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Cover Page Footnote

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THE CASE AGAINST EXEMPTING SMALLER REPORTING COMPANIES FROM SARBANES-OXLEY SECTION 404: WHY MARKET-BASED SOLUTIONS ARE LIKELY TO HARM ORDINARY INVESTORS

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INTRODUCTION

Should Congress exempt smaller reporting companies from Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX")?[1] Section 404,[2] which is arguably the most controversial of SOX's provisions,[3] requires reporting companies (i.e., companies that are subject to the public reporting requirements of the Securities Exchange Act of 1934,[4] the "Exchange Act") to take greater responsibility for their internal control over financial reporting ("ICFR").[5] Specifically, Section 404 requires that (i) a

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered Sections of 11, 15, 18, 28 and 29 U.S.C.) [hereinafter SOX].

2. 15 U.S.C. § 7262 (2002).

3. *See, e.g.*, COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT (Nov. 30, 2006) 115 [hereinafter CCMR REPORT] ("The main policy debate over SOX . . . is focused on the implementation of a single provision, Section 404 . . . .").

4. The Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a–78mm (2006)) [hereinafter Exchange Act].

5. Section 404 does not use the phrase "internal control over financial reporting," but instead refers to a company's "internal control structure and procedures for financial reporting." SOX §§ Section 404(a), (b), 15 U.S.C. § 7262(a), (b) (2002). To provide greater clarity to the concept, the SEC adopted and defined the term "internal control over financial reporting" in its rules implementing Section 404. Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Release Nos. 33-8238; 34-47986; IC-26068 (June 5, 2003), *available at* http://www.sec.gov/rules/final/33-8238.htm [hereinafter SEC Release 33-8238]. The SEC amended rules 13a-15(f) and 15d-15(f) of the Exchange Act, 17 C.F.R. § 240.13a-15(f) and § 240.15d-15(f), to define "internal control over financial reporting" as:

> [a] process designed by, or under the supervision of, the registrant's principal executive and financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
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> (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
>
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
>
> (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.

17 C.F.R. §§ 240.13a-15(f), 240.15d-15(f) (2007).

reporting company's management annually assess and publicly disclose the effectiveness of the company's ICFR[6], and (ii) the company's outside auditor attest to that assessment.[7]

The primary objective for Section 404 is presumably to improve the accuracy of financial disclosure by requiring companies to maintain effective ICFRs.[8] The controversy surrounding Section 404, however, has not focused on the provision's underlying objective,[9] but rather on whether the substantial compliance costs involved with Section 404 exceed the statute's benefits.[10] In its June 2003 release adopting the implementation rules for Section 404,[11] the Securities and Exchange Commission (the "SEC") estimated that the annual cost for Section 404 compliance would run $91,000 per company.[12] Subsequent studies have shown, however, that the actual cost is exponentially greater than the

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6. SOX § 404(a), 15 U.S.C. 7262(a) (2002).

7. *Id.* § 7262(b).

8. CCMR REPORT, *supra* note 3, at 119.

9. *Id.* at 115. Note, however, that the CCMR Report states a slightly different objective for Section 404 than is proposed by this Article, as the CCMR Report focuses more on a possible public perception goal. The CCMR Report states that Section 404 "is aimed at reducing the market impact from accounting 'errors' – whether from fraud, inadvertent misstatements, or omissions – by assuring investors that public companies maintain effective controls over financial reporting." *Id.*

10. *See, e.g.*, HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE – WHAT WE'VE LEARNED; HOW TO FIX IT 38-42, 53-55, 82-85 (2006); STEPHEN M. BAINBRIDGE, THE COMPLETE GUIDE TO SARBANES-OXLEY 4-7, 247-50 (2007) [hereinafter BAINBRIDGE GUIDE TO SOX]; Ehud Kamar et al., *Sarbanes-Oxley's Effects on Small Firms: What is the Evidence?* 2 (USC CLEO Research Paper No. C07-9, 2007), *available at* http://ssrn.com/abstract=993198; Robert A. Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404,* 29 CARDOZO L. REV. 703, 725-57 (2007); William J. Carney, *The Costs of Being Public after Sarbanes-Oxley: The Irony of "Going Private"*, 55 EMORY L.J. 141, 141-43 (2006); CCMR Report, *supra* note 3, at 115.

11. SEC Release 33-8238, *supra* note 5.

12. *Id*. The SEC described its methodology for its estimate as follows:

> This estimate is based on the estimated total burden hours of 5,396,266 [divided by 14,000 companies, results in roughly 385 hours per company], an assumed 75%/25% split of the burden hours between internal staff and external professionals, and an hourly rate of $200 for internal staff time and $300 for external professionals. The hourly cost estimate is based on consultations with several registrants and law firms and other persons who regularly assist registrants in preparing and filing periodic reports with the Commission. Our PRA estimate does not reflect any additional cost burdens that a company will incur as a result of having to obtain an auditor's attestation on management's internal control report.

Id. at n.174.

SEC's initial estimate.[13] Far from a slight additional regulatory cost, reporting companies could be spending more to comply with Section 404 than on any other SOX provision.[14] The fact that a regulation generates substantial compliance costs, however, is not by itself problematic. Rather, a problem arises when a regulation generates substantial compliance costs without generating benefits that equal or exceed those costs. Specifically, if Section 404 imposed substantial compliance costs accompanied by benefits to companies and their shareholders that exceeded those costs, then Section 404 would be "cost-effective" and should be considered a beneficial regulation. If Section 404 generated benefits that are less than its substantial compliance costs, however, then Section 404 would be "cost-ineffective."

Currently, there is no consensus on the cost-effectiveness of Section 404.[15] Critics of the statute decry that Section 404 "has gone too far"[16] and point to: (1) the substantial compliance costs, reasoning that it is unrealistic to expect that Section 404 generates sufficient benefits to offset those costs; and (2) anecdotal evidence that suggests smaller reporting companies are employing strategies to avoid being subject to Section 404.[17] Conversely, proponents for Section 404 tend to focus on the beneficial impact that Section 404 *should* have on investor protection and on an issuer's cost of capital by improving financial disclosure accuracy.[18]

If Section 404 turns out to be cost-ineffective, the companies that are most threatened are smaller companies, as cost-ineffective regulations tend to disproportionately harm smaller companies.[19] At the same time, certain classes of smaller companies have proven to be particularly

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13. *See* discussion *infra* Part III.B.

14. Cynthia A. Glassman, SEC Comm'r, Internal Controls Over Financial Reporting – Putting Sarbanes-Oxley Section 404 in Perspective, Speech Before the 12th Annual CFO Summit (May 8, 2006), *available at* http://www.sec.gov/news/speech/2006/spch050806cag.htm.

15. CCMR REPORT, *supra* note 3, at 115.

16. *See, e.g.*, John Stossel, *Sarbanes-Oxley has Gone Too Far,* JFS PRODUCTIONS, INC., Dec. 21, 2005, *available at* http://www.realclearpolitics.com/Commentary/com-12_21_05_JS.html.

17. *See* discussion *infra* Part IV.B.

18. *See, e.g.*, Charles D. Niemeier, Bd. Member, Pub. Co. Accounting Oversight Bd., American Competitiveness in International Capital Markets (Sept. 30, 2006), *available at* http://www.pcaobus.org/News_and_Events/Events/2006/Speech/09-30_Niemeier.aspx.

19. *See* discussion *infra* Part II.A.

valuable to the U.S. economy by creating a disproportionate amount of the innovations, macroeconomic growth, and net new jobs in the United States.[20] These two premises, taken together, argue for federal policy-makers to be extremely cautious before imposing potentially cost-ineffective regulations like Section 404 on smaller companies. At the same time, however, smaller reporting companies – and the investors who tend to invest in them – may also have the greatest need for the services provided by Section 404,[21] which would argue against granting smaller reporting companies relief from Section 404.

In the face of this uncertainty, what should federal policymakers do? To date, the SEC has not ignored Section 404's potential negative impact on smaller companies. It has chosen to implement Section 404 slowly to allow for a learning curve to develop on how best to implement the Section 404 process before requiring smaller reporting companies to comply.[22] The SEC has also tried to make management's and auditors' evaluations of ICFRs more effective and efficient – and thereby less expensive – by amending the rules relating to management's evaluation of ICFR, issuing interpretative guidance that management can use as a safe harbor in its evaluation of ICFRs, and adopting new auditing standards.[23] In February 2008, the SEC announced an additional delay of Section 404's auditor attestation requirement for the smallest reporting companies (i.e., non-accelerated filers, which generally speaking are those with worldwide public equity floats of less than $75 million)[24], so that the SEC can study the cost-benefit impact of that auditor attestation requirement for smaller companies.[25] The auditor attestation requirement will therefore not become mandatory for these smallest reporting companies until they file their annual reports for the fiscal year ending on or after December 15, 2009.[26]

20. *See* discussion *infra* Part II.B.

21. Kamar et al., *supra* note 10, at 9-11, 27.

22. *See* discussion *infra* Part I.C.

23. *Id.*

24. The term "non-accelerated filer" is not defined in the Exchange Act. Instead, the term "non-accelerated filer" captures issuers that are not "large accelerated filers" or "accelerated filers" as defined in rule 12b-2 of the Exchange Act, 17 C.F.R. § 240.12b-2 (2008).

25. SEC Begins Small Business Costs and Benefit Study of Sarbanes-Oxley Act Section 404, Release No. 2008-8 (Feb. 1, 2008), *available at* http://www.sec.gov/news/press/2008/2008-8.htm.

26. SEC Approves One-Year Extension for Small Businesses From Auditor

This Article considers whether Congress and the SEC should go further and exempt smaller reporting companies altogether from Section 404 compliance. Such exemption could come in a number of different forms – from complete exemption from Section 404, to allowing smaller reporting companies the ability to opt out of Section 404, to granting smaller reporting companies relief from the auditor attestation portion of Section 404.[27] These exemption requests do have some appeal, as they suggest a market-based resolution to the uncertain value of Section 404 for smaller reporting companies. In each case, smaller reporting companies would be relieved (either substantially or completely) from mandatory compliance with Section 404, but would retain the ability to voluntarily choose to more fully comply with Section 404 if they found it to be cost-effective. Rather than debate the cost-effectiveness of Section 404, these Section 404 relief proposals appear to provide a definitive mechanism for answering the cost-benefit question simply by allowing investors to express their demand (or lack of demand) for the services provided by Section 404 through the price they pay for securities.

While empowering smaller reporting companies with such market-based regulatory solutions might seem appealing at first glance, this Article explains why structural factors within the public securities markets for smaller reporting companies will prevent such market-based proposals from accurately determining the net effect of Section 404. Instead, exempting smaller reporting companies from Section 404 is likely to significantly increase the information asymmetry between smaller reporting companies and their investors. This outcome would be particularly problematic since unsophisticated, ordinary investors (rather than institutional investors) are the predominant external shareholders for smaller reporting companies and ordinary shareholders have historically demonstrated themselves to be vulnerable to just this type of information asymmetry.[28] This Article constructs a model for analyzing the probable impact of granting Section 404 relief to smaller reporting companies and concludes that making Section 404 voluntary for smaller reporting companies would almost certainly guarantee an insufficient

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Attestation Requirement in Sarbanes-Oxley Act, Release No. 2008-16 (June 20, 2008), *available at* http://www.sec.gov/news/press/2008/2008-116.htm [hereinafter SEC Release 2008-16].

27. *See* discussion *infra* Part V.A.

28. *See infra* Part V.C.2.

amount of investment by those companies in their ICFR, with the cost for that insufficient dedication of resources to ICFR being borne primarily and unknowingly by unsophisticated, ordinary investors.

This Article recommends, therefore, that smaller reporting companies be subject to the same Section 404 requirements as large companies and that Congress resist calls to grant substantial Section 404 relief to smaller reporting companies. Further, this Article advocates that smaller reporting companies be required to become fully Section 404 compliant as soon as practicable.

In furtherance of these propositions, this Article proceeds as follows: Part I provides an overview of Section 404 and its intended benefits. Part II then considers the special attributes of smaller companies that might warrant their receiving particular attention from policy-makers. Part III examines the evidence regarding Section 404's substantial compliance costs. Part IV sifts through evidence on the benefits that derive from Section 404 and examines the Section's probable net effect, including an examination of certain post-SOX trends that could indicate that Section 404 is cost-ineffective, such as: (1) an increase in "going-dark" transactions, (2) a decrease in U.S. IPOs by smaller companies, and (3) an increase in IPOs on foreign stock markets by smaller U.S. companies. Part IV also explains why, in spite of the anecdotal evidence, Section 404's net effect on smaller reporting companies remains unclear. Part V examines the market-based proposals to exempt smaller reporting companies from Section 404 and provides a model for analyzing the probable impact of granting Section 404 relief to smaller reporting companies. Finally, Part VI offers a conclusion as well as some cautionary qualifications.

PART I: SECTION 404 AND ITS INTENDED BENEFITS

A. Basic Statutory Requirement

For the all the controversy it has stirred, Section 404 is a relatively straightforward statute. It consists of two provisions. The first, Section 404(a),[29] requires that each annual report filed by a reporting company contain an "internal control report"[30] that:

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29. SOX § 404(a), 15 U.S.C. § 7262(a) (2002).
30. *Id.*

(1) "state[s] the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting;"[31] and
(2) "contain[s] an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting."[32]

In short, management must identify, understand and assess the company's internal systems for gathering and evaluating the information needed to generate accurate financial reports,[33] and disclose any "material weaknesses"[34] in the company's ICFR. Section 404 focuses specifically on ICFR, which is defined as:

> [A] process designed by, or under the supervision of, the issuer's principal executive and financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.[35]

The process must include policies and procedures for maintaining accurate accounting records, ensuring that receipts and expenditures are made only in accordance with management authorization, and safeguarding assets.[36]

The second provision, Section 404(b),[37] inserts an external monitor to help ensure the accuracy of the Section 404(a) internal control report. Specifically, Section 404(b) requires that the company's registered public accounting firm that audited the financial statements included in the

31. *Id.*
32. *Id.*
33. *See* BAINBRIDGE GUIDE TO SOX, *supra* note 10, at 198.
34. Regulation S-K, 17 C.F.R. § 229.308(a)(3). "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." *Id.*
35. Exchange Act Rules 13a-15(f) & 15d-15(f), 17 C.F.R. §§ 240.13a-15(f), 240.15d-15(f).
36. *Id.*
37. SOX § 404(b), 15 U.S.C. § 7262(b) (2002).

annual report "attest to, and report on, the assessment made by the management of the issuer."[38]

B. Intended Benefits

Overall, SOX involves a broad range of corporate governance reforms that were meant to improve investor protection and increase the efficiency of the U.S. public securities markets, primarily by increasing the disclosure requirements of reporting companies and establishing stronger standards for: (i) reporting company directors and senior management; (ii) public auditors; and (iii) investment banks.[39] Why did Congress decide to include in this batch of reforms a requirement that reporting companies enhance their ICFR? And more importantly, does an increased regulatory focus on internal controls significantly improve financial reporting? The true answer to this latter question is that nobody really knows, as little research has been conducted on the efficacy of mandatory internal controls.[40]

The fact that nobody really knows whether mandatory internal control requirements such as Section 404 are a valuable regulatory approach does not mean that they cannot be valuable. It simply means that the case has yet to be proved. Theoretically, requiring companies to improve their ICFR "should" improve the quality of financial reporting, which should in turn increase social welfare, so long as the cost of these enhanced requirements does not exceed their benefit. Before addressing the cost-benefit issue, it is useful to understand the benefits that one should expect to flow from Section 404, if it works as intended.

1. More Accurate Financial Reporting

The primary objective of Section 404 is (presumably) to improve the accuracy of the financial disclosure made by reporting companies. The Exchange Act imposes substantial reporting obligations on report-

38. *Id.*

39. For a thorough discussion of the various requirements of SOX, see BAINBRIDGE GUIDE TO SOX, *supra* note 10.

40. JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 145 (2006). "Some critics suspect that this new emphasis on internal controls has become a knee-jerk regulatory response that is empty of actual content, serving a function more symbolic than substantive." *Id.*

ing companies,[41] including extensive disclosure of the company's financial data.[42] This financial reporting obligation is ultimately discharged by the company's senior management (e.g., its chief executive officer ("CEO"), its chief financial officer ("CFO"), and, to a lesser extent, its board of directors). Unfortunately, there is a significant risk that those managers will not provide accurate financial information when they discharge their duty.

To begin with, the managers may decide to deliberately falsify the data (e.g., Enron or WorldCom). Corporate managers may fall prey to the classic "agency problems" that arise in corporations due to the separation of ownership from control[43] and try to take advantage of corporate governance deficiencies to fraudulently appropriate for their own private benefit a portion of the corporation's wealth.[44] For example, a CEO whose bonus is tied to the corporation's reported profits may be motivated to fraudulently inflate its profits in order to receive a higher bonus. Better internal controls could help to prevent such fraudulent practices by creating a clearer trail for identifying inappropriate managerial behavior.[45]

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41. *See, e.g.*, Exchange Act § 13(a), 15 U.S.C. § 78m(a), and Exchange Act § 15(d), 15 U.S.C. § 78o(d) (2006).

42. *See, e.g.*, Exchange Act Form 10-K, Item 8 (requiring reporting companies to publicly disclose extensive financial information about themselves).

43. Adam Smith described the problem as follows:

> The directors of [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

ADAM SMITH, *Of the Revenue of the Sovereign or Commonwealth*, *in* AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 264–65 (Univ. of Chi. Press 1976) (1776); *see also*, ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

44. *See* Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 271 (2003); Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 339 (2006).

45. Congress first used this method of employing internal controls as a supplement to prohibited behavior with the Foreign Corrupt Practices Act ("FCPA"), Title I of Pub. Law No. 95-213 (1977). COFFEE, *supra* note 40, at 144. Inspired primarily by "concerns over foreign kickbacks and other corrupt practices taking place abroad,"

While deliberate falsification of data by companies occurs on occasion and receives a lot of attention, it is actually the exception and not the rule.[46] The more systemic source of inaccurate data likely arises from managers' inadvertent disclosure of incomplete and/or inaccurate financial data. A company's senior management does not inherently have complete and accurate financial information about the issuer, particularly as economic activities of companies grow ever more complex. In order for management to "output" accurate financial disclosure, it needs to have in place robust systems that gather and assess the information that feeds the eventual financial disclosure. Better information input systems (i.e., better internal controls) should lead to management having more complete and accurate information about the issuer, which should in turn lead to better public disclosure. One can think of this as an example of the "garbage in, garbage out" principle.[47] In order to provide better financial disclosure output, management needs to have in place better information input systems. Section 404 could help to encourage such better information input systems.

2. Improve Market Efficiency and Reduce Cost of Capital

Better financial disclosure by reporting companies should lead to more efficient securities markets and a lower cost of capital for issuers. Information is often characterized as the "lifeblood" of securities

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THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 22.2, at 803 (5th ed. 2005), Congress, among other things, amended Section 13 of the Exchange Act to require reporting companies to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that . . . transactions are recorded as necessary . . . to maintain accountability for assets." Exchange Act § 13(b)(2)(B)(ii)(II), 15 U.S.C. § 78m(b)(2)(B)(ii). In effect, the FCPA required companies to "record" their previously off-book accounts (i.e., slush funds) that were used to pay bribes to foreign officials. COFFEE, *supra* note 40, at 144.

46. Frank Fernandez, *The Roles and Responsibilities of Securities Analysts*, 7 RES. REP. 3, 6 (2001), *available at* http://www.sia.com/research/pdf/RsrchRprtVol2-7.PDF.

47. Garbage In, Garbage Out (abbreviated to GIGO) is a commonly used phrase in the computer science field. Wikipedia, Garbage In, Garbage Out, http://en.wikipedia.org/wiki/Garbage_in,_garbage_out (last visited Jan. 15, 2009). "It is used primarily to call attention to the fact that computers, unlike humans, will unquestioningly process the most nonsensical of input data and produce nonsensical output." *Id.* The term Garbage In, Garbage Out can also be used more liberally to describe any process where "it is difficult to create a good result when given bad input." *Id.* This Article employs the second, more liberal usage of the term.

markets.[48] In an ideal securities market, fully-informed buyers and sellers negotiate at arm's length (and at low transaction costs) to determine whether or not a particular transaction makes sense. Accurate information about an investment facilitates proper allocation of investment capital among competing investment opportunities. On the one hand, the seller of the investment is properly informed about the value of the company, as well as the optimal timing and structure of the financing, so as to achieve the lowest cost of capital. On the other hand, the buyer of the investment is properly informed about the merits of that particular investment, as well as other available investment opportunities, so that the buyer can allocate her capital to the investments that are likely to generate the highest returns.

A reporting company's financial disclosure is some of the most important information that impacts the price of its securities. Take, for example, common stock, which represents a percentage ownership in a corporation. Assuming a typical form of common stock, this ownership share entitles the stockholder to a number of rights (both economic and non-economic),[49] the most significant of which is a residual claim on the corporation's net assets.[50] In plain English, that residual claim means:

- The stockholders do not have direct ownership in the corporation's assets, nor are they responsible for the corporation's liabilities. The corporation owns its own assets and is responsible for its own liabilities.

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48. John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 ARIZ. ST. L.J. 861, 879 (2005) [hereinafter Orcutt, *Angel Finance Market*]; *see also* Arthur Levitt, Chairman, SEC, Quality Information: The Lifeblood of Our Markets, Remarks at the Economic Club of New York (Oct. 18, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch304.htm.

49. Voting rights are typically the most important non-economic rights associated with common stock. Those voting rights include the right to vote on directors, certain business combinations, amendments to the corporation's charter documents (e.g., its certificate of incorporation), and dissolution of the corporation.

50. "[H]olders of common stock possess the residual claim on the corporation's assets . . . each share of common stock has an equal right to participate in distributions of the firm's earnings in the form of dividends and, in the event the corporation is liquidated, to share equally in the firm's assets remaining after all prior claims have been satisfied." STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 66 (2002).

- Instead, the stockholders have an ownership interest in what this Article will refer to as the corporation's "residual." The residual is the assets that remain upon the liquidation of the corporation after all of the corporation's liabilities have been satisfied.[51] In addition to waiting for the ultimate liquidation of the corporation, stockholders may also receive a portion of the residual on a current basis if the corporation is solvent[52] and decides to use a portion of its net assets to pay a dividend or buy back outstanding stock.

This economic right in the corporation's residual drives the value of a stock. Roughly speaking, the value of a stock should be based on the share of the corporation's eventual residual (including future dividend payouts and stock buybacks) represented by the stock, discounted back to present value.[53] Assuming a healthy growing corporation, the eventual residual should be substantially greater than its current net asset position, which means that much (if not most) of the corporation's eventual residual will be generated in the future by the corporation generating future profits. The value of the stock is therefore fundamentally driven by forecasts of the corporation's future profits.[54] Competently forecasting a corporation's future profits and eventual residual is an inherently difficult task, as predicting the future will always entail a substantial amount of error.[55] However, having the corporation provide credible information about its current financial position and historical financial track record is important for those seeking to develop intelligent forecasts and value the corporation's stock price.

When corporations do not consistently provide credible financial information, at least two substantial negative consequences should be expected. First, the market will be less efficient at pricing the corpora-

51. *See, e.g.*, DEL. CODE ANN. tit. 8, § 281(a)-(b) (2008).

52. *See, e.g.*, DEL. CODE ANN. tit. 8, § 170(a)-(b) (2008).

53. The present value is the current worth of a future sum of money or stream of cash flows given a specified rate of return. Investopedia, Present Value, http://www.investopedia.com/terms/p/presentvalue.asp (last visited Jan. 14, 2009).

54. *See* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 173 (2003).

55. *See* John L. Orcutt, *Investor Skepticism v. Investor Confidence: Why the New Research Analyst Reforms Will Harm Investors*, 81 DENV. U. L. REV. 1, 69 (2003) [hereinafter Orcutt, *Investor Skepticism*] (analyzing the difficulties that sell-side analysts have demonstrated in forecasting the future earnings of the companies they cover and considering explanations for their struggles other than the conflicts of interest that face such analysts).

tions' securities due to the incomplete or inaccurate information, which will lead to inferior allocation of investment capital (e.g., too much investment capital may be dedicated to bad companies). Second, investors should adjust to this less efficient environment by charging a higher price for their investment capital. Rational, sophisticated investors will discount the price they are willing to pay for securities (i.e., charge a higher cost of capital) to compensate for the increased information risk they face.

Therefore, if Section 404 does, in fact, improve the accuracy of reporting companies' financial disclosure, the price of securities traded on the U.S. public markets should be more accurate and provide issuers a lower cost of capital.

3. Unintended Benefits

While not the direct focus of Section 404, some unintended benefits from the statute have been reported. The Committee on Capital Markets Regulation[56], an independent, nonpartisan organization composed of representatives from business, finance, law, accounting and academia, reported the following:

> In some cases, Section 404 control reviews appear to have acted as a catalyst for companies to improve the efficiency of financial management. This change has led either to direct cost savings – for example, through rationalization of the payments process – or to improved loss avoidance, through enhanced security and safeguards. Section 404 has also served as a catalyst for some companies to develop Enterprise Risk Management programs, which address all sources of risk, not just financial reporting. In the future, Section 404 programs and the control environments they have fostered will be even more useful as companies embark on initiatives to provide investors with real-time and more customizable financial reporting information.[57]

56. *See* Committee on Capital Markets Regulation Homepage, http://www.capmktsreg.org/ (last visited Jan. 14, 2009). "The Committee on Capital Markets Regulation is an independent and nonpartisan 501(c)(3) research organization dedicated to improving the regulation of U.S. capital markets." *Id.*

57. CCMR REPORT, *supra* note 3, at 119 (internal citations omitted).

C. Section 404 Might not be Cost-Effective: Regulatory Response

The controversy surrounding Section 404 has not focused on the provision's goal for companies to have better ICFRs and more accurate financial disclosure. Instead, the controversy centers on whether the substantial costs required to implement Section 404 exceed the statute's benefits, particularly for smaller reporting companies.

Congress charged the SEC with developing the rules for implementing Section 404(a) and designated the Public Company Accounting Oversight Board ("PCAOB")[58] to establish the Section 404(b) auditor assessment standard. The initial implementing rules and procedures were not problem-free. The SEC issued rules implementing Section 404(a) in June 2003,[59] and the PCAOB issued the corresponding auditor standards ("Auditing Standard No. 2" or "AS 2") in March 2004.[60] Reporting companies and auditors struggled with these initial implementation rules and auditing standards, which led to the development of Section 404 policies and procedures that proved to be "burdensome and time-consuming in practice."[61]

The SEC and PCAOB have tried to respond to these implementation concerns. First, the SEC implemented Section 404 slowly to allow for a learning curve to develop on how best to conduct the Section 404 process. As difficulties in implementation became apparent, the SEC postponed compliance deadlines on more than one occasion, in particular for smaller companies, in order to give issuers and auditors time to adapt to Section 404. The following table sets forth the various deadlines and postponements:

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58. Public Company Accounting Oversight Board ("PCAOB") Home Page, http://www.pcaobus.org/ (last visited Jan. 14, 2009). The PCAOB is the independent board created by SOX to oversee the auditors of reporting companies. SOX § 101(a) and (b), 15 U.S.C. § 7262(a) and (b) (2002).

59. SEC Release 33-8238, *supra* note 5.

60. PCAOB, AUDITING STANDARD NO. 2 (Mar. 9, 2002), http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_2.pdf. The SEC approved Auditing Standard No. 2 on June 17, 2004. Order Approving Proposed Auditing Standard No. 2, Release No. 34-49884 (June 17, 2004), *available at* http://www.sec.gov/rules/pcaob/34-49884.htm.

61. WILLKIE FARR & GALLAGHER LLP, SEC DEFINES "MATERIAL WEAKNESS" AND GIVES GUIDANCE ON EVALUATION OF INTERNAL CONTROLS, Aug. 28, 2007, at 2, http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C2486%5CSEC_Defines_Material_Weakness_and_Gives_Guidance.pdf (last visited Jan. 14, 2009) [hereinafter WILLKIE FARR & GALLAGHER PUBLICATION].

Status of Issuer	Section 404 Compliance Deadline
Large accelerated filers[62]	Initially required to include management report on ICFR and auditor attestation in their annual reports for fiscal years ending on or after June 15, 2004.[63] The SEC granted an extension in Feb. 2004 that delayed the initial compliance deadline to the fiscal year ending on or after Nov. 15, 2004.[64]
Accelerated filers:[65]	Initially subject to the same deadlines as large accelerated filers.[66] For accelerated filers with fiscal years ending between and including Nov. 15, 2004 and Feb. 28, 2005, the SEC granted them up to an additional 45 days to include management report on ICFR and auditor attestation in their annual reports.[67]
Non-accelerated filers (including foreign private issuers[68]):[69]	Initially required to include management report on ICFR and auditor attestation in their annual reports for fiscal years ending on or after April 15, 2005.[70] The SEC granted several extensions (the last of which was in Feb. 2008) that delayed the initial compliance deadlines as follows: • Not required to include a management report on ICFR until it files an annual report for the fiscal year ending on or after Dec. 15, 2007.[71] • Not required to include an auditor attestation until it files an annual report for the fiscal year ending on or after Dec. 15, 2009.[72]

62. Public company with a worldwide public equity float (excluding affiliates) of $700 million or more and has filed at least one annual report with the SEC. Exchange Act Rule 12b-2, *supra* note 24.

63. SEC Release 33-8238, *supra* note 5.

64. Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Release Nos. 33-8392; 34-49313; IC-26357 (Feb. 24, 2004), *available at* http://www.sec.gov/rules/final/33-8392.htm [hereinafter SEC Release 33-8392]; 17 C.F.R. §§ 210, 228-29, 240, 249, 270, 274 (2008).

65. Public company with a worldwide public equity float (excluding affiliates) of $75 million or more, but less than $700 million, and has filed at least one annual report with the SEC. Exchange Act Rule 12b-2, *supra* note 24.

66. At the time of the original SEC releases implementing Section 404 (e.g., SEC Releases 33-8238 and 33-8392), the term "large accelerated filers" did not exist. At that time, the category was simply "accelerated filers" and included both "large accelerated filers" and "accelerated filers." The SEC did not split the accelerated filer definition into two separate categories until December 21, 2005. Final Rule: Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports,

In June 2007, the SEC amended the rules relating to management's evaluation of ICFR[73] and issued interpretative guidance for management's use in its evaluation.[74] These changes were meant to make man-

Release Nos. 33-8644, 34-52989 (Dec. 21, 2005), 17 C.F.R. §§ 210, 229, 240, 249, *available at* http://www.sec.gov/rules/final/33-8644.pdf [hereinafter SEC Release 33-8644].

67. Order under Section 36 of the Securities Exchange Act of 1934 Granting an Exemption from Specified Provisions of Exchange Act Rules 13a-1 and 15d-1, Release No. 34-50754 (Nov. 30, 2004), *available at* http://www.sec.gov/rules/exorders/34-50754.htm.

68. Exchange Act Rule 3b-4, 17 C.F.R. § 240.3b-4 (2008), defines the term "foreign private issuer" as:

> [A]ny foreign issuer other than a foreign government except for an issuer meeting the following conditions . . . :
>
> - More than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; and
> - Any of the following:
>   - The majority of the executive officers or directors are United States citizens or residents;
>   - More than 50 percent of the assets of the issuer are located in the United States; or
>   - The business of the issuer is administered principally in the United States.
>
> Like with non-accelerated filers, the SEC has deemed that foreign private issuers require special attention and has granted these issuers significant extensions for complying with Section 404. This Article does not address the special case of foreign private issuers and instead focuses entirely on the special case of smaller companies generally.

69. Public company with a worldwide public equity float (excluding affiliates) of less than $75 million, or one that has yet to file an annual report with the SEC. The term "non-accelerated filer" is not defined in the Exchange Act. Instead, the term "non-accelerated filer" captures issuers that are not "large accelerated filers" or "accelerated filers" as defined in Exchange Act Rule 12b-2, *supra* note 24.

70. SEC Release 33-8238, *supra* note 5.

71. Final Rule: Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, Release Nos. 33-8760; 34-54942 (Dec. 15, 2006); 17 C.F.R. §§ 210, 228, 229, 240, 249 (2008), *available at* http://www.sec.gov/rules/final/2006/33-8760.pdf.

72. SEC Release 2008-16, *supra* note 26.

73. Final Rule: Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, Release Nos. 33-8809; 34-55928 (June 20, 2007), 17 C.F.R. §§ 210, 228, 229, 240, *available at* http://www.sec.gov/rules/final/2007/33-8809.pdf.

74. Interpretive Release: Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Release Nos. 33-8810; 34-55929 (June 20, 2007), 17 C.F.R. § 241, *available at* http://www.sec.gov/rules/interp/2007/33-8810.pdf [herein-

agement's evaluation of ICFR more effective and more efficient by endorsing a "top-down, risk-based evaluation" that focuses on preventing material misstatements in financial statements.[75] In May 2007, the PCAOB adopted Auditing Standard No. 5 ("AS 5")[76] to replace the previously used AS 2,[77] and the SEC later approved AS 5 in July 2007.[78] Among other things, these actions[79] created a safe harbor for management evaluations that comply with the SEC's interpretative guidance[80] and brought management's evaluation of ICFR more into alignment with the auditor's responsibilities under AS 5.[81] These changes were

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after SEC Interpretive Release 33-8810].

75. *Id.* at 1, 4.

76. PCAOB, Auditing Standard No. 5 – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements, *available at* http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_5.pdf. AS 5 applies to audits for fiscal years ending on or after November 15, 2007. PCAOB, *Board Approves New Audit Standard for Internal Control over Financial Reporting and, Separately, Recommendations on Inspection Frequency Rule*, May 24, 2007, *available at* http://www.pcaobus.org/News_and_Events/News/2007/05-24.aspx.

77. *Id.*

78. Order Approving Proposed Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements, a Related Independence Rule, and Conforming Amendments, Release No. 34-56152 (July 27, 2007), *available at* http://www.sec.gov/rules/pcaob/2007/34-56152.pdf [hereinafter SEC Release 34-56152].

79. In a related rule release, the SEC adopted a definition for the term "significant deficiency" for purpose of the SEC rules implementing Section 404 and 302. Final Rule: Definition of the Term Significant Deficiency, Release Nos. 33-8829 and 34-56203 (Aug. 3, 2007), 17 C.F.R. §§ 210, 240, *available at* http://www.sec.gov/rules/final/2007/33-8829.pdf [hereinafter SEC Release 33-8829].

80. SEC Interpretive Release 33-8810, *supra* note 74, at 1.

81. Press Release: SEC Approves New Guidance for Compliance with Section 404 of Sarbanes-Oxley (May 23, 2007), *available at* http://www.sec.gov/news/press/2007/2007-101.htm [hereinafter SEC May 2007 Press Release]. For practical summaries of the mid-June 2007 changes by the SEC and the PCAOB to Section 404 compliance, see WILLKIE FARR & GALLAGHER PUBLICATION, *supra* note 61; PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP, SEC ADOPTS FINAL RULES AND PUBLISHES INTERPRETIVE GUIDANCE FOR MANAGEMENT REGARDING ITS EVALUATION OF INTERNAL CONTROL OVER FINANCIAL REPORTING, July 13, 2007, at 2, http://www.paulweiss.com/files/Publication/205da5f8-e527-48d7-8c89-269a30fab5ee/Presentation/PublicationAttachment/30b4db2e-f850-4887-aeaa-2cc4d4921550/13-Jul-07SECMemo.pdf; JONES DAY, SEC ADOPTS SECTION 404 INTERPRETIVE GUIDANCE AND RULE AMENDMENTS; NEW PCAOB AUDITING STANDARD, July 2007, http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4459.

meant to create a more flexible environment where management and the auditors can scale their Section 404 efforts according to the particular facts and circumstances of the company.[82] For smaller, less complex reporting companies, the changes were meant to allow management and the auditors to tailor their efforts to reflect the company's lower level of complexity.[83]

In practice, even before the recent SEC and PCAOB changes – which should help to reduce compliance costs – Section 404 compliance costs appeared to be declining.[84] Nevertheless, there remains a significant risk that Section 404 compliance costs currently exceed the statute's benefits and that Section 404 may continue to be a cost-ineffective statute.

PART II: DO SMALLER COMPANIES REQUIRE SPECIAL ATTENTION?

In the face of this potentially cost-ineffective statute, is there something about smaller companies that warrants their receiving significant relief from Section 404? The answer to this question turns out to be "maybe." Before analyzing the special case of smaller companies, it is necessary to point out that there is no precise definition for what constitutes a "smaller company." One of the most commonly employed techniques for classifying companies by size is to consider their equity market capitalization. This is the approach, for example, that the SEC has taken with respect to Section 404. Roughly speaking, reporting companies with market capitalizations of $700 million or more are "larger" reporting companies,[85] while those with market capitalizations of less than $75 million are the "smallest" reporting companies.[86] For those reporting companies that fall in the middle range (i.e., market capitalization between $75 million and $700 million), many – if not all of them – could be considered "smaller" reporting companies, and are frequently referred to as "smallcap" companies.[87] Since this Article

82. SEC May 2007 Press Release, *supra* note 81; *see also* SEC Release 34-56152, *supra* note 78, at 4.

83. SEC May 2007 Press Release, *supra* note 81; *see also* SEC Release 34-56152, *supra* note 78, at 4.

84. *See* discussion *infra* Part III.B.

85. Exchange Act Rule 12b-2, *supra* note 24 (defining "large accelerated filers").

86. These companies would not qualify as "accelerated filers" as defined in Exchange Act Rule 12b-2, *supra* note 24.

87. *See, e.g.*, Final Report of the Advisory Committee on Smaller Public

concludes that smaller reporting companies should not be granted special regulatory relief, it will not be exploring the precise boundaries of the classification.

A. Cost-Ineffective Regulations Tend to Disproportionately Harm Smaller Companies

As a general rule, complying with legal mandates is disproportionately more expensive for smaller companies (e.g., as a percentage of revenues or profits) than for larger companies.[88] This increased regulatory burden for smaller companies appears to stem from the tendency of regulatory compliance to involve a significant amount of fixed costs, irrespective of the size of a company.[89] For example, a firm must develop an expertise in the particular regulation or requirement, and establish internal procedures, and assign personnel, to handle the regulatory or compliance function. Many of these information-gathering and personnel costs are not dependent upon firm size. Thus smaller firms with lesser revenues are forced to bear these fixed costs over a smaller revenue base, which disproportionately lowers their profitability.[90] The same principle applies to auditing activities. Smaller companies have also historically paid disproportionately higher audit fees (as a percentage of revenues) than larger companies. Because Section 404 involves both an increased regulatory and auditing burden,

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Companies to the U.S. Securities and Exchange Commission 15 and 16 (2006), *available at* http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

88. EWING MARION KAUFFMAN FOUNDATION, ON THE ROAD TO AN ENTREPRENEURIAL ECONOMY: A RESEARCH AND POLICY GUIDE 28 (July 2007), *available at* http://www.kauffman.org/uploadedFiles/entrepreneurial_roadmap_2.pdf. *But see* W. MARK CRAIN, THE IMPACT OF REGULATORY COSTS ON SMALL FIRMS (Sept. 2005), *available at* http://heartland.temp.siteexecutive.com/pdf/21117.pdf (report delivered under a contact with the Office of Advocacy, the United States Small Business Administration). Crain's study indicates that the most extreme disproportionate impact occurs with small companies that have less than 20 employees. *Id.* at 54-55. Section 404, however, is unlikely to apply to such extremely small companies. When Crain compared companies with between 21 and 499 employees ("medium-sized companies") to companies with 500 or more employees ("large companies"), the disproportionate impact of regulatory costs shrinks substantially. *Id.*

89. *See* Office of Chief Counsel for Advocacy, U.S. Small Bus. Admin., *The Changing Burden of Regulation, Paperwork, and Tax Compliance on Small Business – A Report to Congress* (Oct. 1995), *available at* http://www.sba.gov/ADVO/laws/archive/law_brd.html [hereinafter OCCA Report].

90. *See id.*

it poses a double threat of disproportionate treatment for smaller companies.

A 2006 report by the U.S. Government Accountability Office (the "GAO") to the U.S. Senate Committee on Small Business and Entrepreneurship (the "GAO Report")[91] provides evidence of the disproportionately higher audit fees that smaller companies face and of Section 404's aggravation of the situation. The GAO Report, which analyzed the impact of SOX on smaller public companies (including costs of compliance and access to capital),[92] found that "resource limitations make it more difficult for smaller public companies to achieve economies of scale, segregate duties and responsibilities, and hire qualified accounting personnel to prepare and report financial information."[93] The GAO Report examined public issuers' audit fees in 2003 and 2004 (the first year that internal control reports were required) and found:

- "[s]maller companies historically have paid disproportionately higher audit fees than larger companies as a percent of revenues;"[94] and
- "the percentage difference between median audit fees paid by small versus large public companies grew in 2004, particularly for companies that implemented [SOX's] internal control provisions (section 404)."[95]

The following table provides the summary statistics from the GAO's examination of audit fee costs:[96]

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91. U. S. GOV'T ACCOUNTABILITY OFFICE, REPORT TO THE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP, U.S. SENATE: SARBANES-OXLEY ACT – CONSIDERATION OF KEY PRINCIPLES NEEDED IN ADDRESSING IMPLEMENTATION FOR SMALLER PUBLIC COMPANIES (Apr. 2006), *available at* http://www.gao.gov/new.items/d06361.pdf [hereinafter GAO REPORT].

92. *Id.* at 2.

93. *Id.* at 18.

94. *Id.* at 5.

95. *Id.*

96. *Id. at 16.* Professors Kamar, Karaca-Mandic, and Talley produced a similar table in their article on SOX's effect on small firms. Kamar et al., *supra* note 10, at 14.

Market cap of issuers (in millions)	**Median audit fee (% of 2003 revenues)** [97]	**Companies that filed ICFR reports in 2004**		**Median audit fee (% of 2004 revenues)**[98]	
		No.	**%**	**Companies that filed ICFR Reports**[99]	**Companies that did not file ICFR Reports**
$0 - $75	0.64%	66 of 2,263	3%	1.14%	0.79%
>$75 - $250	0.29%	520 of 1,188	44%	0.56%	0.35%
>$250 - $500	0.18%	376 of 641	59%	0.40%	0.26%
>$500 - $700	0.15%	184 of 309	60%	0.30%	0.20%
>$700 - $1,000	0.13%	183 of 283	65%	0.25%	0.12%
>$1,000	0.07%	927 of 1,342	69%	0.13%	0.07%

While cost-ineffective regulations harm all companies, smaller companies are particularly vulnerable. Due to greater resource constraints, smaller companies already face numerous and substantial disadvantages when trying to compete against larger companies.[100] If Section

97. Based on publicly-reported audit fees. GAO REPORT, *supra* note 91, at 15.

98. Based on publicly-reported audit fees. *Id.* at 15.

99. While the GAO REPORT provides an approximation of the impact of Section 404 on audit fees, the methodology of the GAO REPORT did not allow it to specifically isolate the audit fees associated with Section 404. *Id.* at 15.

100. More than a half century ago, economist Joseph A. Schumpeter explained how the need for smaller companies to overcome their competitive disadvantages vis-à-vis larger, more well-established competitors helps to revolutionize economies from within. This process, which Schumpeter referred to as "Creative Destruction," describes how new, smaller competitors must seek innovations to render their competitors obsolete. JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY 83 (3d ed. 1950). Entrepreneurs create new products, markets, processes for doing business, and even new industries, while old inefficient ones are destroyed. These newly created ventures must be more innovative and productive than their already established competitors in order to compete, which has the added benefit of forcing the established competitors to improve. Established competitors, as well as entire industries, that cannot meet the increased competition and innovations are forced out of business, which causes a constant renewal of the economy. *Id.*

404 is in fact cost-ineffective, the greater resource constraints that tend to hamper smaller companies – coupled with the disproportionately negative impact of cost-ineffective regulations and auditing standards – make it even more difficult for them to compete by retarding their growth (i.e., making them less profitable) and further exacerbating their resource disadvantages vis-à-vis their larger, more well-established competitors. Such an outcome should be expected to render the environment for forming and developing smaller companies less attractive.

B. Small Companies are not a Homogenous Group

Proposals calling for Section 404 relief for smaller reporting companies are frequently motivated, at least in part, by this potential threat to smaller companies and the perceived critical role that smaller companies play in the U.S. economy. For example, in his testimony before the House Small Business Committee on June 5, 2007 regarding the impact of Section 404 on small companies, David T. Hirschmann, Senior Vice President, U.S. Chamber of Commerce and President, U.S. Chamber Center for Capital Markets, made the following statement as a justification for delaying the implementation of Section 404 for non-accelerated filers:[101]

> Small business drives much of the economic activity, innovation, and job creation in the United States. Over the last decade, for example, small businesses have generated 60 to 80 percent of net new jobs. These businesses made up 97 percent of exporters and produced 28 percent of the known export value in FY 2005. Small businesses employ 41 percent of high-tech workers and produce 13 to 14 times more patents per employee than large patenting businesses.[102]

101. David T. Hirschmann, Senior Vice President, U.S. Chamber of Commerce and President, U.S. Chamber Center for Capital Markets Competitiveness, Testimony before the House Small Business Committee, Getting Small Business Right: Sarbanes-Oxley Section 404 and Small Business (June 5, 2007), *available at* http://www.house.gov/smbiz/hearings/hearing-06-5-07-sox/testimony-06-05-07-USCC.pdf.

102. *Id.* at 3 (citing U.S. Small Business Administration, Frequently Asked Questions – Advocacy Small Business Statistics and Research, http://web.sba.gov/faqs/faqIndexAll.cfm?areaid=24 (last visited Jan. 14, 2009)).

Despite the frequency of such small businesses accolades,[103] these general statements about the benefits of small businesses are misleading and can distort the analysis of policy initiatives aimed at assisting U.S. economic growth and job creation.[104] General statements of this sort are misleading because it is simply and unambiguously inaccurate to view small companies as a homogenous group.[105] In reality, the term *small company* encompasses a wide range of different types of companies, not all of which serve such economically and socially beneficial roles. For example, the Small Business Association provides statistics for "small businesses", which are generally defined as those business having less than 500 employees.[106] SOX has almost no impact on the vast majority

103. *See, e.g.*, U.S. Small Business Administration, Frequently Asked Questions, http://www.sba.gov/advo/stats/sbfaq.pdf (last visited Jan. 14, 2009) (providing various statistics about smaller businesses). Even the Chairman of the SEC is prone to such general statements about small businesses. In his opening remarks for the 2006 SEC Government-Business Forum on Small Business Capital Formation, SEC Chairman Christopher Cox made the following statement:

> Since the beginning of our country, small businesses have been the backbone of the American economy. It's a continuing marvel that even today, in the 21st century – in the midst of globalization and globe straddling technology, small business creates more jobs than anyone else . . . . Small businesses pump billions in the economy. They are, in many ways, what makes America great.

25TH ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, FINAL REPORT, 10 (2006), *available at* http://www.sec.gov/info/smallbus/gbfor25.pdf.

104. Daniel Sandler, *Tax Incentives and Angel Capital: Federal & State Incentive Review and Commentary*, VC EXPERTS, Nov. 2, 2004, *available at* http://vcexperts.com/vce/news/buzz/archive_view.asp?id=245 (on file with author).

105. Robert Heilbroner and Lester Thurow discussed this misconception as follows:

> In the last two decades the assertion has often been made that most of the jobs in America are being created by small businesses and that, as a result, such business should be seen as the engines of national economic success. By implication, nothing else is necessary or important. Such assertions are neither factually correct nor economically true. What creates jobs are not small businesses as such, but small businesses that grow large (Wal-Mart, Hewlett Packard, Microsoft).

ROBERT HEILBRONER & LESTER THUROW, ECONOMICS EXPLAINED: EVERYTHING YOU NEED TO KNOW ABOUT HOW THE ECONOMY WORKS AND WHERE IT'S GOING 171 (rev. ed., Simon & Schuster 1998).

106. U.S. Small Business Administration, Frequently Asked Questions, *supra* note 103.

> The Office of Advocacy [of the U.S. Small Business Administration] defines a small business for research purposes as an independent business having fewer than 500 employees. Firms wishing to be designated small businesses for government programs such as contracting must meet size standards specified by the U.S. Small Business Administration (SBA) Office of Size Standards. These standards vary by industry [.]

of "small businesses," as SOX only applies to reporting companies and the vast majority of small businesses are private companies with no desire (or no realistic hope) of ever being a reporting company. More than 90% of small businesses consist of what are commonly referred to as "livelihood businesses"[107] (also referred to as "Mom and Pop businesses"), whose object is:

> [T]o provide an income for the organizers and perhaps members of their families . . . . There is no "exit strategy," no expectation of a dynamic multiple of earnings being paid for the business five years down the road, no equity investors other than the founder . . . no sources of cash capital other than the local bank.[108]

For example, owner-operated convenience stores, suburban construction companies, or hair salons typically fall under the livelihood business classification. As a result, discussions of the potential impact of Section 404 on "small businesses" generally overstate the statute's reach. In practice, the "small companies" that are impacted by Section 404 constitute a very different profile of companies than the traditional small business designation. The group impacted by Section 404 is limited to smaller reporting companies and to private companies for which becoming a reporting company is a reasonable possibility in the foreseeable future (e.g., companies that reasonably forecast conducting an IPO in the foreseeable future). To provide some structure to this concept, and to highlight the heterogeneity of smaller companies and their particular issues, this Article will distinguish between three types of small companies that are impacted by Section 404:

Rapid-Growth Start-ups: These private companies are created with the intention to rapidly grow and become dominant firms. Rapid-Growth Start-ups are well-represented in the high technology sector (e.g., the private technology firms that dominate Silicon Valley) and are frequently the target of venture capital investments.[109] While representing only a very small percentage of private small businesses, it is Rapid-Growth

Id.

107. DANIEL SANDLER, VENTURE CAPITAL AND TAX INCENTIVES: A COMPARATIVE STUDY OF CANADA AND THE UNITED STATES 2 (2004) .

108. JOSEPH W. BARTLETT, EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCTURINGS AND REORGANIZATIONS 7 (2d ed. 1995).

109. Orcutt, *Angel Finance Market*, *supra* note 48, at 865.

Start-ups, and not livelihood businesses, that have demonstrated a capacity to create a disproportionate amount of the innovations,[110] macroeconomic growth,[111] and net new jobs[112] in the United States.[113]

Growth Smaller Reporting Companies ("Growth SRCs"): These smaller reporting companies have a realistic possibility of growing and becoming large companies. This category is dominated by (i) former rapid-growth start-ups that have conducted IPOs, and (ii) former large reporting companies that have struggled (and as a result, have become smaller companies), but that have retained the ability to correct their problems and grow back into larger companies. One common factor among Growth SRCs is that such companies receive a significant level

110. One technique that has been used to measure the innovation advantage from rapid-growth start-ups is to examine the patents that come out of companies that have received financing from VC funds. *See* Samuel Kortum & Josh Lerner, *Assessing the Contribution of Venture Capital to Innovation*, 31 RAND J. ECON. 674, 674-75, 689-91 (2000) (finding that VC-backed companies produced more patents than non-VC-backed companies and the patents the VC-backed firms produced were apparently more valuable).

111. *See* MARK VAN OSNABRUGGE & ROBERT J. ROBINSON, ANGEL INVESTING: MATCHING START-UP FUNDS WITH START-UP COMPANIES – THE GUIDE FOR ENTREPRENEURS, INDIVIDUAL INVESTORS, AND VENTURE CAPITALISTS 22 (2000).

112. *See* Jeffrey E. Sohl, *The Early-Stage Equity Market in the USA*, 1 VENTURE CAPITAL 101, 105 (1999). ("Over the last 4 years [from 1996 to 1999], these high growth start-ups added 6 million jobs to an economy that added 7.7 million jobs in total. For entrepreneurs, size is a transient characteristic where firms start small (and as such receive the small business label) but grow fast."). *Id*; *see also* DAVID BIRCH ET AL., WHO'S CREATING JOBS? 6-7 (1994).

> Most of the new jobs attributable to small firms are thus created by a relatively few small firms that start small and grow fast. Said another way, most small firms grow slowly. It is not the local drug store or beauty shop or restaurant that is the main engine of job growth – it is the Gazelle [Birch's nickname for "mostly smaller firms that start with the intent to grow, and pull it off"].

Id. Gazelles (which accounted for no more than 3% of firms) added 4.4 million jobs to the economy between 1989 and 1993, a period when the economy hardly grew. *Id.* at 6.

113. Furthermore, rapid growth start-ups cull less productive companies and industries, a benefit that allows those resources to be redeployed in a higher value-add manner. One study examined the impact of small firms generally on the competition level of industries in which they operate. Joan E. Mitchell, *Small Firms: A Critique*, THREE BANKS REV. 50 (1980). The essay argues that "small firms have a special role in increasing competition" with large firms within an industry, and they can increase the competitive level of the industry as a whole. One reason is that small firms may be less inclined to adopt collusive and restrictive practices, which can reduce the competitive level of the industry. *Id.* at 54-55.

of institutional and secondary market support for their securities, frequently referred to by academics as support from "securities market intermediaries" or "financial intermediaries".[114] Namely, these companies have meaningful coverage from research analysts[115] and a significant portion of their outside shareholders are large, institutional investors (e.g., mutual funds or hedge funds).[116] These companies may also receive additional secondary support through coverage by the financial press and support from investment banks.

Orphan Smaller Reporting Companies ("Orphan SRCs"): These smaller reporting companies have little to no meaningful institutional support. Orphan SRCs are unlikely to have any meaningful research coverage,[117] and they are also unlikely to have meaningful ownership from large, institutional shareholders. This category is dominated by (i) firms that trade on the Pink Sheets or the OTC Bulletin Board,[118] (ii) former rapid-growth start-ups that have conducted IPOs, but have since proved to be unsuccessful, (iii) former large companies that have strug-

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114. *See, e.g.*, Stephen J. Choi, *A Framework for the Regulation of Securities Market Intermediaries*, 1 BERKELEY BUS. L.J. 45 (2004); Orcutt, *Angel Finance Market*, *supra* note 48.

115. Research analysts (aka securities analysts) conduct research on particular securities and provide research reports to investors in order to assist their investment decisions regarding such securities. Orcutt, *Investor Skepticism*, *supra* note 55, 6-10.

116. For a discussion of the importance of institutional support for smaller companies, see 26TH ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, RECORD OF PROCEEDINGS, 109-111 (2006), *available at* http://www.sec.gov/info/smallbus/2007gbforumproceedings.pdf.

117. COFFEE, *supra* note 40, at 270 (citing statistics provided by Thomson/First Call). ("[O]f the roughly 14,000 publicly-traded companies in the U.S. [including both large and smaller companies], fewer than 6,000 are today covered by even a single analyst (and less than half of these 6,000 are covered by two or more analysts)."). *Id.*

118. Pink Sheets – Electronic OTC Markets, Defining the OTC Market and the Pink Sheets, http://www.pinksheets.com/pink/otcguide/investors_index.jsp (last visited Jan. 24, 2009).

> The OTC, or 'Over-the-Counter,' market is not an organized marketplace or exchange. OTC is a catchall phrase for any market in an equity security that is not listed on a US exchange or on the Nasdaq Stock Market. OTC securities are issued by companies that either choose not to list, or are unable to meet the standards for listing, on NASDAQ or a US stock exchange. OTC equity securities can be quoted on the Pink Sheets Electronic Quotation Service, and/or, if the securities are registered with the SEC and their issuers are current in their reporting obligation, on the OTC Bulletin Board.

Id.

gled so badly that they are unlikely to recover, and (iv) companies that have gone public through reverse mergers with public shells.[119]

Rather than idealized growth companies, it is Orphan SRCs that dominate the smaller companies impacted by Section 404.[120] So, while small company advocates may wish to improve the operating environment for Rapid-Growth Start-ups and Growth SRCs by reducing the impact of Section 404, they must also account for the impact that such regulatory reduction would have on Orphan SRCs and their security holders.

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119. Reverse mergers into public shells are sometimes used as a technique by companies to "go public" without conducting an IPO. Professor Sjostrom offers the following explanation:

> A private operating company merges into a non-operating or shell public company. In the merger, the operating company shareholders are issued shares of the shell in exchange for the operating company shares. Post-merger, the former operating company shareholders own 80-90% of the shell (which now contains the assets and liabilities of the operating company) with the remaining 10-20% owned by the existing shell company shareholders (i.e., the shell's promoter and its affiliates). The shell company's name is then changed to the name of the operating company, and the company's shares are listed for trading on the Pink Sheets or, if it has at least 200 shareholders, the OTC Bulletin Board. Where do these public shells come from? There are many promoters of public shells out there. Do a Google search of "public shell" and you'll see what I'm talking about. These promoters typically incubate their own shells—they incorporate a company, voluntarily register its shares under the 1934 Act, and then timely file with the SEC the required quarterly and annual reports. Because the shell has no operations, it's fairly simple and inexpensive to make these filings. In exchange for letting an operating company merge into a shell, the promoter charges the operating company a fee and retains the 10-20% interest in the shell post-merger. They pitch the shell as quicker, easier and cheaper way to go public than through a conventional IPO . . . The company is now public in the sense that its shares are registered with the SEC and quoted on the Pink Sheets or OTC Bulletin Board, but it has not received the two primary benefits of going public: additional equity capital and share liquidity. Merging with a shell does not raise any capital. As for liquidity, no underwriter is helping to develop active trading in the company's stock, so while the shares are technically publicly traded, the market is illiquid. Nonetheless, the company now faces the many disadvantages of being public including increased expenses, increased liability exposure, and loss of confidentiality.

Going Public Through a Public Shell Reverse Merger, Posting of Bill Sjostrom to Business Law Prof Blog, http://lawprofessors.typepad.com/business_law/2005/10/going_public_th.html (Oct. 30, 2005).

120. Based on the Thomson/First Call statistics cited in COFFEE, *supra* note 40, at 270, more than 8,000 of the 14,000 publicly-traded companies in the United States have no analyst coverage.

C. Do Smaller Companies have a Greater Need for Section 404?

As the picture of the smaller companies impacted by Section 404 becomes clearer – including the fact that the category is dominated by Orphan SRCs – the question that follows is whether smaller reporting companies have a greater need than larger companies for the services provided by Section 404.[121] While Section 404 appears to be disproportionately more expensive for smaller reporting companies, is it also disproportionately more beneficial?

1. The Case for Section 404 being Less Beneficial for Smaller Companies

Rational arguments can be made that Section 404 is less beneficial for smaller reporting companies than for larger reporting companies. For example, smaller reporting companies are more likely to have simpler financial operations,[122] which could make it easier for their management to have relatively complete and accurate financial data without the need for elaborate internal controls. Additionally, internal control structures may be less useful for smaller companies since they tend to rely more heavily on top managers for control, who are likely able to override the controls irrespective of Section 404.[123]

2. The Case for Section 404 being More Beneficial for Smaller Companies

There are equally rational arguments, however, that smaller companies may have a greater need for the services provided by Section 404. To begin with, smaller firms have been more likely than large companies to find weaknesses in their internal controls.[124] Weaker

121. *See, e.g.*, Kamar et al., *supra* note 10. In their study on SOX's effect on small firms, Professors Kamar, Karaca-Mandic, and Talley considered whether small firms have greater need for the services provided by Section 404. *Id.* at 9-11, 27.

122. *See, e.g.*, SEC May 2007 Press Release, *supra* note 81.

123. *See, e.g.*, BUTLER & RIBSTEIN, *supra* note 10, at 53-54.

124. Jeffrey Doyle, Weili Ge & Sarah McVay, *Determinants of Weaknesses in Internal Control Over Financial Reporting*, 44 J. OF ACCT. & ECON. 193, 195 (2007). Doyle, Ge & McVay looked at firms disclosing material weaknesses in their internal controls under Sections 404 and 302 from August 2002 to August 2005. *Id.* Their study found that material weaknesses in internal controls "are more likely for firms that are smaller, less profitable, more complex, growing rapidly, or undergoing restruc-

internal controls increase the potential both for financial fraud and for inadvertent financial disclosure inaccuracies. Not surprisingly, researchers have found that smaller reporting companies tend to have a higher incidence of accounting restatements than larger firms.[125] A 2007 study on restatement trends by Glass Lewis & Co. found that restatements by companies with market capitalizations of less than $75 million constituted 50% of financial restatements by reporting companies in 2005 and 62% in 2006.[126]

On a related note, smaller reporting companies – particularly Orphan SRCs – are less likely to have strong institutional and secondary market support than larger companies.[127] This is relevant because such institutional and secondary market support is critical to the efficient functioning of the market for a particular security. All securities investments pose information problems to investors (e.g., investors do not have complete and accurate information), as well as agency problems (e.g., managers may try to take advantage of their controlling role in the corporation to misappropriate a portion of the corporation's wealth for their own private benefit).[128] Overcoming these problems requires costly information-gathering efforts and monitoring of management.[129] For reporting companies, however, the presence of diverse shareholders complicates these information-gathering and monitoring efforts, and leads to a collective action problem.[130] Namely, while the benefit to the security holders as a whole may justify the cost of gathering and assessing information or monitoring management, such cost is greater than the benefit that would be received by any one security holder or

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turing." *Id*. at 220; Stephen Bryan & Steven Lilien, *Characteristics of Firms with Material Weaknesses in Internal Control: An Assessment of Section 404 of Sarbanes Oxley* (March 2005), *available at* http://ssrn.com/abstract=682363. "Based upon early evidence of firms with material weaknesses, as defined by the Public Accounting Oversight Board, we find that firms with material weaknesses are, on average, both smaller and worse performers than their matched industry counterparts." *Id.* at 23.

125. MARK GROTHE, GLASS LEWIS & CO., THE ERRORS OF THEIR WAYS 8 (Feb. 27, 2007), *available at* http://www.pbs.org/nbr/pdf/GlassLewis-Errors.pdf.

126. *Id.*

127. *See* discussion *supra* Part II.B.

128. Choi & Fisch, *supra* note 44, at 271; *see also,* Cross & Prentice, *supra* note 44, at 339.

129. Choi & Fisch, *supra* note 44, at 271; *see also,* Cross & Prentice, *supra* note 44, at 339.

130. Choi & Fisch, *supra* note 44, at 271; *see also,* Cross & Prentice, *supra* note 44, at 339.

potential security holder.[131] Without a mechanism to spread the costs across the security holders (or potential security holders) collectively, one should expect a suboptimal level of such activities.

A common market response to these information, agency and collective action problems is the presence of institutional and secondary support, which helps to provide the information-gathering and monitoring services on behalf of collective groups of security holders. As a result, companies with more institutional and secondary support should generally be expected to have more efficient pricing of their securities, since they will have a greater level of information-gathering and monitoring services provided to their security holders.

Smaller reporting companies, therefore, face a double problem:

- They are more prone to inaccurate financial disclosure; and
- They receive less collective information-gathering and monitoring services to cope with this increased level of inaccuracy, due to their reduced institutional and secondary support.

As a result, smaller companies may actually have a greater need than larger companies for Section 404's collective mechanism for providing the information gathering and monitoring services that are not being adequately provided by the market.[132]

PART III: SECTION 404 COMPLIANCE COSTS ARE SUBSTANTIAL

While doubt may exist about the overall net effect of Section 404 on smaller companies, there is no doubt that compliance with Section 404 has turned out to be very expensive.

131. Choi & Fisch, *supra* note 44, at 271. For example, a single shareholder who expends resources individually to monitor management may improve the corporation's management and benefit all of the shareholders of the corporation collectively. However, the single shareholder will likely have to bear this cost on its own. *Id.* at 278. Therefore, while the collective group of shareholders may benefit from this increased monitoring, including those that did not bear the cost, such monitoring will not likely take place unless the benefit is so great that it is justified by the individual benefit to the single shareholder. *Id.*

132. *See* Kamar et al., *supra* note 10, at 9-11, 27.

A. Isolating Impact of Section 404 is Difficult

Before examining the available evidence about the costs and benefits of Section 404, it is necessary to point out that isolating the specific impact of Section 404 is an extremely challenging, if not impossible, pursuit.[133] To begin with, Section 404 has not been implemented in a vacuum, but rather is only one part of SOX's complex and far-reaching set of regulatory reforms. As companies have adjusted to Section 404, they have also been adjusting to a multitude of other regulations – many of which are closely related to Section 404, such as SOX Section 302's requirement that CEOs and CFOs individually certify their companies' annual and quarterly Exchange Act reports,[134] a new audit committee requirement,[135] multiple provisions related to management compensation,[136] and a prohibition on auditing firms from providing certain non-audit services to their auditing clients.[137] When trying to determine the costs associated with implementing Section 404, it is not always clear that researchers have been able to segregate the effects of Section 404 from these related regulations, which could falsely inflate the costs associated with Section 404.[138] At the same time, these other various reforms are aimed at reducing the same information and agency problems that Section 404 aims to treat, which makes it difficult to identify with precision whether benefits attributed to Section 404 stem solely from Section 404, or partially from Section 404 and partially from one of the related measures.[139]

Regarding smaller companies, there is the further issue that Section

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133. *See id.* at 2-3.

134. SOX § 302, 15 U.S.C. § 7241.

135. SOX § 302 15 U.S.C. § 78j-1(m) (amending Section 10A of the Exchange Act).

136. For example, Section 306 of SOX prohibits directors and executive officers from trading in their firms' equity securities during pension fund blackout periods, 15 U.S.C. § 7244. Section 402(a) of SOX amends Section 13 of the Exchange Act, 15 U.S.C. § 78m to prohibit most personal loans by issuers to their directors and executive officers. Section 403 of SOX amends Section 16 of the Exchange Act, 15 U.S.C. § 78p to require directors, officers and beneficial owners of more than 10% of the issuer's stock to report their trades in the issuer's securities within two business days of the trade.

137. SOX § 201, 15 U.S.C. § 78j-1(g), (h) (amending Section 10A of the Exchange Act).

138. *See generally* Kamar et al., *supra* note 10, at 2-3.

139. *See generally id.*

404 has yet to be fully implemented for the smallest public companies (i.e., non-accelerated filers). As a result, there is little direct evidence on the specific impact that Section 404 will have on that class of issuers.

B. Direct Compliance Costs

Complying with Section 404 involves a number of direct costs for issuers that can be grouped into three primary categories:[140]

Internal costs: The internal people hours that an issuer is required to dedicate for complying with Section 404.[141]

External costs (excluding audit attestation fees): The external people hours (e.g., external consultants) and expenses (e.g., purchases of improved information technology systems) incurred by the issuer for Section 404 compliance, excluding people hours and expenses from the issuer's primary auditor.[142]

Auditor attestation fees: The amount the issuer pays to receive the Auditor's Internal Control Report.

These direct compliance costs are substantial. In fact, they have proven to be much greater than the SEC's original forecast of annual internal and external costs (excluding auditor attestation fees) of $91,000 per company.[143] For example, Financial Executives International (FEI) annually surveys FEI-member executives from public issuers to determine their direct Section 404 compliance costs.[144] These surveys gener-

140. These are three categories employed by Financial Executives International in its annual survey on the costs associated with implementing Section 404. FIN. EXECUTIVES INT'L & FIN. EXECUTIVES RESEARCH FOUND., FEI AUDIT FEE SURVEY: INCLUDING SARBANES-OXLEY SECTION 404 COSTS, 12, 13, 15 (Apr. 2008) [hereinafter FEI 2008 Survey]; FIN. EXECUTIVES INT'L & FIN. EXECUTIVES RESEARCH FOUND., FEI SURVEY ON SARBANES-OXLEY SECTION 404 IMPLEMENTATION 3, 11-13 (May 2007) [hereinafter FEI 2007 Survey].

141. FEI 2008 Survey, *supra* note 140, at 5, 6.

142. *Id.*

143. SEC Release 33-8238, *supra* note 5. For a discussion of the SEC's methodology for that calculation, see *supra* note 12.

144. FEI provides the following description of the methodology for its 2008 and 2007 surveys. For its 2008 survey:

> In late March 2008, FEI sent an e-mail invitation to participate in an Internet-based

ate roughly 200 responses per year from a range of issuer sizes over the first four years following Section 404's implementation. The following table provides the average results from those surveys for U.S. accelerated and large accelerated filers:[145]

	2004	2005	2006	2007
Large accelerated filers:				
No. of responses to survey	140	136	118	104
Average internal costs[146]	$1,851,545	$1,707,205	$1,200,421	$748,950
Average external costs	$2,319,714	$1,790,067	$1,016,204	$263,954
Average auditor attestation fees	$1,717,134	$1,932,671	$1,599,631	$1,024,649
Total	**$5,887,853**	**$5,429,943**	**$3,816,256**	**$2,037,553**
Accelerated filers:				
No. of responses to survey	65	102	54	64
Average internal costs[147]	$389,350	$401,656	$269,725	$250,820
Average external costs	$618,613	$680,829	$368,185	$249,236
Average auditor attestation fees	$547,227	$645,193	$452,737	$550,654
Total	**$1,555,190**	**$1,727,678**	**$1,090,647**	**$1,050,710**

> survey to 3,566 FEI members from publicly-held companies. Those usable responses (185) received by April 7, 2008, were included in the survey results. This is a response rate of about 5.2%.

FEI 2008 Survey, *supra* note 140, at 10.

For its 2007 survey:

> In early April 2007, FEI sent an e-mail invitation to participate in an Internet-based survey to FEI members from publicly-held companies. Those usable responses (200) received by April 24, 2007, were included in the survey results.

FEI 2007 Survey, *supra* note 140, at 10.

145. Source for the 2007 figures: FEI 2008 Survey, *supra* note 140, at 12. Source for the 2004 – 2006 figures: FEI 2007 Survey, *supra* note 140, at 13.

146. FEI asks respondents to provide the total number of internal people hours that are dedicated to Section 404 compliance, then assumes full-time professionals at 2,000 hours per year at a compensation rate (salary plus benefits) of $100,000 per year. *Id*. at

It should be noted that surveys are notoriously troublesome and can contain serious data distortions, so the findings from the FEI surveys should be taken with at least some degree of skepticism. For example, the issuers who chose to participate in the FEI survey changed from year to year; yet FEI does not report how much a "different group of firms responding to each survey" impacted the change in compliance costs.[148] It also remains unclear whether FEI's surveys were adequately designed to exclude increased costs from Section 302 compliance into its survey of Section 404 compliance costs. Nevertheless, the FEI surveys do provide credible evidence that Section 404 direct compliance costs are significant. Specifically, Section 404 compliance costs are certainly much higher than the $91,000 initially estimated by the SEC. The FEI surveys also support the notion that issuers and auditors may be adapting to Section 404 and becoming more efficient at implementing and assessing ICFR. From 2005 to 2007, the FEI surveys show a 62.5% decrease in direct compliance costs for large accelerated filers, and a 39.2% decrease for accelerated filers.

Other surveys that have been conducted support these basic insights,[149] which can be summarized as follows:

- Section 404 significantly increased accounting and audit costs for all companies (both large and small) that have had to comply with its provisions.
- Efficiencies have been achieved by both large and smaller issuers that have reduced the direct compliance costs somewhat.

Thus, some of the initial concern over Section 404 direct costs appears to have been triggered by one-time, exceptional expenses that

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4, 11-13.

147. FEI asks respondents to provide the total number of internal people hours that are dedicated to Section 404 compliance, then assumes full-time professionals at 2,000 hours per year at a compensation rate (salary plus benefits) of $100,000 per year. *Id*. at 4, 11-13.

148. Kamar et al., *supra* note 10, at 12.

149. *See, e.g.*, CRA INT'L INC., SARBANES-OXLEY SECTION 404 COSTS AND IMPLEMENTATION ISSUES: SPRING 2006 SURVEY (Apr. 17, 2006) *available at* http://polaris.umuc.edu/~kklose/website/Sox%20404.pdf; CRA INT'L INC., SARBANES-OXLEY SECTION 404 COSTS AND IMPLEMENTATION ISSUES: SURVEY UPDATE (Dec. 8, 2005), *available at* www.deloitte.com/dtt/cda/doc/content/us_investorcenter_CRAIIfinal.pdf.

issuers faced in order to develop and implement systems for documenting internal controls that comply with Section 404. These expenses were amplified for smaller companies, as it appears that Section 404 caused many of them to document their internal controls for the first time in the 2004 – 2005 period,[150] even though internal accounting control systems had been required for public companies since 1977.[151] Going forward, it will be interesting to see whether issuers can squeeze further efficiencies out of their Section 404 direct compliance costs (the SEC is trying to help this initiative via its new interpretive guidelines[152] and AS 5[153]) or whether the major efficiencies have already been captured.

As non-accelerated filers begin to comply with Section 404, it will also be interesting to examine their experience with initial Section 404 costs. On the one hand, one should expect their initial development and implementation expenses to be somewhat reduced due to the accumulation of knowledge that has been generated by accelerated filers. On the other hand, there are thousands of non-accelerated filers who will now need auditor attestations for fiscal years ending on or after December 15, 2009. It is plausible that the increased demand for auditor attestations by non-accelerated filers could cause an increase in auditing costs generally as auditors seek to meet this increased demand.[154]

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150. GAO REPORT, *supra* note 91, at 5.

151. Exchange Act §§ 13(b)(2)(A), (B), 15 U.S.C. § 78m(b)(2)(A), (B), which were implemented as part of the FCPA in 1977. Section 13(b)(2)(A) requires reporting companies to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." 15 U.S.C. § 78m(b)(2)(A). Section 13(b)(2)(B) requires reporting companies to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that . . . (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statement, and (II) to maintain accountability for assets." 15 U.S.C. § 78m(b)(2)(B)(ii)(I), (II).

152. SEC Interpretive Release 33-8810, *supra* note 74, at 1.

153. *Supra* note 81.

154. *See generally* Keith Crandell, Board Director for the National Venture Capital Association, Written Testimony to House Small Business Committee, Hearing on Sarbanes-Oxley Section 404 Relief (May 4, 2006), *available at* http://www.nvca.org/pdf/Crandell%20Testimony%205-3-06.pdf.

C. Indirect Compliance Costs Difficult to Calculate, but may be Substantial

In addition to its direct compliance costs, which have received much attention, Section 404 also involves substantial indirect costs. Many of these indirect costs are easy to identify, but unlike the direct costs, they are unfortunately much more difficult to value. One of the more commonly cited indirect costs is the management time and energy dedicated to Section 404 that could be spent elsewhere. Professors Butler and Ribstein point out that "management energy and resources are scarce. What is spent on SOX compliance is not spent on other activities that may be more valuable to the firm and to society."[155]

For smaller companies, where senior management is often relied upon to actively manage the day-to-day operations of the issuer, these lost opportunity costs could be substantial. According to the GAO Report:

> [S]ome of the smaller companies that responded to our survey reported that their CFOs and accounting staff spent as much as 90 percent of their time for the period leading up to their first Section 404 report on Sarbanes-Oxley Act compliance-related issues. Finally, many of the smaller companies incurred missed "opportunity costs" to comply with the act that were significant. For example, nearly half (47 percent) of the companies that responded to our survey reported deferring or canceling operational improvements and more than one-third (39 percent) indicated that they deferred or cancelled information technology investments.[156]

Another commonly-cited indirect cost was expressed by Keith Crandell, director for the National Venture Capital Association, in his May 4, 2006 testimony before the House Small Business Committee regarding the impact of Section 404 on small companies:

155. BUTLER & RIBSTEIN, *supra* note 10, at 50.
156. GAO REPORT, *supra* note 91, at 17.

> [A]t a time when small companies need their accounting firms more than ever, Section 404 has created an unhealthy motivational shift in the accounting profession as it relates to supply and demand. In response to Sarbanes-Oxley, the [“Big Four” auditors] I am familiar with have shifted their focus on auditing companies of all sizes to leveraging lucrative 404 practices at large corporations. Thus they are abandoning the smaller companies whose needs are equally as critical. [157]

PART IV: WHETHER SECTION 404 IS COST-EFFECTIVE IS LESS CLEAR

While Section 404’s costs are well-documented, quantifying its benefits has proven difficult, which leads critics and supporters to argue over the cost-benefit implications of Section 404.[158] Critics decry that Section 404 “has gone too far” and point to: (1) the substantial compliance costs, reasoning that it is unrealistic to expect that Section 404 generates sufficient benefits to offset those costs, and (2) anecdotal evidence that suggests that smaller reporting companies are employing strategies to avoid being subject to Section 404. Conversely, proponents for Section 404 tend to focus on the beneficial impact that Section 404 should have on investor protection and on an issuer’s cost of capital. This Part IV will attempt to sift through evidence on Section 404’s net effect.

A. Management Surveys Suggest that Section 404 is Cost-Ineffective

A number of surveys have been conducted asking management of issuers subject to Section 404 to provide perceptions of the provision’s net effect. The findings from three of the more frequently cited of those management surveys follow.

1. FEI Survey

The FEI surveys covering 2005 and 2006 asked survey participants whether the benefits of compliance with Section 404 exceeded their costs. That question generated the following results:[159]

157. Crandell, *supra* note 154.
158. *See* CCMR REPORT, *supra* note 3, at 115.
159. FEI 2007 Survey, *supra* note 140, at 19.

	2005	**2006**
Large accelerate filers		
Number of responses	136	118
Benefits of Section 404 exceed costs for their company:		
Agree	17.7%	21.1%
Disagree	82.3%	78.9%
Accelerated filers		
Number of responses	102	54
Benefits of Section 404 exceed costs for their company:		
Agree	11.2%	23.5%
Disagree	88.8%	76.5%

Respondents to the FEI survey covering 2007, however, expressed "more confidence in the value of Section 404,"[160] in particular those respondents that were accelerated (rather than large accelerated) filers.

160. FEI 2008 Survey, *supra* note 140, at 9.

	Accelerated Filers		Large Accelerated Filers	
	2006[161]	2007[162]	2006[163]	2007[164]
Number of Responses	54	64	118	104
Financial reports are more accurate as a result of Section 404:				
Agree	33.3%	51.8%	51.4%	49.5%
Disagree	66.7%	48.2%	48.6%	50.5%
Financial reports are more reliable as a result of Section 404:				
Agree	39.2%	55.4%	52.3%	56.4%
Disagree	60.8%	44.6%	47.7%	43.6%
Section 404 helped prevent or detect fraud:				
Agree	29.4%	41.1%	36.4%	45.2%
Disagree	70.6%	58.9%	63.6%	54.8%
Section 404 has generated more investor confidence in your financial reports:				
Agree	58.0%	69.1%	60.6%	69.1%
Disagree	42.0%	30.9%	39.4%	30.9%

2. *Rittenberg/Miller Survey*

Professor Larry Rittenberg and Patricia Miller published a survey in 2005 that was aimed at capturing the benefits of Section 404.[165] The Rittenberg/Miller survey asked participants for their opinion regarding the relative costs and benefits associated with Section 404 compliance, and generated the following results from 171 respondents (which were predominantly larger companies):[166]

161. FEI 2007 Survey, *supra* note 140, at 18.
162. FEI 2008 Survey, *supra* note 140, at 16.
163. FEI 2007 Survey, *supra* note 140, at 18.
164. FEI 2008 Survey, *supra* note 140, at 16.
165. Larry E. Rittenberg & Patricia K. Miller, *Sarbanes-Oxley Section 404 Work – Looking at the Benefits*, THE IIA RESEARCH FOUNDATION (Jan. 2005), *available at* http://www.theiia.org/research/research-reports/chronological-listing-research-reports/downloadable-research-reports/?i=248.
166. The 171 responses consisted of 54 from companies with more than $6 billion in annual sales (or 31.6%), 64 from companies with annual sales between $1 billion and

	First year effort to get ready for Section 404	**Ignoring the year-one start-up costs and looking forward to steady state of control assessments**
Costs greatly exceed benefits	37%	6%
Costs exceed benefits	35%	30%
Costs equal benefits	14%	25%
Benefits exceed costs	13%	31%
Benefits greatly exceed costs	1%	8%

3. Foley & Lardner Survey

Foley & Lardner LLP has been conducting annual surveys to gauge the impact of corporate governance reform on public companies since 2003.[167] The 2006 survey generated 114 responses from public companies (33 from issuers with annual revenue of $1 billion or more; 80 from issuers with annual revenue of less than $1 billion; 1 company did not specify).[168] The Foley & Lardner surveys included the following question that relates somewhat to the cost/benefits of Section 404:[169]

$6 billion (or 37.4%), 42 from companies with annual sales between $200 million and $1 billion (or 24.6%) and 4 from companies with less than $200 million in annual sales (or 2.3%). Seven of the respondents did not report their annual sales. *Id.* at 5.

167. FOLEY & LARDNER LLP, THE COST OF BEING PUBLIC IN THE ERA OF SARBANES-OXLEY 18 (June 15, 2006), *available at* http://www.foley.com/files/tbl_s31Publications/FileUpload137/3420/ndi%202006%20public%20study%20FINAL.pdf (Foley & Lardner worked with the national research firm KRC Research on the survey).

168. *Id.*

169. *Id.* at 12.

	2003	2004	2005	2006
Do you feel that the corporate governance and public disclosure reforms implemented since the enactment of the Sarbanes-Oxley Act in 2002 are too strict, or not strict enough?				
Too strict	55%	67%	82%	82%
About right	38%	27%	16%	18%
Not strict enough	5%	2%	2%	–
Don't know/no answer	3%	4%	–	1%

The above responses would seem to reflect a growing dissatisfaction with SOX reforms and their costs. In 2006, Foley & Lardner included the following two new questions:[170]

	2006
Do you agree or disagree with the following statement: The cost of Sarbanes-Oxley Act compliance has resulted in budget and/or staffing cuts in critical areas of my business.	
Agree	34%
Disagree	65%
Don't know/no answer	1%
[Only asked of those agreeing with the above statement] To what extent do you agree or disagree with the following statement: The cost of Sarbanes-Oxley Act compliance has negatively impacted my organization's earnings.	
Agree	95%
Disagree	5%

4. Interpreting the Findings from the Various Surveys

Together, these surveys provide very inconclusive evidence regarding Section 404's net effect and should be interpreted cautiously. At first glance, the surveys seem to offer support to the Section 404 critics, as they provide evidence that public company executives do not find

170. *Id.* at 14.

Section 404 to be cost-effective. There are a number of problems with that conclusion, however. First, the surveys suffer from many of the typical problems that plague surveys, such as a small sample size. More significantly, the surveys do not necessarily ask the right party about whether Section 404 is cost-effective. Issuer executives are particularly well-suited to determine the costs associated with Section 404, since the issuer bears most of the costs associated with Section 404. Issuer executives, however, are not necessarily well-suited to estimate the benefits that derive from the provision. Section 404 is designed primarily to benefit investors, not issuer management, so issuer management may be less capable of judging the benefits. Moreover, these executives should be expected to be biased against Section 404 for a number of reasons wholly unrelated to the actual effectiveness of the regulation. In particular, Section 404 generates immediate and concrete monetary costs to the issuer, while the benefits, in the form of reduced information and agency problems, are not immediate and concrete, and are actually an implicit criticism of management's competence and honesty. It should be expected, therefore, that many executives will want to find that their financial data is no more accurate post-Section 404 than it was pre-Section 404.

B. Section 404 Avoidance Strategies Also Suggest that Section 404 is Cost-Ineffective

Since SOX applies only to reporting companies, firms that wish to avoid Section 404 because they find it cost-ineffective may engage in strategies to avoid being a reporting company. Section 404 critics point to three public market trends that developed post-SOX: (i) an increase in "going-dark" transactions by smaller reporting companies; (ii) a reduction in U.S. IPOs by smaller companies; and (iii) an increase in U.S. smaller companies conducting IPOs on foreign stock markets (in particular the AIM market in London).

1. Increase in Going-Dark Transactions

The Exchange Act subjects companies with a class of registered securities (frequently referred to as "reporting" companies) to an elaborate regulatory system that includes periodic reporting requirements[171],

171. Exchange Act § 13(a), 15 U.S.C. § 78m(a); Exchange Act § 15(d), 15 U.S.C. §

federal proxy rules[172], federal tender offer rules[173], the Foreign Corrupt Practices Act[174] and SOX. For reporting companies that wish to free themselves from this regulatory system (including the requirements of SOX and Section 404), the Exchange Act also provides them with the ability to "deregister" their securities.

Section 12(g)(4) of the Exchange Act provides that companies with a class of registered securities may terminate the registration if the number of "holders of record" for that class of securities falls below 300.[175] Interestingly, the provision focuses on "holders of record" rather than "beneficial owners." The beneficial owner is the person one typically thinks of as the "real" owner of the security (e.g., the investor who purchased the security and enjoys the "benefits" of ownership such as collecting dividends and voting the shares),[176] while the holder of record, in contrast, is the party in whose name the securities are held on the books of the issuer or its transfer agent.[177] For example, when an investor buys securities through a brokerage firm, most brokerage firms will hold those securities in "street name,"[178] which means the brokerage firm will hold the securities in its name, and not in the name of the investor.[179] Thus, the investor is the beneficial owner of the securities, and the brokerage firm is the holder of record. Because publicly-held securities are predominantly held in street name,[180] even public companies of a significant size and with multiple thousands of beneficial shareholders may still be eligible for deregistration. If the class of securities the issuer is trying to deregister is listed on a national securities ex-

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78o(d).

172. Exchange Act § 14, 15 U.S.C. § 78n.

173. Exchange Act §§ 13(d), (e), 14(d)-(f), 15 U.S.C. § 78m(d)(e), n(d)-(f).

174. FCPA, *supra* note 45.

175. Exchange Act § 12(g)(4), 15 U.S.C. § 78l(g)(4); Exchange Act Rule 12g-4(a), 17 C.F.R. § 240.12g-4(a). For issuers whose total assets have not exceeded $10 million on the last day of each of the issuer's three most recent fiscal years, the issuer may seek to terminate registration for a class of securities when held of record by less than 500 persons. Exchange Act Rule 12g-4(a), 17 C.F.R. § 240.12g-4(a).

176. Investopedia, "Beneficial owner", http://www.investopedia.com/terms/b/beneficialowner.asp (last visited Jan. 14, 2009).

177. Exchange Act Rule 12g-5-1, 17 C.F.R. § 240.12g5-1.

178. SEC, On-Line Publications for Investors, Holding Your Securities – Get the Facts, *available at* http://sec.gov/investor/pubs/holdsec.htm (last visited Jan. 14, 2009).

179. *Id.*

180. *See* Hazen, *supra* note 45, at 329, n. 13.

change, the issuer must also delist those securities from that exchange.[181]

Issuers can "deregister" through two basic methods:

Going private: An issuer "goes private" when it discontinues public trading of its securities and becomes a private company.[182] This could be accomplished through a number of techniques, including encouraging an unrelated private company to acquire the issuer (e.g., through a private equity transaction[183]), conducting a management buyout or conducting a transaction that involves a combination of both. For example, the wave of leveraged-buyouts in the 1980s that were conducted by private equity investors (a.k.a. buyout firms) and managers were classic examples of "going-private" transactions.

Going dark: An issuer "goes dark" when it deregisters its securities, but continues to maintain public trading in those securities through the OTC markets.[184] Going-dark transactions can be accomplished by cashing out enough security holders (typically shareholders) to reduce the holders of record to less than 300, but leaving enough beneficial owners of the securities to allow for some level of OTC trading.

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181. There are ten securities exchanges registered with the SEC as national securities exchanges under Section 6 of the Exchange Act, 15 U.S.C. § 78f: New York Stock Exchange, Nasdaq Stock Market LLC, American Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, International Securities Exchange, National Stock Exchange (formerly the Cincinnati Stock Exchange), NYSE Arca (formerly the Pacific Stock Exchange) and the Philadelphia Stock Exchange. For a helpful discussion on delisting, see BAINBRIDGE GUIDE TO SOX, *supra* note 10, at 223-34.

182. Christian Leuz, *Was the Sarbanes-Oxley Act of 2002 Really this Costly? A Discussion of Evidence from Event Returns and Going-Private Decisions,* 44 J. ACCT. & ECON., 146, 149 (2007).

183. This Article is using the term "private equity" as it is commonly employed in the U.S. financial markets. Namely, private equity refers to large buyout funds (e.g., The Blackstone Group, The Carlyle Group, KKR, or the Texas Pacific Group) that seek to acquire a substantial ownership stake in operating companies. In addition to providing financial capital, private equity investors typically take a very active role in the management of the firms in which they invest. *See, e.g.*, Private Equity: Frequently Asked Question, http://www.privateequitycouncil.org/just-the-facts/private-equity frequently-asked-questions/ (last visited Jan. 14, 2009).

184. Leuz, *supra* note 182, at 149.

In addition to regulatory avoidance, a multitude of other reasons can motivate a reporting company to "go private,"[185] including the benefit of managerial expertise or other synergies of a strategic partner, or the desire to undertake a higher risk strategy for the firm that might not be appreciated by external shareholders. Going-dark transactions, however, appear to be motivated entirely by a desire for regulatory avoidance.

(a) Available Data

A number of studies have been conducted to try to determine whether deregistrations increased post-SOX, potentially indicating that firms were seeking to avoid being subject to SOX. While the various studies employed different methodologies, they universally found a substantial increase in post-SOX deregistrations. The following are summaries of five such studies.

(1) Leuz, Triantis and Wang Study

Professors Christian Leuz, Alexander Triantis and Tracy Wang compared a sample of 484 firms that went dark and 436 firms that went private between January 1998 and December 2004 to a sample of firms that remained reporting companies.[186] Leuz, Triantis and Wang found a significant increase in going-dark transactions in 2003 and 2004,[187] but no discernable increase in going-private transactions during that period.[188] The study also found that going-dark firms tend to exhibit the following characteristics:

- They are smaller firms.[189]
- They have "poorer stock market performance, higher leverage, and fewer growth opportunities than the population of firms that could but choose not to go dark. They also exhibit higher levels of distress and experience a decline in capital market interest."[190]

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185. *Id.*

186. Christian Leuz, Alexander Triantis & Tracy Wang, *Why do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 J. ACCT. & ECON. 181, 187-89 (2008).

187. *Id.* at 189.

188. *Id.*

189. *Id.* at 190, 204.

190. *Id.* at 204. Distress was measured by examining: (1) a distress score from a bankruptcy prediction model; (2) increases in short-term debt; (3) unreported

- They have a lower level of institutional ownership.[191]
- Finally, they have "larger (positive and negative) accruals relative to their cash flow from operations (consistent with poorer accounting quality and hiding motives), larger free cash flow problems, and weaker board governance and outside monitoring."[192]

Based on their findings, Leuz, Triantis and Wang concluded that many firms went dark "in response to poor future prospects, financial distress and increased compliance costs after SOX."[193] They also found "evidence suggesting that controlling insiders take their firms dark to protect private control benefits and decrease outside scrutiny, particularly when governance and investor protection are weak."[194]

(2) Engel, Hayes and Wang Study

Professors Ellen Engel, Rachel M. Hayes and Xue Wang examined a sample of 470 firms that went private or went dark from January 1998 through May 2005[195] and filed a Schedule 13E-3.[196] The study did not include foreign private issuers or firms that deregistered due to liquidation or bankruptcy. Engel, Hayes and Wang found an increase in the quarterly frequency of deregistrations – including both going-private and going-dark transactions – after the passage of SOX.[197] In analyzing the data, however, Professors Kamar, Karaca-Mandic and Talley found that the increase became insignificant when going-dark transactions

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regressions showing a large drop in Return on Assets; and (4) a lower cash to total assets ratio. *Id.* at 191. For details on the bankruptcy prediction model, see James A. Ohlson, *Financial Ratios and the Probabilistic Prediction of Bankruptcy*, 18 J. ACCT. RES. 109 (1980).

191. Leuz et al., *supra* note 186, at 193, 194, n.13.

192. *Id.* at 205.

193. *Id.* at 181.

194. *Id.*

195. Ellen Engel, Rachel M. Hayes & Xue Wang, *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*, 44 J. ACCT. & ECON., 116, 125-26 (2007).

196. Schedule 13E-3s under the Exchange Act are filed for transactions conducted under Exchange Act Rule 13e-3, 17 C.F.R. § 240.13e-3. Rule 13e-3 transactions involve deregistrations conducted by an issuer or its affiliates as opposed to an outsider. Rule 13e-3(a)(3), 17 C.F.R. § 240.13e-3(a)(3).

197. Engel et al., *supra* note 195, at 143.

were excluded.[198] Finally, Engel, Hayes and Wang found that smaller firms with high insider ownership that announced their deregistration post-SOX experienced higher returns at the announcement than similar firms that announced their deregistration pre-SOX,[199] which could indicate that SOX was imposing a net negative effect on the de-registering companies.

(3) GAO Report

The GAO Report included a deregistration analysis as part of its study on the impact of SOX on smaller reporting companies.[200] The GAO Report examined deregistrations (both going-private and going-dark transactions) that took place from 1998 through the first quarter of 2005.[201] The report did not, however, include firms that deregistered securities other than common stock, companies that were headquartered in a foreign country, or companies that deregistered due to merger into another company, bankruptcy or liquidation.[202] The GAO Report found that deregistrations increased from 143 in 2001 to 245 in 2004[203] – although the numbers are slightly lower if blank check[204] and shell companies[205] are excluded.[206] In addition to noting an increase in deregistrations, the GAO Report analyzed the reasons that companies

198. Kamar et al., *supra* note 10, at 19.
199. Engel et al., *supra* note 195, at 143.
200. GAO REPORT, *supra* note 91, at 21-25, 73-83.
201. *Id.* at 22.
202. *Id*. 74-77.
203. *Id*. at 21, 76.
204. "A blank check company is a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies, other entity, or person." Blank Check Companies, http://www.sec.gov/answers/blankcheck.htm (last visited Jan. 14, 2009).
205. A shell company is a reporting company "with no or nominal operations and either no or nominal assets, assets consisting solely of cash and cash equivalents, or assets consisting of any amount of cash and cash equivalents and nominal other assets." SEC, Final Rule: Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Release Nos. 33-8587, 34-52038, Int'l Series Release No. 1293, 17 C.F.R. Parts 230, 239, 240, 249 (July 15, 2005), *available at* http://www.sec.gov/rules/final/33-8587.pdf.
206. GAO REPORT, *supra* note 91, at 76-77.

reported for deregistering.[207] The following table provides a summary of those reported reasons from the GAO Report:[208]

	Direct Costs of being Reporting Co.	**Indirect Costs of being Reporting Co.**	**Market/Liquidity Issues**	**Private Company Benefits**	**No Reason Cited**
	(% of companies that cited it as a reason for their deregistration)				
Q1 2005	62.2	28.9	28.9	8.9	27.8
2004	52.7	25.7	28.6	15.9	38.4
2003	57.8	27.5	38.5	21.3	31.6
2002	44.4	13.9	35.4	22.9	45.1
2001	32.2	13.3	31.5	23.8	49.0
2000	20.0	11.1	32.2	37.8	38.9
1999	33.3	12.2	33.3	42.2	37.8
1998	12.3	5.3	14.0	26.3	54.4

The most striking result from the "reasons" study is the significant increase in companies that attribute their decision to deregister to the costs associated with being a reporting company, coupled with a corresponding decrease in companies citing private company benefits.

Finally, the GAO Report analyzed where companies that deregistered from July 2003 through the end of March 2005 were trading prior to deregistration. The following table provides a summary of the results:[209]

NYSE	**AMEX**	**Pink Sheets**	**NASDAQ**	**No Public Trading Market**	**OTCBB**
1.8%	5.3%	13.6%	17.6%	24.8%	36.9%

207. The GAO used various sources to identify these reported reasons, including SEC filings, press releases and newswire announcements. *Id*. at 79.

208. *Id*. at 23.

209. *Id*. at 24-25.

(4) Block Study

Professor Stanley B. Block surveyed 110 formerly Nasdaq-listed companies that deregistered (including both going-private and going-dark transactions) between January 2001 and July 2003 to determine why they deregistered.[210] Ninety-six of the firms that participated in the Block study had market capitalizations below $100 million prior to deregistering.[211] The survey generated the following primary reasons for deregistration:[212]

	No. of companies that responded it was the primary reason for deregistering
Cost of being public as opposed to being private	33
Pressures and time constraints for top management	21
Lack of coverage by security analysts	19
Absence of liquidity in the public market	14
No opportunity for a secondary market	12
Threat of delisting by the Nasdaq market	11

(5) Marosi and Massoud Study

Finally, Professors András Marosi and Nadia Massoud examined a sample of 406 firms that deregistered from 1996 through May 2004 to determine why they went dark. Marosi and Massoud did not include firms that filed a Form 15 to deregister only their preferred stock or publicly traded bonds, foreign companies, or companies that deregistered due to merger, bankruptcy or liquidation.[213] The study found that the recent deregistration trend is primarily a going-dark phenomenon, "[u]nlike the wave of LBOs in the 1980s and 1990s."[214] They also

210. Stanley B. Block, *The Latest Movement to Going Private: An Empirical Study*, 14 J. APPLIED FIN. 36, 36 (2004).
211. *Id.* at 38.
212. *Id.* at 40.
213. András Marosi & Nadia Massoud, *Why Do Firms Go Dark?*, 42(2) J. FIN.& QUANTITATIVE ANALYSIS 421, 426 (2007).
214. *Id.* at 423.

found that "firms with fewer growth opportunities, greater insider ownership, lower institutional ownership, lower market momentum, and higher leverage are . . . more likely to go dark"[215] and that the audit costs of complying with SOX were "among the major driving forces behind a firms' decision to go dark."[216]

(b) Basic Picture of Post-SOX Deregistration Phenomenon

The above studies yield the following basic picture of the recent deregistration phenomenon:

The Post-SOX increase in deregistrations has been driven by going-dark transactions: There is little doubt that deregistrations increased following the enactment of SOX. Unlike the deregistration trend in the 1980s and 1990s, however, which primarily involved LBO-driven going-private transactions, the post-SOX increase in deregistrations stemmed from going-dark transactions.[217]

Smaller, weaker firms have gone dark: Going-dark firms have been predominantly smaller firms.[218] Moreover, these going-dark firms have also tended to be "weaker" firms. Specifically, they tend to have weaker recent stock performance, higher leverage, and exhibit higher distress. They also tend to have lower growth opportunities and frequently decide to go dark after experiencing a decline in capital market value.[219] While some of the going-dark firms were listed on one of the major markets in the United States (i.e., NYSE, Nasdaq or Amex), a substantial percentage of the post-SOX going-dark firms were not. Instead, they were trading over-the-counter on either the OTC Bulletin Board or the Pink Sheets, or had no public trading market at all.[220] Presumably, these companies were never listed on a major market because they were not strong enough to satisfy the listing requirements for one of the major markets.

215. *Id.* at 441.
216. *Id.*
217. Leuz et al., *supra* note 186, at 189; Marosi & Massoud, *supra* note 213, at 423.
218. Leuz et al., *supra* note 186, at 190, 204.
219. *Id.* at 204; Marosi & Massoud, *supra* note 213, at 441.
220. GAO REPORT, *supra* note 91, at 24-25.

Going-dark firms suffered from greater agency problems: The going-dark firms appear to present greater agency problems to external equity investors. First, going-dark firms had fewer independent directors,[221] which increased the opportunities for insiders to capture the firm's assets at the expense of outside shareholders. Going-dark firms also tended to have fewer effective external mechanisms for monitoring management performance, as these firms tended to have a lower level of institutional ownership.[222] Finally (and not surprisingly, once one considers the greater agency problems), going-dark firms tended to have poorer accounting quality.[223]

Going-dark firms cited regulatory burden as a significant factor in their decision to go dark: While companies cite a number of reasons for going dark, the direct costs associated with being a public company, including the audit costs required to comply with SOX, is one of the most frequently cited reasons.[224]

(c) Impact of SOX (and Section 404) – Possible Interpretations

Interpreting this data to determine the impact that SOX and Section 404 had on the going-dark phenomenon is not a simple task. Quite simply, a multitude of factors affected firms' decisions to go dark, and there is no mechanism for specifically isolating the effect of SOX or Section 404.[225] For example, consider the substantial number of going-dark firms that had never been listed on a major stock market and had instead always been relegated to the OTC Bulletin Board or the Pink Sheets. Since securities that trade on those markets frequently suffer from substantial liquidity problems and are less likely to be attractive as targets for potential acquisitions, the poor quality of their public market experience may have been the primary driver in their decision to go dark, irrespective of the implementation of SOX.

Accepting the difficulty in isolating the specific impact of SOX and Section 404, there are a few plausible theories that have been offered to explain SOX's impact on the going-dark phenomenon and which find

221. *See* Leuz et al., *supra* note 186, at 194.
222. *See id.* at 193, 194, n.13.
223. *See id.* at 205.
224. *See* GAO REPORT, *supra* note 91, at 23; Block, *supra* note 210, at 37, 40; Marosi & Massoud, *supra* note 213, at 441.
225. *See* Kamar et al., *supra* note 10, at 2-3.

support in the available data. Two of the more prominent theories will be referred to in this Article as (1) the "cost saving" hypothesis[226] and (2) the "private benefits" hypothesis.[227]

(1) Cost Saving Hypothesis

The cost saving hypothesis looks at the net effect of SOX and Section 404 on public issuers and assumes that an issuer's management will be motivated solely by its duty to maximize shareholder value.[228] Under this theory, a public issuer's management will look to deregister if it determines that the additional costs imposed by SOX cause the total costs associated with being a reporting company to outweigh the benefits.[229] Since Section 404 is generally considered to be the most expensive of SOX's provisions, it could be the tipping point that causes management to determine that the public securities regulatory scheme has now become too costly. In short, one can view the cost saving hypothesis as an attempt by management to "increase shareholder value by ceasing to file with the SEC when the net benefit of such reporting has become negative."[230]

The available data supports the cost saving hypothesis in a number of ways. The data strongly suggests that going-dark companies have a decreased ability to access the public capital markets for further capital due to their weak performance. It is also possible that going-dark companies have less need for accessing the public equity markets due to their tendency toward lower growth rates. Since external equity is typically used to fund an issuer's projected growth, companies with low-growth potential should be expected to have less need for such external equity funding. All told, the available data suggests that, on a relative basis, going-dark companies may not derive a very high level of benefit from being a reporting company.[231] At the same time, going-dark companies appear to be the least capable of absorbing the additional regulatory costs imposed by SOX and Section 404, since: (1) their tendency toward economic distress indicates they are less likely to be able to deal with the increased burden, and (2) their small size suggests that the

226. Leuz et al., *supra* note 186, at 185.
227. *Id.*
228. *Id.*
229. *Id.*; Engel et al., *supra* note 195, at 118.
230. Leuz et al., *supra* note 186, at 185.
231. *Id.* at 204.

regulatory burden hits them disproportionately harder than larger firms. The GAO Report's survey evidence provides further support for the cost saving hypothesis, as it indicates that the costs associated with being a public company – including the audits costs required to comply with SOX – were a significant determinant in firms' decisions to deregister.[232]

It is important to note, however, that SOX is not the only factor that can change the balance between the costs and benefits of being a reporting company. There are a multitude of factors wholly unrelated to Section 404 that might reduce the benefits of being a reporting company so dramatically that it is no longer cost-effective to be a reporting company.[233] Consider a Pink Sheet company with the following realistic characteristics: (1) the issuer operates in a sector that is currently not favored by the market; (2) the issuer has no analyst coverage; (3) there is limited secondary-market liquidity for its shares, and manipulative secondary trading practices appear to be taking place involving the issuer's shares; and (4) the issuer's profitability recently took a hit and the issuer forecasts slower growth going forward. In such a setting, the net benefit of being a reporting company may be negative, irrespective of any additional costs generated by Section 404 compliance.

(2) Private Benefits Hypothesis

The private benefits hypothesis offers a plausible alternative theory to the cost saving hypothesis. Under the private benefits hypothesis, management does not receive the altruistic assumption that they will focus solely on maximizing shareholder value. Instead, the private benefits rationale considers whether the decision to go dark may be driven instead by "insiders' interests, rather than the pursuit of [higher] shareholder value."[234] The Leuz, Triantis and Wang study describes the theory as follows:

> Controlling insiders, such as managers or large owners, could take the firm dark to avoid the outside scrutiny that comes with, or is greatly facilitated by, SEC reporting. After going dark, insiders may increase their private benefits of control, including perk consumption, loans on favorable terms, generous compensation pack-

232. See GAO REPORT, *supra* note 91, at 21-23.
233. *See* Kamar et al., *supra* note 10, at 21.
234. Leuz et al., *supra* note 186, at 185.

> ages, the investment of free cash flows into projects that serve insiders' interests, or self-dealing with other companies in which insiders hold stakes. And even for firms that generate little cash that insiders could directly or indirectly appropriate, going dark can offer insiders more entrenchment and less outsider interference. Without SEC reporting, it is easier to extract and protect these private benefits, and the expected (private) costs of detection are lower. Conversely, regulatory events that extend firms' reporting requirements or strengthen their enforcement . . . can increase the expected costs to insiders of being a registered company, which in turn can trigger the decision to go dark.[235]

In short, the private benefits hypothesis predicts that companies that suffer from greater agency problems and private control benefits should be expected to implement regulatory avoidance strategies (such as going dark) when regulations improve outsiders' ability to detect and take action against those problems. The available going-dark data also supports the private benefits hypothesis, as going-dark firms have tended to suffer from greater agency problems. As noted earlier, these firms tend to have greater concentrations of inside shareholders, fewer independent directors, fewer effective external mechanisms for monitoring management performance, and poorer accounting quality.[236]

(3) Addressing the Lemons Problem

We are left, then, with two plausible theories that offer different explanations for SOX's role in the going-dark phenomenon. Under the cost saving rationale, SOX may have harmed smaller companies by disproportionately increasing their regulatory burden and making it too expensive for them to remain as reporting companies. Even if that is the case, some have questioned whether that is actually a bad outcome.[237] The key factor for going-dark firms may not be their smallness, but rather their "weakness." Perhaps encouraging these weaker firms to deregister provides a signal not only of their weakness, but also of the greater strength of those smaller companies that are able to remain reporting companies.[238]

Under the private benefits hypothesis, SOX and Section 404 can

235. *Id.*
236. *See supra* Part IV.B.1.(a)-(b).
237. *See, e.g.*, Kamar et al., *supra* note 10, at 9-11, 27.
238. *See id.*

also be viewed in a positive light, as the increased regulation can be interpreted as providing an improved mechanism for monitoring management performance, which once again will tend to encourage weaker companies to flee this increased scrutiny. Professors Butler and Ribstein raise a legitimate concern about this outcome of chasing away companies with weaker corporate governance structures:

> Even before SOX, insiders could try to avoid disclosure obligations by going private and dark. But SOX's higher disclosure costs now give them a legitimate explanation. Even if this is the real explanation, SOX would be indirectly causing a loss of securities law protection for precisely those shareholders who need it most.[239]

This author suggests, however, that the real culprit for increasing corporate governance requirements (thereby chasing out weaker companies), in such a scenario is not Section 404. Instead, the real culprits are Exchange Act Sections 12(g)(1) and (4) and Rules 12g-1 and -4, for focusing on "record" holders rather than "beneficial" holders, thereby allowing for public secondary markets in securities that do not meet minimum standards for corporate governance.

All told, if Section 404 serves to encourage weaker small companies to leave the public markets – particularly if problems with Exchange Act Section 12(g)(1) and (4) and Rules 12g-1 and -4 are resolved – that could help to reduce a potential lemons problem for smaller companies, by creating a mechanism that allows stronger smaller companies to differentiate themselves from the weaker ones.[240]

2. *Substantial Decrease in U.S. IPOs by Smaller Companies*

If Section 404 is as cost-ineffective as many of its critics claim it to be, its impact should be felt by more than just existing public companies. Private companies that are in a position to access the U.S. public markets through an IPO and become reporting companies should also be expected to exhibit SOX-avoidance strategies. Specifically, if a significant number of IPO-eligible private companies actively seek to avoid U.S. IPOs, that phenomenon could be another indication that Section

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239. BUTLER & RIBSTEIN, *supra* note 10, at 55.

240. The impact of asymmetric information on markets and the resulting "lemons problem" can be traced back to George A. Akerlof, *The Market for "Lemons": Quality, Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

404's costs are not justified. In fact there is evidence to suggest that U.S. IPO avoidance by smaller companies has occurred post-SOX. The following table sets forth summary data for the U.S. IPO market since 1990:[241]

Year	Number of U.S. IPOs	Aggregate Proceeds
2007	159	$35.63 billion
2006	157	$30.48 billion
2005	161	$28.33 billion
2004	174	$31.53 billion
2003	63	$9.58 billion
2002	66	$22.03 billion
2001	80	$34.30 billion
2000	382	$65.11 billion
1999	477	$64.79 billion
1998	284	$33.80 billion
1997	474	$31.59 billion
1996	675	$42.25 billion
1995	458	$30.16 billion
1994	405	$17.40 billion
1993	490	$29.29 billion
1992	397	$21.92 billion
1991	280	$14.16 billion
1990	110	$4.27 billion

The year 2000 (and more precisely, the close of the first quarter of 2000) marked the end of one of the hottest IPO markets in U.S. history. The fact that the window shut on a hot IPO market, however, is nothing exceptional. IPO markets are highly volatile and have always gone through hot periods and cold periods.[242] In particular, a cold stock market should be expected to trigger a cold IPO market. In 2001 and

241. Jay R. Ritter, *Some Factoids About the 2008 IPO Market* 2 (Working Paper, Dec. 15, 2008), *available at* http://bear.cba.ufl.edu/ritter/IPOs2008Factoids.pdf [hereinafter Ritter, *2008 IPO Market*]. Ritters study and the table above excludes IPOs with an offer price of less than $5.00, as well as IPOs involving unit offers, closed-end funds, REITs, partnerships, banks and S&Ls, and stocks not listed on CRSP (which includes Amex, NYSE, and NASDAQ stocks).

242. *See infra* notes 248-52 and accompanying text.

2002, the major stock indices (i.e., the Dow Jones, the S&P 500 and the Nasdaq Composite indices) suffered substantial losses as each continued to retreat from the peaks they had achieved during the first quarter of 2000.[243]

	Peak	**Trough (Oct. 10, 2002)**	**Percentage Change**
Dow Jones	11,908 (1/14/00)	7181	-39.7%
S&P 500	1,553 (3/24/00)	769	-50.5%
Nasdaq Composite	5,132 (3/10/00)	1108	-78.4%

In such an environment, a cold IPO market should be expected. A company will typically seek investment capital when its free cash flows are insufficient to fund the company's growth opportunities. An IPO is one such mechanism for seeking investment capital. Because investment capital is a scarce resource relative to its need, sources of investment capital naturally demand a price for use of their capital.[244] In an IPO, investors charge that price by demanding an ownership percentage of the company in exchange for their funds. Just like with any other good or service, however, the price of IPO investment capital can fluctuate substantially over time. When the public stock markets are "hot", public investors are indicating a desire to part with their investment capital more readily and at valuations that are more favorable to issuers (i.e., an issuer will be required to part with a smaller percentage of the company in order to obtain the investment capital).[245] In such a setting, the cost of equity will be cheaper for many issuers. When the public stock markets are "cold", the inverse is true.[246] In a cold market, public investors are indicating a reduced demand for acquiring public

243. Yahoo! Finance, http://finance.yahoo.com (select specific index under "Market Summary," then "Historical Prices") [hereinafter Historical Prices].

244. Simply put, there are more parties that would like to receive investment capital than there is available investment capital. In order to be motivated to part with their investment capital, these sources of capital will charge the potential users of capital a price (the cost of capital) to compensate for its use.

245. *See generally* Douglas Cumming & Jeffrey MacIntosh, *Boom, Bust, and Litigation in Venture Capital Finance*, 40 WILLAMETTE L. REV. 867, 877 (2004).

246. *See generally id.*

equity, which means the cost of equity will be more expensive for issuers (i.e., an issuer will be required to part with a greater percentage of the company in order to obtain the investment capital). Since the primary reason for conducting an IPO is typically to obtain investment capital to pursue growth opportunities, an issuer should only conduct an IPO when the cost of equity from the IPO is justified by the expected returns from the growth opportunities. Where the cost of equity is particularly expensive, one should expect to see fewer IPOs, as it will require substantially greater growth opportunities to justify conducting the IPOs. Viewed in this light, the lack of IPOs in 2001 and 2002 is very understandable.

What is remarkable is how long the U.S. IPO market has remained cold. In particular, it is surprising to see the U.S. IPO market remain so cold during a period when the U.S. public stock markets experienced a substantial recovery, which should indicate that a more favorable cost of equity would be available for IPO issuers. The following table sets forth the year-end closes for each of the three major stock indices from 2002 through 2007.[247]

	Year End Close					
	2002	**2003**	**2004**	**2005**	**2006**	**2007**
Dow Jones	8,342	10,454	10,783	10,717	12,463	13,265
S&P 500	880	1,112	1,212	1,248	1,418	1,468
Nasdaq Composite	1,336	2,003	2,175	2,205	2,415	2,652

The Dow Jones, S&P 500 and Nasdaq indices each increased from 2003 – 2007 resulting in the following cumulative increases:[248]

	% Increase: Close of 2002 – Close of 2007
Dow Jones	59.0%
S&P 500	66.8%
Nasdaq Composite	98.5%

In spite of this strong post-2002 market growth, the U.S. IPO

247. *See* Historical Prices, *supra* note 243.
248. *Id.*

market remained cold. More specifically, the U.S. IPO market remained "ice cold" for smaller companies. From 2001 – 2007, the U.S. IPO market posted seven consecutive years with less than 200 IPOs being completed. Prior to 2001 the last time that less than 200 IPOs were completed in a year was 1990 and only three times during that 11-year span were less than 300 IPOs completed.[249] If one eliminates 1999 and 2000 as bubble years, the aggregate proceeds raised by IPOs in 2004 recovered to a very respectable level and maintained that level through 2007, despite the drop in number of the number IPOs compared to the pre-2001 era. It does not appear, therefore, that large IPOs for large companies have disappeared; there were twenty IPOs conducted in 2007 with deal sizes of $500 million or more for an aggregate deal size of more than $20 billion.[250] The big reduction in the number of IPOs, therefore, clearly stems from fewer U.S. IPOs by smaller companies.

(a) Section 404 may Render Cost of IPO Equity too Expensive

Section 404 critics argue that the increase in costs imposed by SOX, and specifically by Section 404, is a significant reason for the failure of the U.S. IPO market to rebound for smaller companies. Mark Heesen, President of the National Venture Capital Association, described the problem during his June 2007 testimony to the House Small Business Committee regarding Section 404's impact on smaller companies, as follows:

> [W]e are now seeing companies that have a high enough profit run rate to consider an IPO choosing to be acquired instead. They want to rid themselves of the SOX burden [his testimony focused particularly on Section 404's burden] which currently remains for smaller public companies. The result is a long list of companies that should have been stand alone economic contributors being absorbed into larger entities. Rather than an IPO on a US exchange being the ultimate achievement for a venture backed company, it has now

249. Ritter, *2008 IPO Market*, *supra* note 241, at 2.

250. Renaissance Capital IPO Home.com, Largest IPOs, http://www.ipohome.com/marketwatch/biggest.asp (last visited Jan. 14, 2009). The two biggest IPOs were the June 2007 $4.1 billion IPO by The Blackstone Group and the July 2007 $2.9 billion IPO by MF Global Ltd. THE BLACKSTONE GROUP L.P., 2007 PROSPECTUS 424(b)(4), *available at* http://www.sec.gov/Archives/edgar/data/1393818/000104746907005160/a2178575z424b4.htm; MF GLOBAL LTD., 2007 PROSPECTUS 424(b)(4), *available at* http://www.sec.gov/Archives/edgar/data/1401106/000119312507158324/d424b4.htm.

> become, at best, one of many options to be considered and, at worst, an outcome that is actually avoided. Imagine if Google had been acquired by Microsoft, or Dell by Compaq, or Genentech acquired by J&J. Perhaps the innovation would have survived but the market value, jobs and revenues would have been diluted substantially.[251]

In effect, Section 404 critics like Heesen argue that Section 404 has substantially increased the cost of equity for potential IPO issuers by increasing the regulatory cost of conducting an IPO (and being a reporting company) without a sufficient corresponding benefit from Section 404, such as improved valuation for issuers due to the greater transparency required by Section 404.

To provide some numbers to place this argument in context, consider the following examples of two IPOs that were conducted by "smaller" companies in November 2007:

251. Mark G. Heesen, President, Nat'l Venture Capital Ass'n, Testimony before the House Small Business Committee, Sarbanes-Oxley Section 404: Will the SEC and PCAOB's New Standards Lower Compliance Costs for Small Companies (June 5, 2007), *available at* http://www.nvca.org/pdf/mheesen-testimony-6-5-07.pdf.

Issuer:	**SoundBite Communications, Inc.**	**Nanosphere, Inc.**
Description of Issuer from Prospectus:	A leading provider of on-demand automated voice messaging solutions.[252]	Develops, manufactures and markets an advanced molecular diagnostics platform that enables simple, low cost and highly sensitive genomic and protein testing on a single platform.[253]
Listing/Quotation:	NASDAQ Global Market[254]	NASDAQ Global Market[255]
Amount Sold to Public:	$41,616,176[256]	$98,000,000[257]
Post-Money IPO Valuation of Issuer:	$119,950,744[258]	$295,665,580[259]
Direct Costs Associated with IPO:		
Underwriting discount	$2,913,132	$6,401,250
SEC registration fee	$2,966	$3,955
FINRA fee	$10,160	$13,380
NASDAQ Global Market listing fee	$100,000	$100,000
Printing & mailing fee	$125,000	$350,000
Legal fees & expenses	$825,000	$1,600,000
Accounting fees & expenses	$1,050,000	$1,150,000
Transfer agent & registrar fees	$15,000	$3,500
Miscellaneous	$71,874	$237,540
Total direct costs	$5,113,132[260]	$9,859,625[261]

252. SOUNDBITE COMMC'NS PROSPECTUS 424(b)(1), at 1, *available at* http://www.sec.gov/Archives/edgar/data/1163698/000095013507006649/b64836b1e424b1.htm (last visited Jan. 14, 2009).

253. NANOSPHERE PROSPECTUS 424(b)(4), at 1, *available at* http://www.sec.gov/Archives/edgar/data/1105184/000095015007000046/a32360b4e424b4.htm (last visited

Let us make two further assumptions to complete the picture:

- Two-thirds of the issuer's IPO accounting fees and expenses were due to Section 404 compliance: $700,000 for SoundBite and $766,667 for Nanosphere.
- On a going-forward basis, each issuer will annually incur an additional $1,000,000 of accounting and auditing expenses (internal, external and auditor attestation fees) due to Section 404.

Based on these assumptions – which coincide with the available data on Section 404 compliance costs (and could possibly overstate those costs) – each of the issuers will incur slightly under $6 million over the next five years in Section 404 compliance costs.[262] Let us further assume that Section 404 is highly cost-ineffective and generates only $1 of benefits to an issuer and its shareholders for every $3 of direct costs incurred to comply with the regulation. Given such facts, each of these companies will waste approximately $4 million over the next five years for the right to be a reporting company. Further, that

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Jan. 14, 2009).

254. SOUNDBITE COMMC'NS PROSPECTUS 424(b)(1), *supra* note 252, at cover page.

255. NANOSPHERE PROSPECTUS 424(b)(4), *supra* note 253, at cover page.

256. SOUNDBITE COMMUNICATIONS PROSPECTUS 424(b)(1), *supra* note 252, at cover page.

257. NANOSPHERE PROSPECTUS 424(b)(4), *supra* note 253, at cover page.

258. SOUNDBITE COMMC'NS PROSPECTUS 424(b)(1), *supra* note 252, at 4 (multiplied the common stock to be outstanding after the offering, or 14,993,843 shares excluding the underwriters' over-allotment option, by the public offering price of $8.00 per share).

259. NANOSPHERE PROSPECTUS 424(b)(4), *supra* note 253, at cover page, 6 (multiplied the common stock to be outstanding after the offering, or 21,118,970 shares excluding the underwriters' over-allotment option, by the public offering price of $14.00 per share).

260. SOUNDBITE COMMC'NS REGISTRATION STATEMENT ON FORM S-1/A (filed with the SEC on Nov. 1, 2007), Part II, Item 13 at II-1, *available at* http://www.sec.gov/Archives/edgar/data/1163698/000095013507006582/b64836a8sv1za.htm.

261. NANOSPHERE REGISTRATION STATEMENT ON FORM S-1/A (filed with the SEC on Oct. 29, 2007), Part II, Item 13 at II-1, *available at* http://www.sec.gov/Archives/edgar/data/1105184/000095013407022102/a32360a3sv1za.htm.

262. The assumption only projects out five years because, in this author's past experience working with smaller companies, they seldom do meaningful financial forecasts beyond five years. It is unlikely, therefore, that regulatory costs beyond five years are substantial motivators of their decisions.

wasted $4 million represents 9.6% of SoundBite's public issuance and 3.3% of its post-money IPO valuation, and 4.1% of Nanosphere's public issuance and 1.4% of its post-money IPO valuation.

(b) Counter Argument – Historical Lack of Price Sensitivity by IPO Issuers

At first glance, it seems logical to conclude that adding $4 million of additional expenses over a period of five years to what is already a very expensive endeavor could explain the substantial drop in IPO activity by smaller companies. That $4 million could serve as the proverbial "straw that breaks the camel's back"[263], the additional marginal cost that renders being a public company too expensive for many smaller IPO-eligible companies. Such a conclusion, however, suffers from a significant problem: companies that conduct IPOs tend not to be price sensitive with respect to a few million dollars when making decisions about going public.

There is a substantial amount of empirical support for this lack of price sensitivity. The clearest example is the well-documented phenomenon of issuers "leaving money on the table" in IPOs.[264] In a firm-commitment underwritten IPO (which is the typical method of conducting an IPO), the issuer sells an allotment of its shares to the underwriters, who then sell those shares to the public. The price at which the

263. A more apt analogy might be Mr. Creosote, a fictional character from *Monty Python's The Meaning of Life*. Mr. Creosote is a morbidly-obese man who dines at a French restaurant and proceeds to eat almost all of the food in the restaurant. At the conclusion of his meal, Mr. Creosote states, "I couldn't eat another thing. I am absolutely stuffed." The maitre d' convinces Mr. Creosote to eat a "wafer-thin mint" to finish off his meal. The mint was one bite of food too many, and Mr. Creosote explodes upon swallowing the mint. *See* Wikipedia, Mr. Creosote, http://en.wikipedia.org/wiki/Mr._Creosote (last visited Jan. 14, 2009). Maybe the $4 million are the equivalent of the mint?

264. *See, e.g.*, Ritter, *2008 IPO Market*, *supra* note 241, at 2; Tim Loughran & Jay R. Ritter, *Why Has IPO Underpricing Changed Over Time?* 33 FIN. MGMT. 5-37 (Fall 2004) [hereinafter Loughran & Ritter, *IPO Underpricing*]; Alexander Ljungqvist, *IPO Underpricing: A Survey*, HANDBOOK IN CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE, B. Espen Eckbo, ed., (forthcoming, *available at* http://ssrn.com/abstract=609422); Tim Loughran & Jay R. Ritter, *Why Don't Issuers Get Upset About Leaving Money on the Table in IPOs?*, 15 REV. OF FIN. STUD., 413-43 (2002) [hereinafter Loughran & Ritter, *Money on the Table*]; Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795-1828 (2002).

underwriters initially sell those shares to the public is the product of a negotiation between the issuer's senior management and the underwriters, and that price is not set until the night before public trading in the shares is to commence. This pricing decision typically follows a multi-week investor "road show"[265] and "book building"[266] process that provide valuable information to the issuer and underwriters about the probable demand for the issuer's shares. In such a setting, one should expect the initial offering price to the public to be fairly representative of the public's initial demand (i.e., the initial offering price should end up being very close to the first-day closing price for the shares). In fact, studies have documented that issuers consistently and systematically leave money on the table when they agree to the initial offering price with the underwriters, as IPO issuances frequently close the first day of trading at a significant price increase from the initial offering price (referred to as the "first-day IPO pop"), which means that the issuer "left money on the table."[267]

"Money left on the table" is defined as "the first-day price gain multiplied by the number of shares sold."[268] Professors Loughran and Ritter further explain the concept as follows:

> If the shares had been sold at the closing market price rather than the [initial] offer price, the proceeds of the offering would have been higher by an amount equal to the money left on the table. Alternatively, the same proceeds could have been raised by selling fewer shares, resulting in less dilution of the preissue shareholders. The [first-day] investors' profits come out of the pocket of the issuing company and its preissue shareholders.[269]

Historically, issuers have left an enormous amount of money on the table when pricing their IPOs.[270]

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265. The road show is the company's marketing trip to investors that takes place prior to setting the actual price for the offering. It typically involves a few of the company's executive officers who try to explain to investors why their company will make a good investment.

266. Book building is the process by which an underwriter attempts to determine at what price to offer an IPO based on demand from prospective institutional investors, by collecting non-binding commitments from prospective investors.

267. Ritter, *2008 IPO Market*, *supra* note 241, at 2; Loughran & Ritter, *Money on the Table*, *supra* note 264, at 413.

268. Loughran & Ritter, *Money on the Table*, *supra* note 264, at 413.

269. *Id*.

270. The table is derived from Ritter, *2008 IPO Market*, *supra* note 241, at 2.

Period	No. of IPOs	Aggregate Proceeds	Aggregate Amount Left on Table	Average First-day Return
2004 – 2007	651	$125.97 billion	$15.40 billion	12.2%
2001 – 2003	209	$65.91 billion	$5.11 billion	7.7%
1999 – 2000	859	$129.90 billion	$66.63 billion	51.3%
1990 – 1998	3,573	$224.84 billion	$29.18 billion	12.9%
1990 – 2006	**5,292**	**$546.62 billion**	**$116.32 billion**	**21.3%**

This money left on the table constitutes a substantial transfer of wealth from the issuer and its pre-IPO shareholders to the new IPO shareholders.[271] Interestingly, issuers seldom complain about money left on the table following an IPO. Research has shown, for example, that issuers who left large amounts of money on the table at their IPO do not appear to hold that against the IPO underwriters when choosing underwriters for a follow-on offering.[272] While there is no clear answer as to why issuers and their pre-IPO shareholders are willing to leave so much money on the table when they price their IPOs,[273] the fact remains that such parties exhibit, on a not too infrequent basis, a lack of price sensitivity when conducting IPOs. This lack of price sensitivity is so substantial that it is plausible to wonder whether a few million dollar increase over a five-year period is truly such a significant motivator for an issuer contemplating an IPO.

Another powerful example of issuers' lack of price sensitivity is the general lack of price competition for many of the expenses that are involved with conducting an IPO. Investment banks, for example, are notorious for not competing based on price for underwriting business. The typical underwriting discount for an IPO is seven percent.[274] While the underwriting discount may vary somewhat based on the size of the deal (e.g., extremely large deals will typically be conducted at a lesser

271. *See id.* at 414.

272. Laurie Krigman, Wayne H. Shaw & Kent L. Womack, *Why do Firms Switch Underwriters?* 60 J. FIN. ECON. 245, 256-58 (2001).

273. For summaries of some of the more common theories for the IPO underpricing phenomenon, see generally Loughran & Ritter, *IPO Underpricing*, *supra* note 264, and Ljungqvist, *supra* note 264.

274. Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. FIN. 1105, 1108 (2000).

discount), investment banks will almost never vary that percentage in order to win business.[275] This lack of price competition over the highest direct cost involved with an IPO strongly suggests that issuers are not price sensitive to a few million dollars. The same could be said about legal fees associated with IPOs, where issuers similarly tend not be very price sensitive when choosing outside counsel to assist with the IPO.

In the face of this lack of price sensitivity evidence, claims that Section 404 has rendered IPOs unaffordable lose much of their force.

(c) Spotlight Hypothesis

IPOs for smaller companies did, however, drop substantially following the introduction of SOX, during a period when the U.S. stock markets showed significant growth. This Article offers an informal theory to explain why price-insensitive issuers may have indeed reacted to Section 404 when deciding whether to pursue an IPO.

As discussed above, a company should be expected to conduct an IPO when: (1) the issuer's growth opportunities require external funding, (2) external funding can be obtained at a cost that is justified by the expected returns from the growth opportunities, and (3) an IPO provides the lowest cost of capital of the potential sources of capital. To intelligently make such a calculation, an issuer must undertake a number of difficult assessments. First, the issuer must competently forecast its growth opportunities, which is inherently difficult since it involves predicting the future. Thus, when calculating the cost of equity to determine whether the growth opportunities justify the cost of capital, the issuer should be aware that it is comparing the cost of capital against a growth number that is likely to involve a significant degree of inaccuracy. Second, the issuer must calculate the cost of obtaining external capital – another inherently imprecise calculation, particularly when trying to calculate the cost of equity from an IPO. Three broad categories of factors impact the cost of equity from an IPO: (1) the valuation the company achieves; (2) the various costs associated with conducting the IPO; and (3) the ongoing maintenance costs associated with being a publicly-traded company.

Company valuation: The valuation the company achieves (i.e., the price at which the stock is sold to the public) will typically be the big-

275. Orcutt, *Investor Skepticism*, *supra* note 55, at 17, n.76.

gest factor in the company's cost of equity. A myriad of factors impact a company's valuation, only some of which are in the company's control, such as the company's financial performance or the quality of its management team. Others factors are outside the company's control, such as the condition of the public stock markets, the condition of the IPO market, and whether the sector in which the issuer operates is in demand at the time. To make the cost of equity calculation particularly difficult for the issuer, the decision as to whether or not to conduct an IPO will typically be based on a projected valuation range that is calculated many months before the IPO is actually conducted, which leaves the issuer vulnerable to changes in those factors that are outside of its control.

Costs associated with conducting the IPO: Numerous costs associated with conducting an IPO reduce the net proceeds the issuer will actually receive. Those costs include the underwriting discount, fees paid to legal counsel and public auditors, the listing fees for the public stock market on which the issuer's stock will trade, printing and mailing fees, transfer agent fees and the expenses involved with conducting the investor roadshow.

Ongoing maintenance costs associated with being a publicly-traded company: These costs include the various costs associated with being a reporting company, including notably the costs of complying with the Exchange Act's disclosure requirements.

In total, a multitude of factors interacts to establish the eventual cost of equity that an issuer achieves in an IPO. While it might be comforting to imagine an issuer's management working through all of the various factors and scenarios and attempting to make a precise mathematical calculation, such an outcome is unlikely. Even if an issuer's management can recognize each of the potential factors and understand its potential impact (and few managers would be capable of doing that), the probability of any particular outcome occurring is negligible.[276] This Article offers an informal theory that, when faced with such a monu-

276. *See generally* DAVID DREMAN, CONTRARIAN INVESTMENT STRATEGIES: THE NEXT GENERATION 111 (1998). Dreman's analysis focused on the securities analysts and the fact that they are required to make a single, precise prediction while faced with a multitude of factors that can lead to an almost infinite number of outcomes. *Id.*

mental task, an issuer's management will not try to conduct a detailed cost of equity analysis, but instead will allow its decision-making to be guided by one or more psychological heuristics.[277] For example, an issuer's management may fall prey to the "anchoring"[278] or "focalism"[279] cognitive bias, focusing almost entirely on a few key factors rather than trying to weigh all of them. Based on this author's experience as an investment banker and as IPO counsel, management was generally very attentive to the impact of only a few of the cost of equity factors when deciding whether or not to pursue an IPO. In particular, management typically focused on the issuer's forecasted profits and the condition of the markets, without fully internalizing most of the other factors, including the costs associated with conducting the IPO and the ongoing maintenance costs associated with being a public company. Moreover, management did not fully appreciate the impact of the IPO underpricing that underwriters might seek at the time of the actual IPO. Because management did not base the decision to pursue an IPO on these other factors, these other factors were treated as incidental expenses and were managed less aggressively, ultimately resulting in a lack of price sensitivity.

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277. "In psychology, heuristics are simple, efficient rules, hard-coded by evolutionary processes or learned, which have been proposed to explain how people make decisions, come to judgments, and solve problems, typically when facing complex problems or incomplete information. These rules work well under most circumstances, but in certain cases lead to systematic cognitive biases." Wikipedia, Heuristic, at http://en.wikipedia.org/wiki/Heuristic (last visited Feb. 2, 2009). "Although much of the work of discovering heuristics in human decision-makers has been done by Amos Tversky and Daniel Kahneman, the concept was originally introduced by Nobel laureate Herbert Simon." *Id.*

278. Professors Amos Tversky and Daniel Kahneman describe anchoring as follows:

> In many situations, people make estimates by starting from an initial value that is adjusted to yield the final answer. The initial value, or starting point, may be suggested by the formulation of the problem or it may be the result of a partial computation. In either case, adjustments are typically insufficient. That is, different starting points yield different estimates, which are biased toward the initial values. We call this phenomenon anchoring.

Amos Tversky & Daniel Kahneman, *Judgment under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124, 1128 (1974).

279. "Focalism" refers to the tendency to focus exclusively on a particularly salient element without consideration of other potentially relevant information. HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT 295 (Thomas Gilovich, Dale Griffin & Daniel Kahneman, eds., 2002).

Section 404 changed the above situation by causing an issuer's management to focus on the costs associated with conducting the IPO and the ongoing maintenance costs associated with being a public company when deciding to conduct an IPO. All of the attention Section 404 has received has caused management to become much more cognizant of the multitude of expenses that issuers conducting an IPO must face. Thus, instead of being perceived as an incremental cost of $4 million (per the earlier example), Section 404 may have helped management to more fully internalize two entire categories of costs when deciding whether an IPO offers an appropriate cost of equity. Rather than fundamentally changing the cost of conducting an IPO, Section 404's greater impact – at least temporarily – may have been to change management's psychology in respect of those costs. Since Section 404 was the source of this change in psychology, management ascribes to it a disproportionate amount of the blame.

Issuers with an IPO cost of equity that is not justified by the projected growth returns (or where the spread is only very slight) are now more cognizant of the costs and should be more likely to seek an alternative source of capital, such as selling the company to a large strategic acquirer or getting an investment from a private equity fund. Interestingly, the availability of these alternative sources of capital has increased substantially during the IPO lull for smaller companies, which could indicate that the investment market is properly adjusting to a tight IPO market for smaller companies. It is also worth noting that while a vibrant IPO market for smaller companies can provide a number of significant benefits (e.g., promoting a vibrant venture capital industry[280]), over-dependence on IPOs as a financing tool for smaller companies can pose significant problems to social welfare. Such problems include sometimes encouraging an inappropriate risk transfer of higher-risk investments from investors that are specialized in such higher-risk investments (e.g., venture capital funds) to less sophisticated public investors, and motivating venture capitalists to engage in certain behaviors that have less positive implications for social welfare (e.g., shifting their investments from early-stage investment to lower value-added late-stage investing and over-investment in "hot" industry sectors to the exclusion of other industry sectors).[281]

280. *See* Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON. 243, 274 (1988).

281. *See* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 345-47 (2d

Viewed in this light, the reduction in IPOs and their replacement by alternative sources of financing might be positive. This author predicts, however, that as the uproar over Section 404 quiets, its ability to focus management on factors other than the core valuation factors will likely wane and will soon have the negligible impact on IPO decision-making that one would normally expect from only a few million dollars.

3. Increase in IPOs on Foreign Stock Markets by Smaller U.S. Companies

One additional potential Section 404 avoidance strategy that has received a fair amount of attention is the increase in IPOs on less-heavily regulated foreign stock markets by smaller U.S. companies. The London Stock Exchange's Alternative Investment Market ("AIM") is the foreign stock market that appears to have become the most viable alternative for smaller U.S. companies. Touted as the "most successful growth market in the world,"[282] AIM was launched in 1995 and at year-end 2007 had 1,634 listed companies with a total market capitalization of over £94 billion.[283] Beginning in 2000, AIM became an option for U.S. companies seeking to conduct an IPO.[284]

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ed. 2004)); *see also* Cumming & MacIntosh, *supra* note 245, at 877-81.

282. London Stock Exchange, Company Services – AIM, http://www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/aim_new/AIM (last visited Jan. 14, 2009).

283. London Stock Exchange, AIM Market Statistics 1 (Dec. 2007), http://www.londonstockexchange.com/NR/rdonlyres/B6293B90-1125-4591-9E32-C67135B3EE4D/0/AIMMarketStatistics0712.pdf (last visited Jan. 114, 2008).

284. VC Experts.com, VC Encyclopedia, AIM International Fact Sheet – USA (July 2007), http://vcexperts.com/files/encyclopedia/2825/us_aim_international_fact_sheet.pdf (last visited Jan. 14, 2009) [hereinafter AIM International Fact Sheet – USA]. Prior to 2000, only one U.S. company conducted an IPO on AIM. The U.S. company was Reflec, a chemical company, that listed on AIM in May 1997. *Id*.

	No. of U.S. Companies that Conducted IPOs on AIM	**Aggregate Market Capitalization at Admission**
2006	25	$3,216.4 million
2005	18	$2,908.7 million
2004	9	$444.0 million
2003	3	$161.9 million
2002	2	$125.5 million
2001	1	$34.8 million
2000	1	$18.9 million

One possible interpretation of the AIM phenomenon is that smaller U.S. companies are raising equity capital on AIM because it offers them a lower cost of equity due to the lower regulatory costs involved with an AIM listing (including the fact that regulations governing AIM listings do not include a Section 404 type of provision). For this interpretation to be plausible, however, it requires that the smaller U.S. companies who conducted their IPOs on AIM were attractive enough to conduct an IPO on a U.S. stock market. Otherwise, the companies are not making a choice between AIM and the U.S. stock markets. For example, companies wishing to list on the NASDAQ Global Market are effectively required to have a market capitalization of $50 million.[285] To attract meaningful interest from U.S. underwriters and investors, however, the threshold is more likely to be a market capitalization of at least $100 million at admission. The following table sets forth market capitalization figures for the U.S. companies that conducted IPOs on AIM from 2004 – 2006.[286]

	Total No. of U.S. companies that conducted IPOs on AIM	**Aggregate market capitalization at admission**	**No. with market capitalization of $50 million or more at admission**	**No. with market capitalization of $100 million or more at admission**
2006	25	$3,216.4 million	18	10
2005	18	$2,908.7 million	14	10
2004	9	$444.0 million	2	2
Total	**52**	**$6,569.1 million**	**34**	**22**

285. NASD Marketplace Rules 4420(b), 4450(b).

286. AIM International Fact Sheet – USA, *supra* note 284.

The result is that less than half of the companies that listed on AIM had a realistic ability to conduct an underwritten IPO in the United States. Instead, 22 companies over a three-year period may have made the choice to conduct an AIM IPO in order to escape potentially cost-ineffective U.S. securities regulation. This is no mass exodus. In considering the decision of the 22 companies that initially chose to list on AIM rather than a U.S. stock market, it is worth noting that cost savings may not have been the only – or even the dominant – factor in their decision making. The private benefits hypothesis[287] and the spotlight hypothesis[288] are also very plausible explanations for their decisions.

Interestingly, of the 52 U.S. companies that conducted an AIM IPO between 2004 and 2006: seven are currently Exchange Act reporting companies,[289] one has gone on to list on the NASDAQ Global Select Market,[290] one has gone on to list on the NASDAQ Capital Market,[291] and two have gone on to list on AMEX.[292]

C. Net Effect of Section 404 Remains Unclear

Overall, Section 404's net effect on smaller companies remains unclear. There does not appear to be any question that Section 404 is costly and disproportionately more expensive for smaller companies than for larger companies. However, Section 404 is not without significant potential benefits, and it is possible that those benefits exceed its significant compliance costs. Unfortunately, Section 404's benefits are difficult to calculate with any level of precision, which renders a simple cost-benefit analysis for Section 404 nearly impossible to conduct. Furthermore, the available anecdotal evidence fairs no better at defini-

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287. *See* discussion *supra* Part IV.B.1.c(2).

288. *See* discussion *supra* Part IV.B.2.c.

289. Analysis updated through Mar. 1, 2008: The seven companies are: Allied Healthcare International Inc., Elcom International, Inc., Energy XXI (Bermuda) Limited, Enova Systems, Inc., FutureFuel Corp., Spearhead Limited, Inc., and UTEK Corporation.

290. Analysis updated through Mar. 1, 2008: Allied Healthcare Int'l Inc., http://www.alliedhealthcare.com (last visited Jan. 14, 2009).

291. Analysis updated through Mar. 1, 2008: Energy XXI (Bermuda) Limited, http://www.energyxxi.com (last visited Jan. 14, 2009).

292. Analysis updated through Mar. 1, 2008: UTEK Corporation, http://www.utekcorp.com (last visited Dec. 27, 2008); Enova Systems, Inc., http://www.enovasystems.com (last visited Jan. 14, 2009).

tively resolving whether Section 404 is ultimately cost-effective or cost-ineffective for smaller companies.

In the face of this uncertainty, what should federal policymakers do about Section 404 and its application to smaller public companies?

PART V: WHAT SHOULD FEDERAL POLICYMAKERS DO IN THE FACE OF THIS UNCERTAINTY?

The SEC has not ignored Section 404's potential negative impact on smaller companies. For example, the SEC has implemented Section 404 slowly in order to give smaller reporting companies time to adjust.[293] It has also tried to make management's and auditors' evaluations of ICFRs more effective and efficient by amending the rules relating to management's evaluation of ICFR, issuing interpretative guidance that management can use as a safe harbor in its evaluation of ICFRs, and adopting revised auditing standards.[294] The question remains, however: Should Congress and the SEC do more?

A. Exempting Smaller Reporting Companies from Section 404

This Article considers whether Congress and the SEC should exempt smaller reporting companies from Section 404 compliance. Such exemption could come in several different forms. Three of the more commonly suggested methods for exempting smaller reporting companies from Section 404 are as follows:

Complete Exemption: Smaller reporting companies under a certain size-threshold could be completely relieved from complying with Section 404.

Opt-out Approach: Smaller reporting companies could be subject to Section 404, but would also be allowed the ability to "opt out" of Section 404.[295]

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293. *See supra* Part I.C.

294. *Id.*

295. Professors Butler and Ribstein have proposed such an opt-out solution for Section 404. BUTLER & RIBSTEIN, *supra* note 10, at 88-90.

Eliminate the Auditor Attestation Requirement: Since auditor attestation fees make up a substantial portion of Section 404's compliance costs,[296] some have suggested eliminating the external audit of the effectiveness of a reporting company's ICFR as a means to reduce Section 404's compliance costs for smaller reporting companies.[297]

B. Exemption Proposals Offer a Market-Based Solution to Determine whether Section 404 is Cost-Effective

The exemption proposals do have some appeal, as they offer a market-based resolution to the uncertain value of Section 404. In each case, smaller companies would be relieved (either completely or substantially) from mandatory compliance with Section 404, but would retain the ability to voluntarily choose to comply with Section 404 if they found it to be cost-effective. Market-based solutions can be attractive because they help to address the inherent allocation problems that exist for the services provided by the U.S. securities regulatory system. The U.S. securities regulatory system provides a variety of services – such as rule making, monitoring and supervision – to various stakeholders in the securities markets,[298] including issuers of securities, broker-dealers, investors and even the public at large. While there is some debate as to the ultimate goal of securities regulation,[299] the more typically cited goals of the formal regulatory system include:

296. *See* discussion *supra* Part III.B.

297. *See, e.g.*, Mark G. Heesen, President, Nat'l Venture Capital Ass'n, Comment on Proposed ICFR Rules, Standards and Guidance: SEC File No. S7-24-06, PCAOB Docket Matter No. 021, at 10-11 (Feb. 23, 2007), *available at* http://www.nvca.org/pdf/NVCA_SEC_PCAOB404.pdf.

298. David Llewellyn, *The Economic Rationale for Financial Regulation* 6 (FSA Occasional Papers in Financial Regulation, Apr. 1999), *available at* http://www.fsa.gov.uk/pubs/occpapers/OP01.pdf.

299. The most commonly cited rationales for securities regulation are investor protection and enhancing market efficiency. *See, e.g.*, Franklin Allen & Richard Herring, *Banking Regulation versus Securities Market Regulation* 2 (Wharton Fin. Inst. Ctr., Working Paper No. 01-29, 2001). *But see,* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711 (2006). The authors assert that protection of the common investor is an antiquated goal of securities regulation and that the more appropriate goal of securities regulation is to "create a competitive market for sophisticated professional investors and analysts (information traders)." *Id.* at 711.

- to reduce market problems such as information asymmetries or agency problems that either (i) expose members of the public to inappropriate risk that they are not capable of properly evaluating, or (ii) reduce the efficiency of a securities market;
- to provide the economies of scale to reduce numerous collective action problems that plague widely dispersed investors;
- to help to reduce the impact of potential "lemons problems" that are inherent to securities markets by signaling or establishing minimum standards of quality; and/or
- to allow expert regulators to standardize certain procedures, which could lead to lower transaction costs for issuers, investors and market professionals.[300]

Presumably, Section 404 provides a service that addresses in some manner many, if not all, of the above goals. Unlike most goods or services, however, the services provided by the formal securities regulatory system are not supplied through a market process, which can lead to a number of serious allocation problems for the securities regulatory services.[301] For example, information can be lost about the amount and type of regulation that various consumers desire, the price the consumers are willing to pay for the regulation, and the changes in the cost of the regulation that may occur over time.[302] Overall, the lack of market process increases the likelihood that a sub-optimal level of regulation will be provided – with certain matters being over-regulated while other matters are under-regulated. It is this allocation problem that drives the complaints lodged by critics that Section 404's application to smaller companies "goes too far." No one argues that improving ICFRs for smaller reporting companies is undesirable; instead, critics contest that Section 404 involves over-regulation, as "too much" of this service is provided to the relevant stakeholders. Presumably, the critics believe

300. For a thoughtful overview of various reasons for financial regulation (including reducing market problems, providing economies of scale and addressing lemons problems), see Llewellyn, *supra* note 298, at 21-26. Llewellyn's analysis had a particular focus on banking regulation, but is also applicable to securities regulation. With regards to lowering transaction costs by standardizing procedures, Regulation S-K provides a good example. In theory, Regulation S-K's standardization of disclosure should reduce the costs (i) to issuers of furnishing information and (ii) to market professionals and investors of analyzing and comparing the information.

301. Llewellyn, *supra* note 298, at 6.

302. *See id*.

that smaller company shareholders would not pay for the Section 404 service if given the choice, because the cost of the service outweighs the benefit.

In a market-based setting, such an allocation problem works itself out through consumers expressing their demand for a service either by purchasing or not purchasing the service. In the regulatory setting, regulations are less clearly bought and sold, which makes it much more difficult to identify consumers' actual demand for the service. The proposals help to address the allocation problem by providing a market-based mechanism for smaller reporting companies to decide whether to "purchase" (i.e., voluntarily adopt) Section 404. If managers of smaller reporting companies act to maximize shareholder value, one should expect them to: (1) voluntarily choose to comply with Section 404 if it proves to be cost-effective, since it would have a net positive impact on shareholder value, or (2) avoid Section 404 if it is cost-ineffective, since it would have a net negative impact.

C. A Model for Analyzing the Probable Impact of Exempting Smaller Reporting Companies from Section 404

While empowering smaller reporting companies with such market-based regulatory solutions seems appealing at first glance, this Article posits that structural factors within the public securities markets for smaller reporting companies will prevent such market-based proposals from achieving such a beneficial allocation outcome.[303] Instead, the proposed Section 404 relief proposals are more likely to increase information asymmetries for smaller reporting companies, with the risk of these greater information asymmetries being borne almost entirely by unsophisticated ordinary investors.

303. This reminds the author of Myron Scholes' (co-author of the famous Black-Scholes equation for valuing options) famous quote that "markets look a lot more efficient from the banks of the Charles than from the banks of the Hudson." John Gapper, *A Mathematician with a Mission*, FT.COM (FINANCIAL TIMES), Sept. 11, 2005, *available at* http://www.columbia.edu/cu/news/clips/2005/09/12/AMathematicianFT.pdf. The idea behind the quote is that while academic theories involving efficient markets can often appear to provide clean and simple approaches to a given financial problem, applying those efficiency theories to actual markets can be much more complicated.

1. Foundational Premises

This Article constructs a model for analyzing the probable impact of granting Section 404 relief to smaller reporting companies. In constructing the model, this Article relies on three foundational premises, each of which will be explained in greater detail below:

- The strength of a company's ICFR is significant to the overall value of that company's securities;
- The strength of ICFRs varies widely among smaller reporting companies; and
- The primary external security holders for smaller reporting companies are ordinary investors whose overall level of investment sophistication is generally quite low.

(a) Information About the Strength of a Company's ICFR is Significant to the Value of its Securities

As discussed earlier, a reporting company's financial disclosure ranks among the most important information for pricing its securities.[304] Since companies with stronger ICFRs should provide more accurate financial disclosure than companies with weaker ICFRs, such stronger companies should receive more favorable valuations; conversely, the weaker companies should receive less favorable valuations. Assuming two companies that are similar in all respects except for the strength of their ICFRs, securities of the company with the weaker ICFRs should trade at a discount to securities of the stronger company (an "ICFR Discount"), as investors should treat the greater risk of inaccurate financial disclosure as though it were an additional "cost" in making the investment.

(b) Strength of ICFRs Varies Widely Among Smaller Reporting Companies

The strength of ICFRs varies widely among smaller reporting companies. Some smaller reporting companies should be expected to have relatively strong ICFRs, while others will have very weak ICFRs. Moreover, Orphan SRCs dominate the number of smaller reporting com-

304. *See* discussion *supra* Part I.B.2.

panies, and these Orphan SRCs pose a substantial risk for weak ICFRs. Orphan SRCs have little to no meaningful institutional and secondary support, which means these companies have few effective external mechanisms for monitoring their performance, including the strength of their ICFRs.[305]

(c) Predominance and Vulnerability of Ordinary Investors

For a market-based approach to investor-protection regulations to work properly, the investors who are empowered with the choice of whether or not to encourage their companies to "purchase" the regulation must have the rationality and capacity to: (1) recognize that they have such a choice, (2) evaluate that choice intelligently, and (3) price the impact of that choice into the price of the security. Investors, however, are not a homogenous group. Different investors have different levels of sophistication, including the ability to account for and evaluate the various factors that go into the price of a given security. For illustrative purposes, this Article will oversimplify the matter and group investors into two broad categories: institutional investors and ordinary investors. Institutional investors, such as mutual funds, insurance companies, pension funds, investment banks, or other entities who regularly invest large amounts of money in the securities markets, are generally sophisticated investors; they have both the rationality and capacity to intelligently investigate and value securities investments. More specifically, institutional investors have the capacity to: (1) identify and obtain the information they need in order to intelligently evaluate the worth of a given security, (2) evaluate that information, (3) recognize when they receive questionable information or lack sufficient information, and appropriately account for such questionable or missing information (e.g., by discounting the price they will pay for the securities investment), and (4) understand and internalize the risks involved with investing in securities.

Ordinary investors are basically everyone other than institutional investors. Smaller reporting companies in general, and Orphan SRCs in particular, tend to have much less institutional shareholder ownership than large reporting companies. For smaller reporting companies, ordinary investors are likely to play a much more significant role. This heavy ordinary shareholder ownership is problematic for market-based

305. *See supra* Part II.B.

regulatory approaches because ordinary investors have historically demonstrated an inability to intelligently investigate and value securities investments. In fact, the federal mandatory disclosure system was designed primarily to protect ordinary investors,[306] not only because they suffer from the typical informational disadvantage that all investors face,[307] but also because ordinary investors are generally so unsophisticated that they do not recognize the magnitude of their informational disadvantage, and therefore do not sufficiently discount the value of securities offered them to compensate for this informational disadvantage.[308]

2. Exemption Proposals would Increase Informational Asymmetries for Smaller Reporting Companies at the Expense of Ordinary Investors

If this Article's foundational premises in Part V.C.1 are correct, granting smaller reporting companies relief from Section 404 should increase informational asymmetries between those companies and their ordinary investors. Moreover, the informational asymmetries will im-

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306. *See, e.g.*, Proposed Rules: Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145, Release No. 33-6806 (Oct. 25, 1988) at *10-11.

307. *See* Paul G. Mahoney, *Technology, Property Rights in Information, and Securities Regulation*, 75 WASH. U. L.Q. 815, 842 (1997).

308. *See id*. at 842. In 2003, the NASD conducted an investor survey that strongly suggests that ordinary investors' general lack of sophistication persists today. NASD Investor Literacy Research (Executive Summary), Prepared by Applied Research & Consulting LLC (2003), http://www.nasdr.com/pdf-text/surveyeyecsum.pdf; *see also* NASD News Release, NASD Announces $10-Million Education Fund – Investor Survey Underscores Importance of Education (Dec. 2, 2003), *available at* http:// www.nasdr.com/news/pr2003/release_03_054.html [hereinafter NASD News Release]. In the survey, the NASD "asked 1,086 [ordinary] investors more than 50 basic . . . questions about investing in stocks, bonds and mutual funds." NASD News Release. Some of the more shocking findings of the survey include:

- Nearly 50 percent [of respondents] thought stock market losses were insured.
- Seventy percent of investors failed to understand that when you buy on margin, you can lose all of your investment even if the value of your shares does not go to zero.
- Nearly 80 percent did not understand fully the meaning of "no load" mutual funds.

Id.

pose significant costs on those ordinary investors as they are unlikely to appreciate the magnitude of the asymmetries.[309]

To illustrate why one should expect an increase in informational asymmetries, let us assume for simplicity's sake that there are two kinds of smaller reporting companies:[310] those with weak ICFRs (and the least accurate financial disclosure) and those with strong ICFRs (and the most accurate financial disclosure). The market response to this different quality of ICFRs should be one of pricing.[311] Assuming that the market price for smaller reporting companies is established primarily by sophisticated investors, such sophisticated investors could simply demand a higher forecasted return (i.e., they would pay a lower price for the securities) when investing in a smaller reporting company with weak ICFRs to compensate for the increased risk of inaccurate financial disclosure.[312] Unfortunately, it is inherently difficult to accurately identify the strength of a given smaller reporting company's ICFR; the information needed to make that determination is possessed by the company's managers and is difficult to communicate to investors in a verifiable manner absent some type of certification process. Where sophisticated investors are incapable of distinguishing which smaller reporting companies have weak or strong ICFRs, one should expect the sophisticated investors to discount the securities prices for all smaller reporting companies[313] by some amount to approximate the overall risk of that category of investment. The investors' inability to identify which smaller reporting companies are riskier (and which are less risky) gives rise to a classic lemons problem,[314] as investors will likely establish a discount rate that is overly harsh for companies with strong ICFRs (i.e., they will over-discount these companies and under-pay for their securities). Conversely, investors will likely establish an overly generous discount rate for companies with weak ICFRs (i.e., they will under-discount these companies and over-pay for their securities). The result is

309. *See generally* David T. Llewellyn, *Regulation of Retail Investment Services*, 15 ECON. AFFAIRS 12 (1995) (in examining the banking market, Llewellyn explains why a regulation-free environment imposes costs on retail consumer who are unsophisticated about the financial products sold by banks).

310. This model is based on Dr. Akerlof's model for used cars in Akerlof, *supra* note 240, at 489-92.

311. *See* Choi & Fisch, *supra* note 44, at 272.

312. *See id*.

313. *See id*.

314. *See id*.

that a less than optimal amount of investment capital flows to smaller reporting companies that are stronger, while too much capital flows to those that are weaker.

Stronger companies are penalized by this effect, which should motivate them to clearly differentiate themselves from weaker companies. For example, if the market for smaller reporting companies was dominated by sophisticated investors, a company with stronger ICFRs could signal that strength by voluntarily adopting Section 404, thereby causing the sophisticated investors to reduce the ICFR Discount they apply to that company. Where the excess discount charged to a smaller reporting company with stronger ICFRs exceeds the cost of Section 404 compliance, one should expect that company to voluntarily adopt Section 404. Presumably, the Section 404 compliance costs for those smaller reporting companies with stronger ICFRs would be lower than for weaker companies, so the stronger companies would be highly motivated to adopt Section 404 and distinguish themselves. This would help investors to both better identify those companies with stronger ICFRs and those with weaker ICFRs, thus further increasing the ICFR Discount charged to those companies.

The above analysis is based on the assumption that the market for smaller reporting companies is dominated by sophisticated investors who understand the impact of ICFRs and Section 404, and who can both intelligently evaluate the situation and ascribe a value to the smaller reporting company's decision to voluntarily comply with, or not comply with, Section 404. In fact, however, the market for smaller reporting companies is dominated by unsophisticated ordinary investors, which significantly alters the analysis. Unlike sophisticated investors, ordinary investors should be expected to suffer from a number of problems that reduce their ability to serve as an optimal market feedback mechanism:

- There is a significant risk that ordinary investors will not recognize they are making a choice about the value of ICFRs and Section 404 when making an investment decision regarding a smaller reporting company;
- Even if ordinary investors recognize they are making a choice about the value of ICFRs and Section 404, there is a significant risk that they do not adequately understand the function of ICFRs or how Section 404 helps to address that issue. In short, their decisions on the matter are likely to be uninformed; and/or

- As noted above, ordinary investors have historically shown an inability to sufficiently discount the value of securities when faced with exactly the type of information asymmetry that exists regarding the strength of a smaller reporting company's ICFR.

Moreover, the probability that ordinary investors would largely miss the point about the importance of ICFRs would be increased by any relief proposal, as such relief proposal could easily be interpreted by ordinary investors as a signal that policymakers do not consider ICFRs all that important for smaller reporting companies. In sum, this Article predicts that ordinary investors would apply an ICFR discount that is substantially too low.

Such a scenario should deter smaller reporting companies with strong ICFRs from pursuing strategies that clearly signal the strength of their ICFRs (such as voluntarily adopting Section 404), because the inappropriately low ICFR discount applied by ordinary investors reduces the benefit for strong ICFR companies to pursue such signaling strategies. Unless the cost of the signaling strategy is very low, it becomes cost-ineffective for strong ICFR companies to pursue such strategies. Therefore, while clear signaling efforts would help to increase the overall efficiency of the market for smaller reporting company securities, such signaling is unlikely to occur. The greatest beneficiary of this lack of clear signaling by strong ICFR companies is the weak ICFR companies. Without a clear mechanism for highlighting those companies with weaker ICFRs, weak ICFR companies can sell their securities at prices that are inappropriately advantageous for the weaker companies and inappropriately disadvantageous for the ordinary investors.

In short, making Section 404 voluntary for smaller reporting companies would not provide significant value to smaller reporting companies with strong ICFRs. In fact, it could prove detrimental to these companies, as the securities market for smaller reporting companies should be expected to encourage companies with weaker ICFRs (since they would receive an inappropriately advantageous cost of capital), which could eventually result in a lemons problem for this market. Indeed, it could be that such a lemons problem helps to explain why currently, institutional investors are less likely to invest in smaller reporting companies than are ordinary investors. Instead, the greatest benefit from such relief would flow instead to smaller reporting companies with weak ICFRs. Finally, the cost of assisting those smaller reporting companies with weak ICFRs would be borne unknowingly, and primarily, by ordinary investors who would be paying too much for the securities of these companies.

D. Mandatory Section 404 Compliance for Smaller Reporting Companies Reduces Informational Asymmetries

Mandatory Section 404 compliance for smaller reporting companies helps to resolve such problems by reducing informational asymmetries about the strength of their ICFRs. In general, where a securities market is dominated by unsophisticated ordinary investors, greater informational asymmetries and agency problems will arise because ordinary investors (1) will find it difficult to determine the quality of the information provided and (2) are less capable of effectively monitoring management.[315] Where that very same market also lacks meaningful institutional and secondary support, the problem is exacerbated due to a lack of collective investment in information gathering and monitoring services. In such a scenario, explicit, mandatory federal securities regulation can help to reduce these problems by having the federal government replace unsophisticated investors as the primary determinant of what level of reporting and monitoring services should be provided. Regarding Section 404 specifically, unsophisticated, ordinary investors are not well-equipped to intelligently investigate and evaluate the strength of a company's ICFR and there is little institutional or secondary support to otherwise help deal with the problem. Therefore, requiring compliance with Section 404 addresses the expected informational asymmetry by establishing a minimum standard for ICFRs.

It must be pointed out, however, that mandatory regulatory solutions are never problem free. As noted earlier, the fact that mandatory regulation is not subject to a market process increases the likelihood that a sub-optimal level of regulation will be provided; certain matters become over-regulated while others remain under-regulated. Even though the SEC is a highly-specialized regulatory body that should be much more sophisticated than most ordinary investors, there remains the risk that the SEC will not establish the optimal minimal standards for ICFR disclosure and monitoring.[316] While such a regulatory allocation

315. *See generally* Llewellyn, *supra* note 309 (making a similar argument for retail bank customers).
316. *See* GEORGE J. BENTSON, REGULATING FINANCIAL MARKETS – A CRITIQUE AND

problem is in no way insignificant, this Article suggests that experimentation with market-based proposals to overcome that problem be conducted first in markets where ordinary investors are less vulnerable. Thus, ironically, it is larger reporting companies who have the stronger case for exemption from Section 404, as their public securities markets are dominated by securities intermediaries and sophisticated institutional investors who can serve as an accurate market feedback mechanism for the value of Section 404 (with ordinary investors free riding on the expertise and efforts of these more sophisticated parties).

Regulations that have a significant consumer protection aspect also can give rise to a potential "moral hazard" problem.[317] The recipients of the consumer protection (in this case ordinary investors) may be led to believe that the regulated parties (in this case smaller reporting companies) have been made safe and that less care need be taken when dealing with the regulated parties.[318] There is no easy answer to this moral hazard problem. Federal policymakers must take care to properly manage the expectations of recipients of consumer protection initiatives. Regulatory initiatives should never eliminate an investor's incentive to exercise due care,[319] and that message should be clearly and regularly communicated to investors.

E. Manner of Exemption Could Impact Analysis

The analysis in Part V.C.2 assumes that smaller reporting companies are granted a complete exemption from Section 404. Such analysis could be materially impacted if federal policymakers decide to provide smaller reporting companies a less complete exemption to Section 404. Consider, for example, if federal policymakers pursue an "opt-out" approach, or eliminate the auditor attestation requirement for smaller reporting companies.

An opt-out approach to Section 404 could avoid some of the information asymmetry problems that would likely arise from a complete exemption approach. The benefit of an opt-out approach is that it could be structured so as to require companies wishing to opt out of Section

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SOME PROPOSALS 48 (1999) (making a similar criticism of government agencies' ability to establish disclosure standards for banking customers).

317. *See* Llewellyn, *supra* note 298, at 51.

318. *Id.*

319. *Id.*

404 to undergo a formal shareholder approval process. For example, assume that the opt-out is conditioned upon the smaller reporting company amending its certificate of incorporation to eliminate the corporation's responsibility for complying with Section 404. As a matter of state corporate law, such an amendment would require that the company's board adopt the proposed amendment and submit it to the shareholders for approval.[320] The board would also be required to make a recommendation to the shareholders to adopt the amendment.[321] The opt-out approach would not cure the predominance and vulnerability of ordinary shareholders, but it would at least provide a very clear signal to the existing ordinary shareholders of the ICFR issue and would require the directors to make proxy disclosure on the advisability of the opt-out that would subject them to potential anti-fraud liability under Exchange Act Rule 14a-9[322] if their disclosure contained a false or misleading statement. Therefore, it is at least possible that the opt-out approach would: (1) make the exemption process so public that ordinary investors would be spurred to provide a more appropriate ICFR discount to companies that seek to avoid Section 404; or (2) that the burdens of the opt-out process would be sufficient to motivate a significant number of companies to comply with Section 404, allowing Section 404 compliance to serve as a clear signal of the strength of a company's ICFR.

If the Section 404 exemption proposal is limited to exempting smaller reporting companies from the auditor attestation requirement, it is theoretically possible that such exemption strategy could have a less drastic outcome than is predicted in Part V.C.2. It could be that the Section 404(a) management report on ICFR alone will dramatically improve ICFRs at smaller reporting companies such that the ICFR discount is sufficiently lowered without the need for the costly auditor attestations. While possible, this author is highly skeptical of such an outcome. As noted above, since the securities markets for smaller reporting companies are dominated by unsophisticated ordinary investors and lack meaningful institutional or secondary support, these companies receive less monitoring services which makes them ripe for just the type of agency problems that necessitate external audits generally. Even for

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320. *See, e.g.*, DEL. CODE ANN. tit. 8, § 242; MODEL BUSINESS CORPORATION ACT § 10.03.

321. *See, e.g.*, DEL. CODE ANN. tit. 8, § 242; MODEL BUSINESS CORPORATION ACT § 10.03.

322. 17 C.F.R. § 240.14a-9.

larger companies, which do have substantial external monitoring services, external audits appear to have been necessary to push management to find and disclose material weaknesses in their ICFRs.[323]

It is "possible," then, that a less than complete exemption "could" avoid some of the information asymmetry problems predicted in Part V.C.2. Because the risk of under-regulation would be borne primarily, and unknowingly, by unsophisticated ordinary investors, the burden for establishing that the more tailored exemption is socially beneficial should be placed on the party proposing the exemption. Therefore, rather than continue to delay full implementation of Section 404 for all reporting companies until it is proven that Section 404 is cost-effective, which roughly describes the current treatment of Section 404 for non-accelerated filers, this Article concludes that the threat to ordinary investors is so substantial that the burden should be switched to those seeking delays or modifications to Section 404's implementation.

PART VI: CONCLUSION

This Article recommends that smaller reporting companies not be exempted from Section 404. While a market-based solution to the Section 404 cost-benefit debate is intuitively appealing, this Article demonstrates why exempting smaller reporting companies from Section 404 and allowing market forces to resolve the need for ICFR services is an inherently unworkable solution. Because the market for smaller reporting companies is dominated by Orphan SRCs and unsophisticated ordinary investors, exempting smaller reporting companies from Section 404 is likely to increase information asymmetries between smaller reporting companies and their ordinary investor shareholders (who have historically demonstrated themselves to be particularly vulnerable to this type of information asymmetry). Rather than improve the allocation of ICFR services, exempting smaller reporting companies from Section 404 would almost certainly guarantee an insufficient level of ICFR

323. *See* Letter from Lynn E. Turner, Managing Dir., Glass, Lewis & Co., LLC, to Jonathan G. Katz, Sec'y, SEC 5-6 (Apr. 12, 2005), *available at* http://www.sec.gov/news/press/4-497/leturner041205.pdf. Turner notes that "a record number of errors in financial statements . . . in the fourth quarter of 2004. . . . While the increased transparency and improvement in internal controls is a positive development, we must highlight that many of the Chief Executive Officers and Chief Financial Officers of these same companies had previously certified to their investors that their internal controls were operating effectively." *Id.*

services for smaller reporting companies, with the cost for that insufficient dedication of resources being borne primarily and unknowingly by unsophisticated ordinary investors.

While mandatory Section 404 regulation helps to address the problem of smaller reporting companies under-investing resources in their ICFRs, it must be remembered that the mandatory regulation approach suffers from its own problems. In the case of Section 404, the uncertain net effect of Section 404 still needs to be addressed. Tailoring Section 404 to meet the particular needs of smaller reporting companies and their security holders will need to be conducted by the SEC and the PCAOB, rather than naturally occur through a market-based process. Moreover, the risk of ordinary investors falling prey to a moral hazard problem must continue to be monitored. If the choice, however, is between an increased risk of marginal over-regulation (and/or marginally misplaced regulation) versus smaller reporting companies almost certainly under-investing resources in their ICFRs and exposing ordinary investors to significantly increased investment risk without their realizing it, the preference should be for mandatory regulation and its shortcomings.