanes-Oxley Act would result in greater unintended consequences for small businesses¹⁵¹ than those that have extended from the current regulations. Consequently, this Note proposes that small companies and the investing public are served best by a staggered implementation of Section 404 over three years, with full compliance due by the end of the third year. Smaller companies that are already subject to the requirements of Section 404 should be excused from having an external auditor opine on their internal controls for two annual reporting cycles. However, so that these companies do not regress during this period, the external auditor would still need to provide a review of the internal controls. The reprieve would effectively delay the more expensive audits of internal controls of qualified companies. Under this approach, companies will disperse the costs and pressures of implementing Section 404 over a greater time period. In addition, this proposal allows those companies that have already made the initial investment into Section 404 compliance to have a hiatus from the more expensive audit process and allows the external audit community to develop more cost-effective methods of auditing internal controls. This staggered implementation process relieves small businesses of the burden of enduring the hefty initial investment of compliance in a short period, and the investing public will benefit from the added protection of Section 404 in every public company. The following three sections will seek to explain the basis and reasoning for this approach to implementation.

150. President George Bush, Remarks at Madison Central High School in Madison, Mississippi, 38 Weekly Comp. Pres. Doc. 1319, 1322 (Aug. 7, 2002), available at <http://www.whitehouse.gov/news/releases/2002/08/20020807-1.html> (providing justification for the recent corporate reforms, including the Sarbanes-Oxley Act).

151. See *supra* Part IV.A (discussing the negative consequences of providing small businesses with relief from Section 404 compliance).

1. Rapidly Declining Costs of Compliance

The direct costs of compliance are the main motivation behind the small business community seeking relief from Section 404.¹⁵² While the costs of compliance for Section 404 are much higher than originally anticipated, small companies will find that compliance costs will be cheaper than they are expecting. Some of the negative attention that small business places on high compliance costs is deserved, but much of these worries are the result of insufficient or incomplete information.¹⁵³ Even with the two-and-a-half year delay between the passage of the Sarbanes-Oxley Act and the issuance of the first reports under the new requirements, the authorities at the SEC and PCAOB still have not provided sufficient information and guidance to implement the requirements effectively and efficiently.¹⁵⁴

Initial guidance did not come from authorities until five months prior to the first fiscal year end before compliance was expected.¹⁵⁵ Authorities clarified and expanded upon this guidance over the next six months.¹⁵⁶ As a result, many companies attempting to comply with the legislation found themselves short of the actual requirements that eventually were set forth.¹⁵⁷ This delay in guidance resulted in an extraordinary duplication of efforts, as many tasks needed to be redone.¹⁵⁸ The small companies that have yet to comply with Section 404 will have the benefit of being able to follow the agency guidance available from the onset. As a result, smaller companies seeking for the first time, to comply with Section 404, should see a significant reduction in their initial compliance investment.

152. See DAVERN, *supra* note 73, at 4 (listing seven perceived flaws with Section 404, six of which are related to compliance costs).

153. See *id.* at 6 (estimating the cost of compliance with Section 404 to be \$35 billion). In July 2004, Financial Executives International (FEI) released a study that estimated compliance costs to be approximately \$21 billion. *Id.* Five months later, in December 2004, the American Electronics Association estimated compliance costs to be \$35 billion. *Id.* According to their report, this increase of \$14 billion dollars was based on estimates from the earlier FEI study and conversations with member CFOs. *Id.* This methodology appears very unlikely to yield a reasonable method of estimating total compliance costs across all industries.

154. See PricewaterhouseCoopers Comment, *supra* note 68 (commenting on an SEC release that interprets Sarbanes-Oxley).

155. LARRY E. RITTENBERG & PATRICIA K. MILLER, *SARBANES-OXLEY SECTION 404 WORK: LOOKING AT THE BENEFITS* 17 (2005) (noting that initial guidance was not released until June 2004).

156. *Id.* Many believe that the guidance the SEC has made available is still insufficient. *Id.*

157. *Id.* (observing that the companies that had tried to comply with Section 404 were forced to rework much of what they had already completed).

158. *Id.*

In addition to, and somewhat as a result of, the lack of official guidance, both auditors and companies were developing a methodology for complying with Section 404.¹⁵⁹ As a result, companies were inefficient and performed unnecessary work during the initial compliance process.¹⁶⁰ As of early 2006, external auditors and public companies have completed two years of compliance work and a body of "best practices" is now beginning to emerge.¹⁶¹ A recent survey of companies finishing their second year of compliance work found that "improved efficiency because of progress on the learning curve" was the second-most identified source of savings between year one and year two compliance costs.¹⁶² As of the proposed full compliance date, external auditors and companies from all industries will have completed at least four reporting cycles. By this time, the methodology and processes used in meeting the requirements of Section 404 should have improved significantly. These improvements should again produce significant savings in the initial compliance costs for smaller companies, especially given the significant savings already experienced in a single year.

The requisite extensive documentation of internal controls is the most burdensome portion of first-year compliance costs.¹⁶³ While regulations have required the maintenance of effective internal controls since 1977, most companies have not documented their controls at a level of detail that would have made complying with Section 404 quick or easy.¹⁶⁴ This lack of documentation is the direct result of executives not providing internal controls

159. See *id.* at 16 (observing that initial compliance work was done with methods developed during the audit engagements); PricewaterhouseCoopers Comment, *supra* note 68 (noting that "management and external auditors were learning, interpreting, and applying Section 404 . . . on a real-time basis").

160. See RITTENBERG & MILLER, *supra* note 155, at 17 (observing that companies began compliance work without proper guidance); see also PricewaterhouseCoopers Comment, *supra* note 68 (noting that significant costs of compliance are attributable to uncertainty as to the implementation requirements); Press Release, U.S. Sec. & Exch. Comm'n, Commission Statement on Implementation of Internal Control Reporting Requirements (May 16, 2005), <http://www.sec.gov/news/press/2005-74.htm> (stating that "it . . . appears that some non-trivial costs may have been unnecessary, due to excessive, duplicative or misfocused efforts") (on file with the Washington and Lee Law Review).

161. See CRA INT'L, *supra* note 67, at 9 (surveying companies to gather data on the costs of implementing Section 404).

162. *Id.* at 2.

163. See PricewaterhouseCoopers Comment, *supra* note 68 (noting that documentation of controls averaged twenty-five percent of all compliance efforts); CRA INT'L, *supra* note 67, at 9 (documenting the costs of implementing Section 404).

164. See PricewaterhouseCoopers Comment, *supra* note 68, at 5 (commenting on how many companies have not documented existing internal controls).

the consideration they should have been receiving.¹⁶⁵ The subsequent documentation of internal controls has required an intensive use of resources.¹⁶⁶ Small businesses will experience cost benefits in two ways that initial companies could not. First, the Sarbanes-Oxley Act has made internal controls an ever-present idea for most executives. As a result, smaller companies have likely made efforts to strengthen their existing internal controls. In addition, significant documentation is likely available for any new processes implemented since the passage of the Sarbanes-Oxley Act. Second, the delay for implementation will provide small businesses with the time to spread the documentation process and costs over a significant period of time. While this ability to absorb costs over time would not produce any true cost savings, small businesses would not have to devote significant amounts of time and money to compliance in a single year.

In addition to first year savings, research shows that annual compliance costs decrease significantly after the first year.¹⁶⁷ In smaller companies, the compliance costs in the second year of compliance decreased thirty-nine percent on average.¹⁶⁸ This decrease directly contradicts the general sentiment of small businesses, which had predicted that costs would remain high through at least three years of compliance.¹⁶⁹ Following this decrease in the costs required to maintain compliance, many companies are already beginning to see significant savings as a result of their Section 404 work.¹⁷⁰

In each scenario regarding compliance costs, significant benefits are to be found in implementing Section 404 over an extended period of time. While no business wants to incur the costs that compliance requires, each passing day shows that the process is no longer the unbearable cost burden that small businesses initially feared. The incremental implementation method should

165. See DAVERN, *supra* note 73, at 15 (noting that most CFOs had never heard of the internal controls framework used as the basis for Section 404, which was developed in the 1980s, prior to the passage of the Sarbanes-Oxley Act).

166. See PricewaterhouseCoopers Comment, *supra* note 68 (noting that documentation of controls averaged twenty five percent of all compliance efforts); CRA INT'L, *supra* note 67, at 9 (revealing that documentation of internal controls represented the greatest proportion of companies' compliance costs).

167. See CRA INT'L, *supra* note 67, at 6 (comparing first and second year costs of compliance with Section 404 for smaller companies).

168. *Id.*

169. See DAVERN, *supra* note 73, at 6 (predicting that compliance costs would remain high in years two and three of compliance).

170. See *Learning to Love Sarbanes-Oxley*, BUSINESSWEEK ONLINE, Nov. 21, 2005, http://www.businessweek.com/magazine/content/05_47/b3960113.htm (discussing the benefits companies have experienced as a result of Section 404) (on file with the Washington and Lee Law Review).

continue to alleviate cost concerns for small businesses—their major reason for opposing the regulation¹⁷¹—as additional facts regarding the true costs and benefits of compliance become available.

2. Regulation Will Not Destroy the Benefits of Being Public

The other significant argument that the small business community makes is that without relief from the current Section 404 requirements, smaller companies will exit the market in mass numbers as the costs of regulation make raising capital in the public markets inefficient. The argument continues that the loss of these investment opportunities will harm the investing public more than requiring small businesses to comply with Section 404 will benefit investors. However, the proposals set forth by small business would have a more devastating effect on the capital markets than mandatory compliance.

As discussed in Part IV.A, two significant issues arise from any proposed relief for small business. First, small businesses would be relegated to a "second-class" status in the marketplace.¹⁷² Second, the marketplace would be thrown into utter confusion over which companies were following which standards. This confusion would likely lead to the development of new exchanges or sub-exchanges to handle the companies not fully complying with Section 404 to ease the confusion on investors.

Currently, the capital marketplace is experiencing a resurgence as a result of renewed "investor confidence, fueled by the implementation of [the Sarbanes-Oxley Act] reforms, including those enumerated in Section 404."¹⁷³ Relief from Section 404 for smaller companies would greatly undermine this newly found confidence.¹⁷⁴ Requiring small companies to comply with the regulation of Section 404 would maintain this confidence, while not affecting the current structure of the capital markets. Under specific guidance from the SEC, investors would know at what level of compliance a company will be during the entire three year implementation project. As the implementation process continues, more investors will be attracted to these smaller companies, a direct result of the increased transparency and assurances given by Section 404's requirements. As more investors are attracted to these smaller companies, the influx of available capital will lower the overall costs of raising

171. See DAVERN, *supra* note 73, at 4 (listing seven perceived flaws with Section 404, six of which are related to compliance costs).

172. Levitt, *supra* note 126, at A8.

173. *Id.*

174. *Id.*

capital, thereby making the capital markets an attractive source of equity for smaller companies, even in the face of the increased regulation.

3. *Strong Internal Controls Achieve Their Purposes*

The final argument that small business makes for relief from Section 404 is that internal controls do not detect and prevent fraud effectively.¹⁷⁵ However, recent evidence shows that financial restatements have increased to record numbers in 2004.¹⁷⁶ This increase in restatements has been primarily attributed to the "scrutiny placed on . . . internal controls" leading to the discovery of an increased number of reporting problems.¹⁷⁷ This evidence confirms that Sarbanes-Oxley and Section 404 are achieving their goal of increasing investor confidence through more transparent financial reporting.¹⁷⁸

Further, small business advocates state that internal controls are not effective in preventing million-dollar frauds.¹⁷⁹ However, this argument is very misleading, as proper internal controls will typically detect fraud before it reaches the million-dollar mark.¹⁸⁰ If anything, small businesses need internal controls more than anyone, as a report has shown that the per-employee losses of small businesses are one-hundred times more costly than the per-employee losses at large businesses.¹⁸¹ This report also suggests that one of the major factors behind this statistic is a lack of sufficient controls.¹⁸²

Finally, Section 404 has benefits outside of fraud prevention and investor confidence. Companies are beginning to realize additional benefits from the

175. See *supra* Part IV.A (summarizing the small business argument against complying with Section 404).

176. See *Report: Restatements Increased at Record Pace in '04*, WEBCPA, Jan. 21, 2005, <http://www.webcpa.com/article.cfm?articleid=10404&print=yes> ("[R]estatements . . . due to accounting errors rose 28 percent in 2004, to a record 414.") (on file with the Washington and Lee Law Review).

177. *Id.*

178. See *supra* note 50 and accompanying text (quoting the purpose of the Sarbanes-Oxley Act).

179. See DAVERN, *supra* note 73, at 4 (providing information from an Association of Certified Fraud Examiners report).

180. See Martin T. Biegelman, *Designing a Robust Fraud Prevention Program*, FRAUD MAGAZINE, Mar./Apr. 2004, <http://www.acfe.com/fraud/view.asp?ArticleID=244> ("[A] common denominator of the recent . . . frauds is that strong internal control systems weren't in place.") (on file with the Washington and Lee Law Review).

181. See Joseph T. Wells, *Protect Small Business*, J. ACCT., Mar. 2003, <http://www.acfe.com/fraud/view.asp?ArticleID=27> (discussing an Association of Certified Fraud Examiners' report) (on file with the Washington and Lee Law Review).

182. *Id.*

implementation of Section 404. These benefits range from significant savings in a company's operations to improving the orientation process for new employees.¹⁸³

The staggered implementation plan will successfully allow small business to comply with Section 404 in a manner that will not hinder future growth. Evidence shows that the costs of compliance have decreased significantly and are no longer as burdensome as initially feared by small business. Furthermore, the consequences of partial or non-compliance for small business in the capital markets can be avoided only by full compliance. Finally, strong internal controls benefit not only the investor, but also the company. Mandatory compliance with Section 404 would force small businesses to invest in themselves, protecting and improving their companies in the process.

V. Conclusion

While the initial response to Section 404 was absolute disgust, time is showing that this may have been too harsh, a knee-jerk reaction without understanding all facets of the reforms. The perceived costs of implementation, while still higher than predicted, have retreated from the levels that small business had feared. In turn, these lower costs of compliance will significantly impact the number of companies that will opt to give up or forego their public status. Although some companies will likely choose to avoid the additional regulation from Section 404, the loss of these companies is a small price to pay for the resulting increase in investor confidence. Finally, the unexpected benefits that have appeared as a result of Section 404 have been significant in the two years that the regulations have been effective.

The main benefit from staggered implementation is that it requires companies to absorb the high initial costs over a stretch of time. One lesson learned from the large companies that have already had to comply with Section 404 is that an extension to comply with Section 404 has been used to merely delay the implementation of their compliance steps.¹⁸⁴ Therefore, companies

183. Pitney Bowes, Inc. is expecting to save over \$500,000 as a result of a consolidation of their accounts receivables offices. *Learning to Love Sarbanes-Oxley*, BUSINESSWEEK ONLINE, Nov. 21, 2005, http://www.businessweek.com/magazine/content/05_47/b3960113.htm (on file with the Washington and Lee Law Review). Another company commented that the documentation required by Section 404 has provided them with employee manuals that allow new employees to be introduced to their functions quickly and properly. *Id.*

184. See Stephen Taub, *No Vacation from Section 404 Prep Work*, CFO.COM, July 14, 2004, <http://www.cfo.com/article.cfm/3015183> (revealing that nearly half of the companies had not completed sixty percent of their preparations approximately four months before the compliance year end) (on file with the Washington and Lee Law Review).

will recognize little of the unexpected benefits from Section 404 if they receive a reprieve from compliance for three years without any required interim progress.

An additional benefit from a three-year implementation is that companies should begin to realize the unexpected benefits of Section 404 compliance before they have fully implemented all of the required reforms. The benefits discussed in this Note were realized by companies one and two years into compliance. With a three-year compliance time frame, small businesses should begin to recognize some of these same benefits. This does not suggest that these companies will recognize the full benefit from compliance before they have completed implementation, but these benefits should begin to accrue prior to that time.

Without a doubt, Congress acted hastily in implementing the Sarbanes-Oxley Act. The underlying purpose of this proposal is to ensure that the same mistake does not occur twice. Section 404 is far from perfect, but if the small business community exercises patience in confronting these regulations, they may realize that Section 404 has become a demon of their own creation. By taking the time to understand all of the implications, both good and bad, of compliance with Section 404, the small business community will be able to provide the SEC with specific reforms that should be implemented to ease the burden on all companies, regardless of size. These specific requests for small but significant reform to Section 404 will produce more productive relief for small business than their current demands.

