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DAVID PAYS FOR GOLIATH'S MISTAKES: THE COSTLY EFFECT SARBANES-OXLEY HAS ON SMALL COMPANIES

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I. INTRODUCTION

Haste and rashness are storms and tempests, breaking and wrecking business; but nimbleness is a full, fair wind, blowing it with speed to the heaven.¹

Over a year has passed since one of the most comprehensive corporate reform bills was written into law.² Congress passed the Sarbanes-Oxley Act³ ("Act") on July 29, 2002 in response to some of the most devastating corporate scandals in American history.⁴ Congress had not faced a crisis like this since the Great Depression, when the Securities Acts of 1933 and 1934 were formed.⁵ President George W. Bush declared that the Act included "the most far-reaching reforms of American business practices

* J.D., The John Marshall Law School, January 2005.

1. Thomas Fuller (1608-1661), http://www.nonstopenglish.com/reading/quotations/A_Thomas-Fuller.asp?page=3 (last visited Mar. 9, 2005).

2. Jennifer S. Recine, Note, *Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act*, 39 AM. CRIM. L. REV. 1535, 1535 (2002). The government had not reacted to a situation in corporate America like this since the Securities Act of 1933 and the Securities and Exchange Act of 1934. *Id.*

3. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 [hereinafter Sarbanes-Oxley Act] (codified as amended in scattered sections of title 15 of the U.S. Code) (enacting a broad range of provisions to assist in the governance of publicly traded companies).

4. See generally Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 923-28 (2003) (addressing the history of securities legislation). The vast corporate scandals, the extent of financial losses to employees and stockholders of the companies involved, and the pressure the public put on a conglomerate of elected officials, all led to the "sweeping reform" known as Sarbanes-Oxley. *Id.* at 917 n.1.

5. See Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 5 (2003). Modern securities regulation was born in 1933 and 1934 in the wake of the Depression. However, before enacting the Securities Acts, Congress carefully studied and considered the pending legislation; the same cannot be said of the Sarbanes-Oxley Act of 2002. *Id.* at 5 n.11.

since the time of Franklin Delano Roosevelt.”⁶

However, critics of the Act describe it as 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.”⁷ Congress reacted to the public’s outrage and dwindling confidence in corporate America by enacting legislation “quickly and without a lot of study,” thus creating unintended consequences.⁸

This Comment reviews the provisions of the Act that are causing small companies to struggle to remain engaged in the public market. Part II reviews the events that unfolded in corporate America in late 2001 and early 2002. Part III discusses the public pressure on the federal government to enact new corporate reform measures. Part IV analyzes the implementation of the Act, as well as the provisions of the Act that are forcing many small companies to consider privatization. Finally, Part V introduces a proposal to exempt small companies from certain provisions of the Act in order to foster entrepreneurship.

II. THE POWER OF GREED

In order to establish the basis for Congress’ decision to pass the Act, it is important to understand the events leading up to this “sweeping reform.”⁹ After a slight downturn in the financial markets in the mid-1980s, investors enjoyed a steady incline for more than ten years, due in large part to the invention of the Internet, the development of technology, and the unprecedented growth in telecommunications.¹⁰ The public’s attitude toward

6. Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1. President Bush’s attempt at reforming corporate America and his solution to the problems that arose in the numerous corporate scandals was signing the Sarbanes-Oxley bill. *Id.* Democrats were quick to point out that the Bush Administration had been forced into signing the bill, however, the issue corralled both political parties in the face of concerns that voters would hold them responsible for corporate fraud and plummeting stock prices. *Id.*

7. Hamilton, *supra* note 5, at 49. Professor Larry Ribstein believes that the Act will not prevent future frauds from occurring any more than the old regulations, and stated the Act will have a “significant chance of imposing substantial costs.” *Id.* Professor Ribstein believes that there is a price to having free markets, and falling stock prices and corporate mistakes are part of that price. *Id.* at 50.

8. Anthony Lin, *One Year After Sarbanes-Oxley Act, Many Officers See Need, but Grumble Nonetheless*, N.Y.L.J., July 31, 2003, at 1. Executives recognized that reform was needed, but the Act is full of onerous requirements that will divert resources and executives away from the activities and responsibilities important to a successful enterprise. *Id.* Even the companies with quality internal controls will spend valuable resources on compliance. *Id.*

9. See Cunningham, *supra* note 4, at 917 (comparing the events leading up to the implementation of Sarbanes-Oxley to the events leading to the passage of the Securities Acts of 1933 and 1934).

10. Hamilton, *supra* note 5, at 6. Investors from all walks of life were

corporate America was generally positive, as investors enjoyed substantial growth in a very bullish market.¹¹ However, the public was unaware of the Securities and Exchange Commission's ("SEC") difficulty in monitoring corporate activity through this incredible growth period.¹²

In the spring of 2000, the American public had a revelation.¹³ Investors began to recognize that the markets were extremely inflated, and consequently began selling off their investments, causing a rapid decline in the financial markets.¹⁴ Then, only eighteen months later, the terrorist attacks on September 11, 2001 sent the financial markets into a frenzy, creating widespread uncertainty within the minds of the investing public.¹⁵ In the aftermath of the attacks, the new war on terrorism took a significant toll on the American economy and pushed it deep into a recession.¹⁶

However, the worst was yet to come for the American investor. Between December 2001 and July 2002, four major U.S. companies filed for bankruptcy: Enron, Adelphia, WorldCom, and Global Crossing.¹⁷ Unfortunately, there was much more to these

getting involved in the markets, as the belief grew that the financial markets could only go up. *Id.*

11. *Id.*

12. *Id.* at 6 n.16. "Filings had grown from 61,295 in 1991 to 98,745 in 2000, but the SEC staff had grown only from 125 to 161." *Id.* Other significant events contributed to this "sweeping reform," such as the decision to allow accounting firms to simultaneously sell auditing services along with management and tax services, and the enactment of the Private Securities Litigation Reform Act of 1995 which made class action suits more difficult in corporate transactions. *Id.*

13. Cunningham, *supra* note 4, at 923. The financial markets had attracted millions of people who had little investment experience but wanted a piece of the action, so unsavvy investors continued to put money into the market in the 1990s, regardless of the prices, and with no real strategy in mind. *Id.*

14. *See id.* (discussing public's realization that a financial bubble was ready to burst). The bubble finally burst and panic set in, creating havoc in the markets and causing investors to frantically pull their money out. *Id.*

15. *Id.* at 923-24 n.35. The New York Stock Exchange closed for a week, while New York City and the world tried to make sense and cope with the tragedy. *Id.* For the first couple of weeks the markets stood strong, but that may have been purely a patriotic effort from a nation in mourning. *Id.* A few weeks later the markets began a steady sell-off that continued for the next year. *Id.*

16. *See generally id.* at 923-24 (describing the tragic events that led to the incredible sell-off in the markets).

17. *See* Recine, *supra* note 2, at 1537 (discussing the effect of four of the six largest corporate bankruptcies in U.S. history happening within one year of each other). WorldCom was the largest corporate bankruptcy in U.S. history with \$107 billion in assets protected; Enron was next at \$63.3 billion, followed by Global Crossing as the fifth largest at \$25.5 billion, and finally Adelphia as the sixth largest with \$24.4 billion in assets protected by the filing. *Id.* at

bankruptcies than just a weak economy.¹⁸ All four companies were involved in fraudulent accounting practices that “hid their true financial conditions” from shareholders, creditors, and the investing public.¹⁹

Enron was the first in the line of corporate debacles and currently has a long list of claims against it related to the financial losses sustained by its investors and employees.²⁰ The company was involved in extensive fraudulent accounting practices and business partnerships that inflated its stock price dramatically.²¹ When Enron was forced to restate its earnings and account for the hidden liabilities, it reported enormous losses resulting in a free-falling stock price.²²

There is evidence suggesting Enron employees lost over one billion dollars due to the company’s appalling practices.²³ Enron had advised employees to purchase Enron stock in their retirement plans, many of whom were wholly invested in the company’s stock.²⁴ However, Enron instituted a blackout period that prohibited employees from selling their shares for a period of time before earnings were restated.²⁵ Remarkably, there is

1537 n.10.

18. *Id.* at 1537.

19. *Id.* These scandals could not have come at a worse time for the American economy. *Id.* The stock market was already suffering through a horrible downward cycle, and that cycle was about to get much worse with the uncovering of the most elaborate accounting scandals in U.S. history. *Id.*

20. *See id.* at 1540 (describing the pending litigation that investors as well as employees have against Enron).

21. *See id.* at 1537-40 (discussing the impact accounting practices had on Enron’s stock prices). Arthur Andersen provided very aggressive auditing techniques, and Enron created complex business partnerships and transactions to place its financial statements in the most positive light. *See* Marianne M. Jennings, *A Primer on Enron: Lessons From a Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures*, 39 CAL. W. L. REV. 163, 173-75 (2003) (discussing in great detail the Enron debacle, and its ripple effect on Arthur Andersen).

22. Hamilton, *supra* note 5, at 10-11. The demise of Enron and the effect the bankruptcy had on Enron employees and their retirement plans was devastating. *Id.* at 11-12. Enron consistently used aggressive accounting techniques that created complex financial statements that were at best difficult to understand. *Id.* at 8. Even the most competent accounting experts had a difficult time deciphering the statements, but finally it was discovered that Enron was claiming that its revenues and profits were increasing when in fact the company’s position was declining. *Id.* at 8-10.

23. *Id.* at 10. Employees of Enron were heavily invested in company stock, as the company had enjoyed fantastic growth since the company’s inception. *Id.* at 12. Also, Enron encouraged its employees to invest in corporate stock, even while executives knew of the stock’s outrageous inflation, suggesting further fraudulent and self-dealing activity. *Id.*

24. *Id.* at 12.

25. *Id.* Enron employees watched their life savings vanish before their eyes as the stock price plummeted. *Id.* There is evidence that suggests while

evidence that Enron executives made hundreds of millions of dollars by selling their shares during the four years prior to the restatement of earnings.²⁶

Likewise, Adelphia Communications was involved in hiding extraordinary amounts of debt, and overstating revenues and cash flow.²⁷ The federal government charged executives of Adelphia with bank, securities, and wire fraud.²⁸ To make matters worse, the government also alleged that the executives of Adelphia used the company's money for personal loans to purchase stock, pay for extravagant vacations, and build a golf course.²⁹ Adelphia listed \$18.6 billion in debt when filing for bankruptcy.³⁰

Next, WorldCom's \$107 billion bankruptcy filing was the largest in United States history.³¹ Executives of WorldCom also allegedly filed false financial statements, which permitted the

employees were prohibited from selling their shares, executives were dumping their stock. *Id.* at 11-12.

26. Nelson Antosh & Tom Fowler, *The Fall of Enron; Execs Earned \$600 Million From Stock Over Last 4 Years*, HOUS. CHRON., Dec. 8, 2001, at A1. Right before filing for bankruptcy, the company made significant distributions to favored officers and employees. See Hamilton, *supra* note 5, at 11-12 (discussing Enron's distribution of millions of dollars in retention bonuses and stock awards just before the company filed for bankruptcy). Executives were also selling their shares of stock before the restatement of earnings. *Id.* The former CEO received in excess of \$67 million, and other individuals received payments of more than \$10 million each. *Id.*

27. Deborah Solomon, *Adelphia Overstated Cash Flow, Revenue Over Past Two Years*, WALL ST. J., June 11, 2002, at B5. Adelphia announced that it hid at least \$2.3 billion in loan guarantees for bank debt of corporate officers, causing the stock to collapse and the company to file for bankruptcy. *Id.* The founders of Adelphia were using the company as their "personal piggy bank[s]" and were charged with looting more than \$1 billion. Andrew Ross Sorkin, *Corporate Conduct: Prosecution; Founder of Adelphia and Two Sons Arrested*, N.Y. TIMES, July 25, 2002, at C1.

28. Andrew Ross Sorkin, *Founder of Adelphia and Two Sons Arrested*, N.Y. TIMES, July 25, 2002, at C1. The Rigas family members received \$1 million in "secret" cash payments each month, and also used company funds to pay off \$252 million in margin calls the family had accumulated at brokerage firms. *Id.* The arrests were carried out in a very public manner despite the offers by the executives to voluntarily surrender. *Id.* The government wanted executives to know that it meant business, and that it was reacting to the outrage of the American public. *Id.*

29. *Id.* The founding members of the company lost all control of Adelphia, forgave \$567 million in debt supposedly owed to them by Adelphia, and turned over \$1.2 billion in cable assets purchased with proceeds from personal loans made to them by Adelphia. *Id.*

30. *Id.* Adelphia was the sixth largest bankruptcy filing in U.S. history. *Id.*

31. Recine, *supra* note 2, at 1542. WorldCom was the second largest long distance carrier and the parent company of MCI. *Id.* Similar to Global Crossing, WorldCom's poor decision to invest heavily in fiber optic cable initiated its demise, and caused it to falsely claim billions in profits. *Id.* at 1542-43.

company to claim incredibly inflated profits.³² As a result, the stock price slipped from sixty dollars per share to less than one dollar per share.³³ Incredulously, as WorldCom was in the process of laying off thousands of employees, the company paid executives in excess of \$280 million in retention bonuses.³⁴

Finally, telecommunications giant Global Crossing was the fourth major U.S. company to suffer an accounting meltdown and contribute to the public's outrage.³⁵ Global Crossing filed for bankruptcy protection in January 2002, stating that it owed \$12.4 billion to creditors.³⁶ However, the CEO made over \$735 million from sales of his personal holdings, and built a \$95 million mansion in Los Angeles.³⁷

In addition to these major corporate scandals, various other publicly traded companies admitted to misconduct and fraudulent accounting practices.³⁸ In many of these situations, executives grotesquely took advantage of their positions by selling their personal shares before they released the true financial condition of their company.³⁹ Executives enjoyed millions of dollars in profits,

32. *Id.* at 1543. See also Sallie Hofmeister, *Debt Puts Strain on Cable Stocks; Telecom: High Cost of Operating and Improper Accounting at Some Firms Weigh Down the Sector*, L.A. TIMES, July 1, 2002, part 3, at 1 (discussing how WorldCom originally reported a profit in 2001 of \$1.4 billion instead of a loss). *Id.* These types of accounting practices raised suspicions in all capital-intensive businesses where there are alternatives for reporting operating expenses. *Id.*

33. Recine, *supra* note 2, at 1543. The company's growth was stunted when regulators would not let WorldCom buy Sprint Corp. Toby Weber, *Sprint, WorldCom Nix Deal*, at http://telephonyonline.com/ar/telecom_sprint_worldcom_nix (July 17, 2000). The combination of poor investment decisions and lack of a new revenue stream influenced WorldCom to massage the books.

34. Recine, *supra* note 2, at 1543. See also Louis Uchitelle, *Turmoil at WorldCom: The Workforce; Job Cuts Take Heavy Toll on Telecom Industry*, N.Y. TIMES, June 29, 2002, at C1 (discussing WorldCom's bankruptcy filing as another crushing blow to an already battered American economy).

35. Dennis K. Berman & Henny Sender, *Winnick May Kick in Funds to Aid Global Crossing Rescue*, WALL ST. J., June 10, 2002, at A1. Global Crossing built a phone network undersea linking many countries and cities, and at one time had a market cap of \$48 billion. *Id.*

36. Hamilton, *supra* note 5, at 25. See also Cunningham, *supra* note 4, at 931 (discussing the formation and demise of Global Crossing). Global Crossing was founded by a former junk bond salesman who took the company public one year after its founding, and enjoyed an inflated market cap of \$40 billion. *Id.* at 930. However, two years later it was bankrupt. *Id.*

37. Hamilton, *supra* note 5, at 25. In two years' time, the CEO and founder of Global Crossing created a \$40 billion company, personally made \$735 million from sales of his own shares, then filed for bankruptcy due to fraudulent accounting practices. Cunningham, *supra* note 4, at 930.

38. See Hamilton, *supra* note 5, at 33-34 (reviewing corporate misconduct that led to the implementation of Sarbanes-Oxley).

39. *Id.* at 34. It was not just the big four bankruptcies that pushed the federal government towards a comprehensive reform package; there was

while shareholders, including the companies' employees, lost everything.⁴⁰

Following these appalling corporate scandals, investor confidence dropped sharply.⁴¹ Federal Reserve Chairman Alan Greenspan stated that "an infectious greed seemed to grip much of our business community . . . leading to a loss of investor confidence in the markets."⁴² It has long been recognized that the primary goal of publicly traded companies should be to maximize the wealth of shareholders; however, recent events illustrate that many corporate executives are much more concerned with personal profit.⁴³ Executive self-dealing has contributed to the demise of investor confidence, as demonstrated by the Dow Jones Industrial Average hitting a five-year low in July 2002, causing many Americans to lose most of the value of their retirement plans.⁴⁴

III. THE GOVERNMENT'S RESPONSE TO THE CORPORATE DEBACLES

The American people voiced their outrage over the actions of corporate executives. The Bush Administration realized it had an angry electorate on its hands,⁴⁵ and the cries for reform were clear and could not be ignored.⁴⁶ At the time, however, the only piece of legislation in the congressional pipeline dealing with corporate governance was the Sarbanes-Oxley bill.⁴⁷ In the weeks before the bill became law, few people gave it much consideration.⁴⁸ Interested parties had not seriously studied the ramifications of

additional fraudulent activity within corporate America that added pressure. *Id.*

40. *Id.* Hard-working Americans were losing their retirement accounts due to fraudulent activity and greed of white collar criminals. *Id.*

41. See Allen M. Putterman, *Winning Confidence*, CHI. TRIB., Aug. 18, 2002, at 8 (discussing the need for quality accounting principles to restore investor confidence).

42. Hamilton, *supra* note 5, at 34. Greenspan commented that the character of corporate officers may not change, but the incentives and penalties for misbehaving can change. *Id.* at 75 n.209.

43. Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1277-82 (1991).

44. Jonathan Fuerbringer, *The Markets: Stocks and Bonds; Stockgauges Fall 2% or More on Job Reports*, N.Y. TIMES, Aug. 3, 2002, at C1.

45. See Recine, *supra* note 2, at 1544 (discussing the attempt to appease the American people with high-profile arrests of Adelphia and WorldCom executives).

46. See Cunningham, *supra* note 4, at 927 (describing the pressure the federal government was under following the Enron scandal to create a new corporate reform package).

47. David S. Hilzenrath, *How Congress Rode a Storm to Corporate Reform*, WASH. POST, July 28, 2002, at A01.

48. *Id.*

the bill,⁴⁹ nor had Congress subjected the bill to the vigorous legislative review that almost always attends complex, business-related legislation.⁵⁰

However, the outraged public looked to Congress for answers, pressuring Congress to enact a bill with limited information regarding the potential impact on corporate America.⁵¹ Accordingly, President Bush signed into law the Sarbanes-Oxley Act the same day it was presented to him,⁵² and he acknowledged acting "amid public outrage at recent staggering stock market losses."⁵³ The political solution to the market catastrophe and high-profile bankruptcies became the Sarbanes-Oxley Act.⁵⁴

The Act was established "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws. . . ."⁵⁵ The Act is expansive and regulates many of the corporate practices that affected the stock market and undermined investor confidence.⁵⁶ The Act modifies governance, reporting, and disclosure rules for public companies,⁵⁷ and bolsters criminal and civil liability for securities fraud.⁵⁸ It also creates a new oversight board for independent audit firms to be paid for by stockholders of public companies,⁵⁹ embraces

49. *Id.*

50. *Id.*

51. See Hamilton, *supra* note 5, at 46 (discussing the legislative history of the Sarbanes-Oxley bill).

52. *Id.* at 46-47.

53. Patricia Wilson, *Bush Says Law Means "Hard Time" for Corporate Crooks*, REUTERS, July 31, 2002, at A1.

54. See Sarbanes-Oxley Act, 116 Stat. 745.

55. *Id.*

56. See Recine, *supra* note 2, at 1549 (reviewing the broad provisions of the Act).

57. Sarbanes-Oxley Act §§ 301-02, 401-09. These sections give the SEC authority to direct the national exchanges and securities associations to prohibit the listing of an issuer not in compliance with these sections of the Act. *Id.* §§ 301-02. These sections also require auditors to be independent, and set forth auditor responsibilities and authority. *Id.* §§ 401-09.

58. *Id.* §§ 801-906. Detailed provisions of the Act address: criminal liability for destruction, alteration, or falsification of documents; non-dischargeable debt if incurred in violation of securities fraud; the statute of limitations for securities fraud; the sentencing guidelines for obstruction of justice and extensive criminal fraud; whistleblower protection; the criminal penalties for defrauding shareholders of publicly traded companies; enhancements of penalties for white-collar crime; criminal penalties for mail and wire fraud; criminal penalties for violations of the Employee Retirement Income Securities Act of 1974; and corporate responsibility for financial reports, including penalties for failure of executive to report or misrepresent. *Id.*

59. *Id.* §§ 101, 109. The Act established a new government agency, the Public Company Accounting Oversight Board ("PCAOB"), to oversee the accounting practices of publicly traded companies. *Id.* § 101. It also describes the duties, responsibilities, and requisite membership qualifications of the PCAOB. *Id.* The PCAOB will be funded by monetary penalties, and

restrictions on audit firms engaging in various non-audit services for their clients,⁶⁰ requires internal control certifications by principal executive officers and principal financial officers,⁶¹ and prohibits corporate loans to directors and executives.⁶²

The Act is not short on skeptics, however, in large part because of how quickly the Sarbanes-Oxley bill became law. As one commentator noted, the Act is "a telling example of the law of unintended consequences."⁶³ One of those consequences is the costly effect the Act is having on small companies in America.⁶⁴ The Act did not make distinctions between small companies and the large corporations that were largely responsible for this sweeping reform.⁶⁵ Many executives complain that the extra costs

accounting support fees collected from issuers. *Id.* § 109.

60. *Id.* § 201. Auditors of an issuer may not perform non-audit services, including: bookkeeping, financial information systems design and implementation, appraisal or valuation services, fairness opinions, contribution-in-kind reports, actuarial services, internal audit outsourcing services, management functions or human resources, broker or dealer, investment adviser, or investment banking services, legal services and expert services unrelated to the audit, and "any other service the Board determines, by regulation, is impermissible." *Id.* However, pre-approval of services not prohibited may be requested. *Id.*

61. *Id.* § 302. The Act requires the principal executive and principal financial officer of an issuer to certify in each financial report filed that: the officer has reviewed the report, the officer does not know of any false or misleading information or the omission of information, the information fairly represents the financial condition of the issuer, the signing officers are responsible for internal controls, the signing officers have disclosed to the issuer's auditors all significant information, and the signing officers have indicated if the issuer has undergone any significant changes in internal controls. *Id.* § 302.

62. *Id.* § 402. The Act addresses conflict of interest provisions, specifically prohibiting personal loans to executives, unless: the loan is made or provided in the ordinary course of the business of the issuer, it is of the type generally made available to the public by the issuer, and the terms are no more favorable than those offered by the issuer to the public. *Id.*

63. Gregory P. Joseph, *Master Class: Corporate Fraud Act*, NAT'L L.J., Aug. 5, 2002, at B9. See also Cunningham, *supra* note 4, at 988 n.46 (stating that Congress rarely names or designates companies within legislation, particularly when it is as encompassing as the Act). However, Congress mentions Enron and Global Crossing in the Act, and thus demonstrates "particularized transgressions at named companies... not systemic infirmities." *Id.* "Given the source of legislative inspiration, it is perhaps unsurprising that the resulting legislation is not the product of a reflective social science orientation gauging the real needs or the cost-benefit assessments of the proper response." *Id.*

64. See Murray Coleman, *More Companies Exit Public Markets; New Accounting Rules Get the Blame Burden for Small Companies*, INV. BUS. DAILY, Aug. 26, 2003, at A01 (discussing the expense of the Act). It is becoming too expensive for new companies to not only attempt to go public, but also to remain public, thus creating difficulty in receiving public financing and growth potential to the level that only the public markets can offer. *Id.*

65. Jim Day, *Sarbanes Boom Far from Over as Final Rules Take Effect*,

of compliance with the Act are crippling smaller companies and driving them out of the market.⁶⁶ How much corporate reform is warranted? At what point do the costs outweigh the benefits? It seems "[t]he right dose of medicine for Goliath may nearly kill David."⁶⁷

IV. THE COST OF A HASTY REACTION

The Act materialized under circumstances that forced Congress to rush to the aid of the American public.⁶⁸ Republicans and Democrats were vying for positive public sentiment and hastily adopted Sarbanes-Oxley in the midst of a poor economy, numerous corporate frauds, and a stock market crash.⁶⁹ In comparison, the Securities Acts of the early 1930s were enacted several years after the stock market crash in 1929.⁷⁰

This hasty reaction caused Congress to give little consideration to the Act's effect upon small companies.⁷¹ Because the Act does not distinguish between large and small companies, the burden of compliance is weighing very heavily on smaller firms.⁷² Executives of small companies are more likely to perceive

CHI. LAW., Aug. 2003, at 62. One of the costly burdens companies are facing derives from the provision in the Act that requires attorneys to report evidence of violations of securities laws. *Id.*

66. Coleman, *supra* note 64. The cost of implementing the Act is forcing many small "healthy" public companies to consider privatizing. *Id.* The added costs and restrictions of the Act are forcing executives' hands. *Id.*

67. Greg Farrell, *Accounting Costs Rising as Wary Companies Play It Safe*, USA TODAY, July 31, 2003, at 2B (discussing that the increase in costs to small companies is a heavy burden compared to the cost of the Act for large companies). This burden is causing small companies to reevaluate the benefits of being a public company, and forcing them to privatize. *Id.*

68. See Cunningham, *supra* note 4, at 941.

69. Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 46 (2002). Professor Ribstein discusses the politics of reform legislation within the securities markets, and how the Sarbanes-Oxley Act was influenced by broad political agendas. *Id.* Democrats saw the corporate frauds as a way to discredit Republican pro-business policy, and the Republicans were not likely to fight the reform measures and appear to side with corporate criminals. *Id.*

70. *Id.* at 3. The time period between the 1929 crash and the Securities Acts of the early 1930s gave Congress time to conduct research and extensive hearings to formulate an appropriate solution, whereas Congress did not take the necessary investigative actions before enacting Sarbanes-Oxley. *Id.*

71. Bill Deener, *Cost to Stay Public Soars for Small Companies; Fees an Unintended Result of Sarbanes-Oxley Act, Accounting Experts Say*, THE DALLAS MORNING NEWS, July 20, 2003, at 1D. The CFO of Abatix Corporation, a Dallas distributor of construction supplies, stated that the new legislation will cost him fifty percent more to be a public company due to the additional regulations. *Id.*

72. Peter Zalewski, *Lawyers and Executives Have Spent Months and Money to Comply with Strict Corporate Governance Law, and More Limits are Coming*, BROWARD DAILY BUS. REV., July 21, 2003, at 11. The Act might

the law's demands as costly.⁷³ It is much easier for large firms to comply with the new legislation because they already operate under fairly strict guidelines or have more human and financial capital available to incorporate compliance measures.⁷⁴

This section analyzes the provisions of the Act that are costing small companies their public status. It discusses how a one-size-fits-all regulatory scheme is causing small companies to dip into shareholders' profits to pay for compliance, and shows how the Act is forcing a significant amount of small companies to consider privatization.⁷⁵

A. Small Companies May Not Survive the Cost of Auditor Independence, Director Fees, and Legal Fees

Congress addressed the role that outside auditors played in the corporate scandals with rigorous regulation. Outside auditors typically review a company's internal controls and financial statements by running various tests and performing reviews of management, technology, and procedures.⁷⁶ Title II of the Act formalizes new guidelines for outside auditors, while Title III addresses the audit committee and corporate responsibility of the members.⁷⁷

Under Title II, outside auditors are required to report to the audit committees on a variety of measures.⁷⁸ Also, outside

cause growth companies to rethink their IPO strategy and focus primarily on the private sector for financing. *Id.*

73. Jo-Ann Johnston, *Executive Enforcement*, TAMPA TRIB., July 28, 2003, at 1. Many executives of small companies believe that the Act is too burdensome, and claim there is no evidence that it is building investor confidence. *Id.* Moreover, many feel "the new rules don't shield shareholders from a minority of executives who might commit fraud." *Id.*

74. Day, *supra* note 65, at 62. The Act is hitting small companies harder due to the "huge pipeline of new rules" that is increasing the cost to remain public; namely huge increases in accounting, legal, and internal costs (loss of management time). *Id.*

75. See generally Deener, *supra* note 71 (discussing the effects of the Act on small companies).

76. Cunningham, *supra* note 4, at 946. Professor Cunningham believes that the Act is not a sweeping reform with regards to new audit regulations. *Id.* at 948. He relates the provisions to stock exchange rules approved by the SEC in 1977 and also to reforms that went into effect in the late 1990s. *Id.* at 947. Professor Cunningham realized that "[f]ederalizing these as law is significant, but reform is too strong a word to describe this move." *Id.* at 948. The significance of federalizing these regulations is the costly impact on smaller companies. Deener, *supra* note 71.

77. Sarbanes-Oxley Act §§ 301-308.

78. *Id.* §§ 201-209. Outside auditors are required to report to the audit committee all critical accounting policies and practices, all alternative accounting principles that they discussed with management, and they must share with the audit committee any written material prepared by the auditor for management. *Id.* § 204.

auditors are now prohibited from providing various specific, non-auditing services to their audit clients.⁷⁹ The Act attempts to draw a line for auditors to prevent compromising objectivity.⁸⁰

In addition, Title III states that audit committees must conduct the hiring, compensating, and monitoring of outside auditors.⁸¹ The committee members must be independent, and must certify in their financial reports that: (1) he or she reviewed the report; (2) the financial reports do not contain any untrue statement of a material fact; (3) the report fairly presents the financial condition; and (4) the member has disclosed any significant deficiencies in the design or operation of the internal controls.⁸²

While the Act attempts to remedy an obvious problem that was a major part of the corporate scandals, it now creates a burden that may be insurmountable for small companies. The new auditing regulations are causing migraines for these smaller firms for several costly reasons.⁸³ First, outside auditors charge by the hour, and are working much more to comply with the Act.⁸⁴ More hours means increased compensation for outside auditors.⁸⁵

Second, auditors are required to sign off on internal control systems for all public companies.⁸⁶ However, many small companies have only a limited number of employees, along with either elementary systems of controls, or systems that are not properly documented.⁸⁷ These companies are panicking to

79. *Id.* § 201.

80. Cunningham, *supra* note 4, at 950. An audit firm is not deemed independent if any company executive worked at the audited firm; no officer or director may influence the audit report in any manner. *Id.*

81. Sarbanes-Oxley Act § 301.

82. *Id.* § 302.

83. Johnston, *supra* note 73, at 1. Thus far, the Act has not restored investor confidence. *Id.* Investors are more concerned with the size of their portfolios, rather than whether there are a few bad apples misleading individuals. *Id.*

84. Deener, *supra* note 71. The Act lists requirements for companies regarding their internal control systems, and the auditors must certify a company's system. *Id.* Internal control systems include a company's inventory tracking, financial records, and management responsibility. *Id.* Small companies struggle to document their systems, and have to hire outside help in the documentation process before they even send the financial information to the outside auditor for certification. *Id.*

85. Terri Somers, *Burden of Financial Reforms is Bemoaned; Companies Trying to Find Way Through Maze of Regulations*, THE SAN DIEGO UNION TRIB., May 18, 2003, at H1. Small companies are in a different position than large firms because they do not have the manpower to address the additional requirements of the Act. *Id.* The duties are passed on to management, and companies lose valuable time that executives could be spending on purely business matters. *Id.*

86. Deener, *supra* note 71.

87. *Id.*

implement the necessary procedures to comply with the Act.⁸⁸ The new regulations are forcing companies to focus more on implementing compliance procedures and paying for auditors, rather than focusing on the primary objectives of the business enterprise.⁸⁹

Third, companies are adding independent directors to their boards to comply with the Act's mandate of appointing individuals who do not have business ties to the company.⁹⁰ However, it is becoming increasingly difficult for smaller companies to find qualified individuals to join the board.⁹¹ Individuals are afraid of the potential liability that attaches to the positions.⁹² More small companies are hiring search firms to locate qualified individuals to serve as board members, but the candidates are very cautious in accepting positions because the Act exposes officers to the risk of fines and imprisonment.⁹³ Also, due to the explosion in the number of shareholder lawsuits,⁹⁴ premiums for Director and Officer ("D&O") insurance, which protects board members, are increasing dramatically.⁹⁵ All of these variables add up to drastically increased costs, because director fees have more than doubled due to search firm expenses, lack of qualified candidates, the increased time required to perform accounting and auditing duties, and increased D&O insurance premiums.⁹⁶

Furthermore, public companies' legal fees are increasing in double-digit percentages.⁹⁷ It has become necessary to obtain additional legal counsel with adequate corporate governance capability and expertise to revise committee charters, prepare new

88. *Id.*

89. *See id.* (discussing the damaging effects Sarbanes-Oxley is having on small companies).

90. *See Johnston, supra* note 73 (stating that adding independent directors to the board could potentially dilute the board's overall knowledge base).

91. *Id.*

92. *Id.*

93. *Id.*

94. Deener, *supra* note 71.

95. Johnston, *supra* note 73.

96. Tamara Loomis, *High Cost of Being Public: In the First Months of Existence, Sarbanes-Oxley Act is Doubling Cost of Complying with Law*, BROWARD DAILY BUS. REV., May 7, 2003, at A7. The Act was intended to set the public at ease after numerous high-profile scandals occurred at very large firms. *Id.* However, compliance costs have a drastic effect on small-cap and mid-cap firms. *Id.*

97. FOLEY & LARDNER, THE INCREASED FINANCIAL AND NON-FINANCIAL COST OF STAYING PUBLIC 12 (2004), available at <http://pdfserver.amlaw.com/nlj/051203costs-study.pdf> (Apr. 23, 2004). The study, based on interviews and surveys of corporate executives as well as reviews of proxy statements, found that eighty-seven percent of corporate executives said their costs of corporate governance had risen either "somewhat" or a "great deal" because of the new regulations of Sarbanes-Oxley. *Id.*

filings, and write codes of conduct.⁹⁸

According to a recent survey conducted by the law firm Foley & Lardner, audit-related fees for small to medium-sized companies increased anywhere from 28% to 35% from 2001 to 2002.⁹⁹ Likewise, the survey reveals that small companies incur the brunt of the expense regarding director fees and insurance premiums. Small companies were hit the hardest with 11% increases for director compensation, and a potential 500% increase in D&O premiums.¹⁰⁰ These increases have forced small companies to find other ways to compensate board members and pay the necessary expenses to comply with the Act.¹⁰¹ Additionally, the survey reveals that legal fees associated with compliance with the Act can easily range in the hundreds of thousands of dollars for smaller companies.¹⁰² Ultimately, it is the shareholders who pay for these added compliance costs,¹⁰³ the same shareholders the Act is designed to protect.

B. Sarbanes-Oxley Also Impacts the Job Market and the Economy

Small companies are a vital component to the American economy.¹⁰⁴ They represent more than 99.7% of all employers, and generate 60 to 80% of new jobs annually.¹⁰⁵ It is crucial to a healthy economy that small businesses have the opportunity to grow and prosper.¹⁰⁶ This is precisely why the economy does not need a hastily-enacted piece of legislation that inhibits the ability of smaller companies to grow.

Enforcement of the Act will cause the American employment

98. Deener, *supra* note 71.

99. FOLEY & LARDNER, *supra* note 97, at 5. Of the executives surveyed, seventy-three percent said they believed the government's intentions were appropriate; however, that was the only positive result from the survey. *Id.* The study found the average cost associated with being a mid-cap company drastically increased from \$1.3 million to \$2.5 million dollars. *Id.*

100. *Id.*

101. *Id.*

102. Deener, *supra* note 71.

103. See generally Johnston, *supra* note 73 (evaluating the costs associated with independent directors, audit fees, and privatization).

104. See generally Commissioner Cynthia A. Glassman, Remarks Before Government-Business Forum on Small Business Capital Formation (Sept. 22, 2003), <http://www.sec.gov/news/speech/spch092203cag.htm> (last visited Mar. 12, 2005) (discussing the economics of small business and the importance small business has to the American economy). Ms. Glassman, the Commissioner of the SEC, spoke of the importance of small business to new jobs and a stronger economy. *Id.* There have been reports to the SEC that small companies are having problems finding independent board members, and that they may forego their public status rather than comply with the Act. *Id.*

105. *Id.*

106. *Id.*

market to remain in desperate need of jobs.¹⁰⁷ The costs associated with compliance are challenging CEOs and CFOs of smaller companies to reevaluate their budgets for research and development,¹⁰⁸ an area that typically creates the new jobs and products that the American economy needs.¹⁰⁹ Furthermore, the costs of compliance will also lead to small companies downsizing in order to remain at a certain profit level, thus eliminating rather than creating jobs.¹¹⁰

Additionally, there is concern from CEOs and CFOs of small companies regarding liability. Officers are apt to be conservative with regard to making new investments and introducing new products because the consequences of a failed decision might include lawsuits and criminal sanctions.¹¹¹ Unfortunately, this conservative approach to business will further lead to a slow economy and a weak job market.

Large companies already have the internal tools necessary to alleviate the burdens of compliance and have been able to adapt to the new regulations.¹¹² However, small companies are forced to hire expensive outsiders to help with compliance,¹¹³ and the cost is affecting business. Small companies play a vital role in the American economy, and that role is being drastically affected by a hastily legislated regulation that was not "thoroughly thought through with respect to the downstream ramifications."¹¹⁴

107. *Getting Real About Sarbanes-Oxley—Editorial*, THE CHIEF EXECUTIVE, July 2003 [hereinafter *Editorial*], http://www.findarticles.com/cf_dls/m4070/190/107204657/p1/article.jhtml (last visited Mar. 12, 2005). The SEC Chairman is quoted as saying, "I believe that the costs are justified." *Id.* However, the Chairman recognizes the fact that the Act has unintended consequences and that the SEC will revisit the law's impact, "but not for a while." *Id.*

108. Johnston, *supra* note 73.

109. See Glassman, *supra* note 104 (discussing how important it is for small companies to grow and thrive). The American economy relies upon small businesses for a tremendous amount of jobs and products that stimulate growth. *Id.*

110. Somers, *supra* note 85.

111. See *Editorial*, *supra* note 107 (stating in a letter to SEC Chairman Hon. William H. Donaldson that the prospect of liability is causing executives to avoid risk).

112. Tamara Loomis, *Sarbanes-Oxley Burdens Small Companies*, N.Y. LAW., Dec. 19, 2002, <http://www.nylawyer.com/news/02/12/121902d.html>. Executives of small companies feel there is now a penalty for being public. *Id.* The Act might have seemed reasonable at first glance, but the law does not distinguish between large and small companies. *Id.* The public market is made up of mostly small to medium sized firms, and the Act is proving very costly to them. *Id.*

113. *Id.*

114. Somers, *supra* note 85. Corporate executives have communicated their displeasure with the Act's "one-size-fits-all approach" to corporate regulations. *Id.*

C. Small Companies are Struggle to Determine Whether the Benefits of Being a Public Company are Worth the Costs

Since passage of the Sarbanes-Oxley Act, there has been a twenty-six percent increase in the number of companies deciding to relinquish their public status and privatize.¹¹⁵ The costs associated with complying with the Act are causing companies to reevaluate the benefits of being a public company, and in many instances are driving them out of the highly regulated markets.¹¹⁶ The U.S. economy was built on the entrepreneurial spirit of small firms, and has allowed them easy access to capital through public equity.¹¹⁷ However, now small firms are faced with the cost of complying with the Act, a cost that may prove to be overly burdensome.¹¹⁸

Unfortunately, "the costs of compliance often have little or no correlation to a company's market capitalization, making them proportionately more burdensome for smaller or midsized [public] companies."¹¹⁹ According to the Foley & Lardner survey, the average annual cost of being a public company has almost doubled for small to medium sized firms, adding incentive to privatize.¹²⁰ A private company does not sell shares to the public, and therefore does not have the same level of responsibility.¹²¹ However, wide-scale privatization could cause havoc in the capital markets

115. Farrell, *supra* note 67. The increased costs of compliance with the Act are causing companies to rethink their public status. *Id.* Section 404 of the Act requires public companies to adjust their internal financial systems, examine those systems, and have outside auditors attest to the system adopted. *Id.* Fortune 500 firms already have the resources necessary to comply with these procedures, whereas small firms require consulting firms to assist with compliance. *Id.* The skyrocketing costs of compliance are pushing small and mid-size firms toward the brink of privatization. *Id.*

116. *Do High Regulatory Costs Force Public Firms to Go Private?*, <http://www.upenn.edu/researchatpenn/article.php?715&bus> (Sept. 10, 2003). The steps taken by Congress to increase the financial transparency of publicly traded companies are causing companies to consider deregistering. *Id.* Comprehensive disclosure requirements are more appropriate for large capitalization companies, and will probably help those types of firms raise public equity. *Id.* However, the burden the Act places on smaller firms is unnecessary and is causing more harm than good. *Id.*

117. *Id.*

118. *Id.*

119. David A. Stockton et al., *Going Private: The Best Option?*, NAT'L L.J., June 23, 2003, at 2, <http://www.kilpatrickstockton.com/publications/downloads/NLJNeilFalis6-30-03.pdf>. More public company executives are evaluating the private sector for their firms. *Id.* The never-ending regulations from Sarbanes-Oxley have been adding to the frustration of small companies, and the growing burden and risk of being a publicly traded company are becoming too much to bear. *Id.*

120. See Loomis, *supra* note 96 (reviewing the results of the Foley and Lardner survey).

121. Somers, *supra* note 85.

because it would further decrease investor confidence.¹²²

*D. The Government's Response to the Unintended
Consequence: "It's a Small Price to Pay"*

Many of the objections to the Act were overcome during the brief congressional debate over the bill.¹²³ There were parties who thought corporate reform would not change anything because there would always be people who broke the rules.¹²⁴ However, Congress pushed the bill through without much investigation, and now smaller companies have to pay for the sins of a few giants.¹²⁵ The government's response to critics emphasizes that the cost is "a small price compared to the billions of dollars and public confidence that has been lost by consumers, investors and employees."¹²⁶ However, if Congress had known that the Act would impose such an overwhelming cost to small companies, it might have considered alternatives.¹²⁷

V. A SOLUTION TO AID DAVID IN A WORLD OF GOLIATHS

Congress implemented the Act with the purpose of restoring investor confidence in the markets by forcing public companies to take measures to ensure "greater accountability and transparency."¹²⁸ Unfortunately, Congress did not have the opportunity to investigate the potential consequences of such "sweeping reform," and failed to differentiate among public companies.¹²⁹ The Act is now proving to be very heavy handed

122. *Do High Regulatory Costs Force Public Firms to Go Private?*, *supra* note 116.

123. Somers, *supra* note 85.

124. *Id.*

125. Deener, *supra* note 71.

126. Somers, *supra* note 85. The spokesman for Senator Paul S. Sarbanes discussed the government's reaction to the unintended consequence. *Id.* Additionally, Senator Sarbanes, one of the bill's authors, stated "[t]here may be some impact on small companies that are thinking of going public. . . . But this will bring home the understanding that if your stock is going to be listed and able to be sold to investors, you're assuming some obligations and responsibilities with that." Farrell, *supra* note 67.

127. Deener, *supra* note 71. Investors are the ones who will pay for this expense, just as they paid for the scandals. Somers, *supra* note 85. "The hope now . . . is that the Securities and Exchange Commission will create rules, or Congress will revisit the legislation to try to make parts of it adjustable to the size of companies." *Id.*

128. See Loomis, *supra* note 96 (discussing the reaction to the Foley & Lardner survey). Many corporate attorneys across the nation have recognized the survey's results as accurate. *Id.* The cost of compliance with the Act for small companies will eventually gain the attention of the SEC. *Id.* The goal of the Act is to protect investors through accurate accounting, but investors also want positive returns. *Id.* The cost of compliance jeopardizes the main goal of investing. *Id.*

129. See Loomis, *supra* note 112 (discussing the events leading up to the

toward small firms.¹³⁰

This section proposes a solution that will allow small companies to survive as public issuers. The Act authorizes the SEC to dictate guidelines for compliance. Accordingly, the authorization allows the SEC to implement an application procedure for small companies that would evaluate internal procedures as well as costs associated with compliance with the Act in order to determine a possible exemption.

A. The SEC Has the Power to Keep the Entrepreneurial Spirit Alive in America

In the Act, Congress expressly gave the SEC the authorization to promulgate rules "necessary or appropriate in the public interest."¹³¹ This flexibility allows the SEC to develop procedures that may exempt small companies from compliance.¹³² The current one-size-fits-all approach is proving to be too burdensome for some small companies.¹³³ It follows that the critical issue is not that the Act demands too much regulation, but that it does not differentiate among firms; the right amount of regulation may differ for a company the size of Enron compared to a company that is just getting started.¹³⁴

enactment of Sarbanes-Oxley). Various articles have referred to the Act as "sweeping reform," and have said it "contains some of the most far-reaching changes that Congress has ever introduced to the business world." Cunningham, *supra* note 4, at 988 n.5.

130. See Mark Cecil, *Sarbanes-Oxley Propels More Small Companies to Go Private*, MERGERS & ACQUISITIONS REP., May 19, 2003, at 1, <http://www.usbx.com/experience/docs/MAReport-SarbanesMay03.pdf>

(discussing how the cost of compliance with the Act is forcing small companies to consider privatization). Congress designed the Act to protect shareholders, but it also creates a tremendous amount of expenses for small and microcap companies. *Id.*

131. See Sarbanes-Oxley Act § 201(13) (authorizing the Commission to formulate rules and procedures to enforce and govern public organizations).

132. See Loomis, *supra* note 112 (discussing the SEC's authority to promulgate rules under the Act). A former SEC counsel described the Commission's approach to the Act's effect on small companies as a "wait and see" attitude. *Id.*

133. See Bruce D. Knapp, *Private Sector: With Regulations Looming, Small and Midcap Companies Would Do Well to Go or Stay Private*, PITTSBURGH POST-GAZETTE, Aug. 26, 2003, <http://www.post-gazette.com/pg/pp/03238/215129.stm> (last visited Mar. 12, 2005) (comparing the advantages and disadvantages in privatizing or remaining a public issuer). The added burden of complying with the Act has forced smaller companies to consider privatization. *Id.* Private companies are not only weighing the benefits of becoming a public company, but now more and more public companies are considering the benefits of becoming private. *Id.* "The prestige of being publicly held has been greatly damaged by the barrage of corporate scandals." *Id.*

134. See generally *Do High Regulatory Costs Force Public Firms to Go Private?*, *supra* note 116 (discussing the process of deregistration).

There are many critical characteristics of small companies that make them vastly different to regulate in comparison to large corporations.¹³⁵ First, a small company's stock is usually not covered by major investment analysts because the value of its stock is normally based on speculation, and not on earnings history.¹³⁶ Second, small companies rely on different advisors (accountants, lawyers, and investment bankers) than do large companies.¹³⁷ Finally, the majority of small companies are headed by an entrepreneur with different motivations than a manager of a large corporation.¹³⁸ These differences illustrate that the Act's regulations do not protect the small company investor; instead, the costly regulations jeopardize the investor's return.¹³⁹ Therefore, it is in the public's interest, and within the SEC's authorization, to promulgate the necessary procedures to alleviate the burden the Act is having on small companies.

B. The Application for Exemption: The SEC Has the Discretion and Small Companies have the Burden

Congress implemented the Act in response to corporate scandals among some of the nation's largest corporations.¹⁴⁰ Small

Privatization may cause a reduction in the quantity and quality of relevant investment and business information. *Id.* Therefore, the legislation passed by Congress to increase the accountability and transparency of companies could "backfire" if small companies turn to privatization. *Id.* The purpose of the Act is to restore investor confidence, not to further demoralize the capital markets. *Id.* See also Sarbanes-Oxley Act, 116 Stat. at 745 (stating the purpose Congress implemented the Act).

135. See Letter from John C. Malone, Managing Partner, Malone & Bailey, PLLC, to Jonathan G. Katz, Secretary, SEC (Dec. 31, 2002), <http://www.sec.gov/rules/proposed/s74002/jcmalone1.htm> (discussing how small businesses are different to regulate than large businesses). Some of the major provisions of the Act do not regulate a small company's affairs as it does a large company's. *Id.* For example, the regulation of investment management firms does not affect small companies because rarely do investment analysts give opinions regarding a small company's stock. *Id.* Likewise, the requirement of independent advisors affects small companies differently than large companies. *Id.* Small firms use different auditors than large corporations, and are more concerned with the cost of services. *Id.* Thus, requiring small firms to employ independent auditors is a much greater burden to small companies. *Id.*

136. *Id.*

137. *Id.*

138. *Id.*

139. See *id.* (illustrating how a solution for large corporations is not necessarily the same solution for small companies). Small businesses did not cause the havoc that led to the hastily enacted legislation, therefore there is no need to regulate them as large companies. *Id.* Small businesses should be afforded "right-sized" regulations. *Id.*

140. See Loomis, *supra* note 112 (stating the SEC was not yet willing to exempt small companies). See also Deener, *supra* note 71 (quoting Peggy Peterson, a spokeswoman for the House Financial Services Committee). Ms.

companies were not the cause of the legislation, nor did Congress realize the consequences the Act would have on smaller firms.¹⁴¹ Therefore, this Comment proposes an application process that would enable small companies to apply for exemption with the SEC. The application consists of three components: revenue, current procedures, and estimated costs.

First, the application for exemption would be available to companies with less than \$50 million in revenue. Companies that meet this qualification would submit an application for exemption on a yearly basis, after they report their fiscal earnings. This allows companies that are most affected by the cost of compliance to apply for relief from the Act.¹⁴²

Second, the application would require the company to describe its current auditing procedures and evaluate the process used in reporting its financial disclosures. This section of the application would allow the SEC to investigate the company's financial statements and determine whether the procedures and findings were sufficient for a publicly traded company. The application, in a sense, would be an invitation for an investigation into the company's finances, and would thus provide further incentive for maintaining quality auditing procedures.

Third, the issuer would be required to illustrate the estimated costs and the extent of the burden of complying with the Act. The burden would be on the issuer to demonstrate that it should be granted an exemption from compliance with the Act. The added costs of auditor independence, director fees, and legal fees would all be factors in determining the extent of the burden imposed on the company.

In addition, the SEC should create a separate committee to

Peterson acknowledged the costs and impact the Act is having on small companies, but believes the regulations are necessary due to the level of scandals that preceded the law. *Id.* However, this seems to be further proof that smaller companies pay for the mistakes of the "gigantic rogues." *Id.*

141. See Malone, *supra* note 135 (discussing the overly broad regulatory scheme chosen because of large corporations' mistakes). See also Lin, *supra* note 8, at 1 (reviewing concerns with the cost of compliance with the Act). Unfortunately, the Act was implemented hastily. *Id.* Now, small companies are faced with many compliance expenses that divert resources from other areas of the company. *Id.*

142. See Deener, *supra* note 71 (discussing the burden the Act is having on small companies). According to the Foley & Lardner survey, the average cost for small to mid-sized companies to remain public will increase from \$1.3 million a year to approximately \$2.5 million, equaling a ninety percent increase. *Id.* Many securities law experts believe that small companies suffer because of the hastily enacted legislation. *Id.* A securities lawyer at Foley & Lardner stated, "I think if Congress had known that this law would cost such a large percentage of a small company's revenue, it would have rethought it. People don't realize the financial impact on hundreds of smaller companies." *Id.*

evaluate the applications submitted and have the discretion to grant exemptions. This would allow an exclusive division of the SEC to focus primarily on the needs of smaller companies, and evaluate whether an entirely different regulatory system is warranted.¹⁴³

SEC Commissioner Cynthia Glassman acknowledged the impact that the Act is having on small companies.¹⁴⁴ She realizes if compliance costs discourage small companies from expanding, it poses a serious concern to the American economy.¹⁴⁵ The Commissioner inferred that the SEC is willing to adjust to small companies' needs if there is a sufficient burden.¹⁴⁶ This proposal allows small companies to present evidence of a sufficient burden and allows the SEC to act upon this evidence.¹⁴⁷

In addition, the application for exemption helps to balance the purpose of the Act with the demands of small companies. Specifically, the application would foster the Act's initial purpose of investor protection while preventing smaller companies from becoming overburdened with regulations.¹⁴⁸ Further, the

143. See Malone, *supra* note 135 (suggesting in a letter to the SEC that small companies have separate regulations). A separate regulatory scheme for small companies should also be monitored by a separate group of regulators. *Id.* This would allow the focus of the group to be specifically on small companies and the unique issues that confront them.

144. See Glassman, *supra* note 104 (emphasizing the SEC's recognition of the impact on small companies). In her speech before the Government Business Forum, Ms. Glassman spoke of the need for small companies to inform the Commission about the struggles the businesses are having with compliance. *Id.*

145. See *id.* (recognizing the importance of small companies to the American economy). If costs of remaining public are acting "as a disincentive to expansion" then that is a "serious concern." *Id.* See also *Do High Regulatory Costs Force Public Firms to Go Private?*, *supra* note 116 (discussing the possibility of the SEC's relieving the burden on small companies). The American economy prides itself on the idea that smaller companies are able to easily raise public financing; however, the cost of complying with the new reform measures for public companies are proving to be too much for some smaller companies to handle, and are forcing out new ventures. *Id.* One option suggested by two professors from the Wharton School of Business is to create multi-tiered equity markets, with each tier abiding by separate standards. *Id.*

146. See Glassman, *supra* note 104 (discussing the importance of small companies to the American economy).

147. See *id.* (suggesting that small companies need to express their difficulties with compliance to the Commission). Cf. Katie Merx, *The Burdens of Proof; After a Year of Sarbanes-Oxley, Costs and Worries Start to Pile on for Publicly Traded Companies*, CRAIN'S DETROIT BUS., Aug. 11, 2003, at 11 (reviewing the impact the Act has had over the course of the year on smaller companies). There are many small companies that believe their current procedures and protocol are more than sufficient, and the Act forces them to implement unnecessary and costly procedures. *Id.*

148. See generally *Do High Regulatory Costs Force Public Firms to Go Private?*, *supra* note 116 (discussing how multi-tiered equity markets might

exemption would allow small companies to promote new jobs and a stronger economy by focusing on the growth of their business rather than the cost of compliance. Lastly, the exemption would promote the core values of our historically entrepreneurial society.

VI. CONCLUSION

The combination of extremely inflated stock markets, the appalling events of September 11, and the corruption that led to four of the largest bankruptcies in U.S. history, all helped spell disaster for the American economy. The political solution to the market catastrophe and corporate scandals was the Sarbanes-Oxley Act.

The Act is very expansive and regulates many of the activities that caused the corporate debacles and undermined investor confidence. The Act is not short on skeptics, however, and is commonly thought to be a law with unintended consequences. Specifically, the cost of compliance with the Act is creating havoc among small public companies.

Small companies struggle with the added costs of auditor independence, director fees, and additional legal fees. These added costs not only adversely affect shareholder returns, but create serious implications for the American job market and thus the American economy as a whole. The solution is an application for exemption for small companies that would provide a balance between the protection of investors and the need to avoid overburdening small companies.