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Financial Regulatory Reform Post-Financial Crisis: Unintended Consequences for Small Businesses

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I. INTRODUCTION	

Although a visit to a small business—from the local, fast order food shop to the dry cleaner and gas station—is an integral part of everyday living, small businesses play an underappreciated role in the United States economy. For example, most business news stories involve large, publicly traded companies. However, the number of small businesses vastly overshadows the number of large businesses. In addition, small businesses’ contribution to the United States economy is overshadowed by media reports of ethical conflicts and potentially unlawful conduct at larger businesses. According to the Small Business Administration Office of Advocacy, in 2006 there were an estimated “29.6 million businesses in the United States. Small firms with fewer than 500 employees represent[ed] 99.9 percent of those businesses”¹ and 73.3 percent of US businesses had no employees.² As of 2006, only 18,000 firms qualified under Small Business Administration criteria as large firms.³ Even though large firms account for about half of the nonfarm private gross domestic product, small firms:

- Employ just over half of all private sector employees.
- Pay 44 percent of total U.S. private payroll.
- Generated 65 percent of net new jobs over the past 17 years.

1. See U.S. SMALL BUSINESS ADMINISTRATION OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS 1 *2009), <http://www.sba.gov/advo/stats/sbfaq.pdf> (last visited Aug. 2, 2010).

2. *Id.* (stating that, out of the 27.5 million businesses in the U.S., 21.4 million business have no employees). Under the Small Business Administration definition of small business, a small business has “fewer than 500 employees” or less than a certain amount in receipts where the amounts vary by industry. See also U.S. SMALL BUS. ADMIN. OFFICE OF ADVOCACY, TABLE OF SMALL BUSINESS SIZE STANDARDS MATCHED TO NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEMS CODES (2008), http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sstd_tablepdf.pdf (last visited Aug. 2, 2010). Under the Small Business Administration definition of small business, a small business has “fewer than 500 employees” or less than a certain amount in receipts where the amounts vary by industry.

3. See FREQUENTLY ASKED QUESTIONS, *supra* note 1.

- Hire 43 percent of high tech workers (scientists, engineers, computer programmers, and others).
- Are 52 percent home-based and 2 percent franchises.
- Made up 97.5 percent of all identified exporters and produced 31 percent of the known export value in FY 2008.
- Produce 13 times more patents per employee than large patenting firms.⁴

The phrase “small business” conjures up images of the sole business owner, the “mom and pop” shop, and the closely-held business with a small number of owner/managers. These enterprises generally are not subject to the Securities Exchange Act of 1934⁵ (“Exchange Act”) periodic disclosure requirements—including certain provisions of the Sarbanes-Oxley Act of 2002⁶ (“Sarbanes-Oxley”)—that apply to publicly-traded companies.⁷ However, a publicly-traded company is subject to the Exchange Act rules regardless of the size of the business.⁸ For example, on a quarterly and annual basis, all publicly-traded companies, including a “smaller reporting company,” must disclose financial information to the Securities and Exchange Commission (“SEC”).⁹ For purposes of the Exchange Act’s disclosure requirements, a smaller reporting company is defined as a business that “had a public float of less than \$75 million . . . or [i]n the case of an issuer whose

4. *Id.*

5. *See* 15 U.S.C. §§ 78(a)-(k) (2006).

6. *See* The Sarbanes-Oxley Act of 2002 Pub. L. No. 107-204 (2002).

7. *See id.* at §§ 302, 401, 404, 409. “Publicly-traded companies” refers to companies whose shares are traded on a national stock exchange, e.g., the New York Stock Exchange. By contrast, privately-held businesses are not traded on a national exchange.

8. *See, e.g.*, 15 U.S.C. § 78(m) (requiring that an issuer register securities prior to those securities trading on a national securities exchange); 15 U.S.C. § 78(d) (requiring that issuers file periodic information reports); *see* The Sarbanes-Oxley Act of 2002 Pub. L. No. 107-204 §§ 302, 401, 404, 409 (2002) (stating that certain Sarbanes-Oxley requirements previously postponed for small businesses—in particular the internal controls attestation and management sign-off—now apply to small, publicly-traded companies); *see also*, *Sarbanes-Oxley Section 404: A Guide for Small Businesses*, U.S. SEC. AND EXCH. COMM’N., Jan. 22, 2008, <http://www.sec.gov/info/smallbus/404guide.shtml> (last visited Aug. 2, 2010).

9. 17 C.F.R. § 240.12(b)(2). Under regulations effective in 2008, small business issuers (those previously defined as having less than \$25 million in revenue and publicly held stock worth no more than \$25 million) are included with non-accelerated filers (those defined as having a public float of no more than \$75 million) in the category of smaller business issuers. *See also* SEC RELEASE NO. 33-8876: SMALLER REPORTING COMPANY REGULATORY RELIEF AND SIMPLIFICATION 8, 12 (2007), www.sec.gov/rules/final/2007/33-8876.pdf [hereinafter *Smaller Reporting Company Release*].

public float . . . was zero, had annual revenues of less than \$50 million. . . .¹⁰

Over the past ten years, equity and debt capital have moved away from small businesses for myriad reasons, including tougher SEC requirements for small business stock issuances, more stringent bank lending requirements as a result of the Great Recession of 2008, and Sarbanes-Oxley.¹¹ Recently, President Barak Obama's administration has recognized the need to focus on freeing up credit for small businesses.¹² In addition, the SEC—whose mission is “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation”¹³—has renewed its attention to small businesses in light of calls to reform Sarbanes-Oxley provisions that apply to small and medium-sized enterprises.¹⁴

The executive branch's attention to small businesses is well-timed for two reasons. First, even though the United States recession is officially over, employment rates have not recovered.¹⁵ Small businesses have led the economy out of past recessions because small businesses

10. See *Smaller Reporting Company Release*, *supra* note 9. Under the Securities and Exchange Act, public float is defined as “the aggregate market value of the issuer's outstanding voting and non-voting common equity held by non-affiliates.” 17 C.F.R. § 240.12(b)(2), Definitions: Small Business Issuer.

11. See The Sarbanes-Oxley Act of 2002 Pub. L. No. 107-204 (2002).

12. See The White House Office of the Press Secretary, *Weekly Address: President Obama Says Small Business Must Be at the Forefront of the Recovery*, Oct. 24, 2009, available at <http://www.whitehouse.gov/the-press-office/weekly-address-president-obama-sayssmall-business-must-be-forefront-recovery> (stating, “[I] also announced that we'll be taking additional steps through our Financial Stability plan to make more credit available to the small local and community banks that so many small businesses depend on—the banks who know their borrowers, who gave them their first loan and watched them grow.”).

13. See *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. AND EXCH. COMM'N., Oct. 20, 2010, available at <http://www.sec.gov/about/whatwedo.shtml>.

14. See, e.g., *Smaller Reporting Company Release*, *supra* note 9; see also FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO THE U.S. SECURITIES AND EXCHANGE COMMISSION 1 (2006), available at www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf [hereinafter *Advisory Committee Report*].

15. See Dean Maki, *Examining Influences That May Impact the Fed's Decision for Interest Rates*, NIGHTLY BUS. REPORT, Aug. 9, 2010, available at http://www.pbs.org/nbr/site/onair/transcripts/nbr_transcripts_100809/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+pbs%2Fnbr-programs+%28nbr-programs%29 (“The Fed's policies are bringing the unemployment rate gradually down. It will continue to fall. Whereas the public just sees the unemployment rate as very high, which it is. So in a way it's the difference between the trend in the unemployment rate and its still high level.”).

have driven post-recessionary employment.¹⁶ Second, nearly two and one-half years after the start of the Great Recession, and nearly two years after Lehman Brothers' collapse triggered an unprecedented period of industry bailouts, bank failures, corporate bankruptcies, mortgage defaults, credit tightening and high unemployment, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"),¹⁷ "the most sweeping financial industry reform legislation since the Great Depression."¹⁸ Most commentary has focused on the law's effect on large financial institutions and on the law's consumer protection provisions.¹⁹ However, the Dodd-Frank Act also contains corporate governance, executive compensation and risk management provisions that apply to publicly-traded companies.²⁰ The Dodd-Frank Act may affect small businesses in two ways: (1) the business is publicly-traded and must comply with the act; or (2) businesses required to comply with the act change their business practices in response to Dodd-Frank Act regulations, and those practices trickle down and become norms of conduct for small businesses that either are exempt from a particular provision or are privately-held and thus not covered by the act. Thus, an unintended consequence of the Dodd-Frank Act may be that the act adversely affects small businesses at a time when those businesses, and the economy as a whole, can least afford it.

This Article proposes that legislators and regulators should learn from the experience of how Sarbanes-Oxley affected small businesses—those that are publicly traded and those that are not—and devise financial regulatory reforms with those experiences in mind. It does not assert that Sarbanes-Oxley and consequent business practice changes unfairly and

16. See TIMOTHY F. GEITHNER & KAREN G. MILLS, REPORT TO THE PRESIDENT: SMALL BUSINESS FINANCING FORUM 18 (2009), available at http://www.sba.gov/idc/groups/public/documents/sba_homepage/small_buss_finan_forum_report.pdf.

17. Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010).

18. Brian Montopoli, *Obama Signs Sweeping Financial Reform into Law*, CBS NEWS POLITICAL HOTSHEET, Jul. 21, 2010, http://www.cbsnews.com/8301-503544_162-20011201-503544.html (last visited Jul. 25, 2010).

19. See Allison Fass, *One Year Later, The Impact of Sarbanes-Oxley*, FORBES, Jul. 22, 2003, http://www.forbes.com/2003/07/22/cz_af_0722sarbanes.html (last visited Aug. 10, 2010); Larry Bumgardner, *Reforming Corporate America: How Does the Sarbanes-Oxley Act Impact American Business?*, GRAZIADIO BUSINESS REPORT, 2003, gbr.pepperdine.edu/031/sarbanesoxley.html (last visited Aug. 10, 2010); Paul Lowengrub, *The Impact of Sarbanes Oxley on Companies, Investors, & Financial Markets*, SARBANES OXLEY COMPLIANCE JOURNAL, Dec. 6, 2005, http://www.s-ox.com/dsp_getFeaturesDetails.cfm?CID=1141 (last visited Aug. 10, 2010).

20. Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173 §§ 121, 165, 813, 951, 952, 953, 954, 955, 956, 957, 971, 972.

adversely affected small businesses, although the reforms' costs clearly are proportionately higher for small businesses and are easier to quantify than the benefits.²¹ Indeed, this Article proposes a cost/benefit analysis to examine: (1) the Dodd-Frank Act's effect on small businesses expressly required to comply with the reforms; and (2) the act's impact on small businesses affected by changes in business practices and advisors, because whether intended or unintended, legislated or trickled down, the benefits of regulation exist. Further, that cost-benefit analysis ideally should occur either before the implementation of regulations or, at the latest, in the early stages of implementation. For example, in 2005—three years after Sarbanes-Oxley's enactment—the SEC charged the Advisory Committee on Smaller Public Companies (the "Advisory Committee") with the task of:

assess[ing] the current regulatory system for smaller companies under the securities laws of the United States, and mak[ing] recommendations for changes. The Charter also directed that [the Advisory Committee] specifically consider the following areas of inquiry, including the impact in each area of the Sarbanes-Oxley Act of 2002:

- frameworks for internal control over financial reporting applicable to smaller public companies, methods for management's assessment of such internal control, and standards for auditing such internal control;
- corporate disclosure and reporting requirements and federally imposed corporate governance requirements for smaller public companies, including differing regulatory requirements based on market capitalization, other measurements of size or market characteristics;
- accounting standards and financial reporting requirements applicable to smaller public companies; and
- the process, requirements and exemptions relating to offerings of securities by smaller companies, particularly public offerings.

²²

21. Christopher Cox, *Testimony: Sarbanes-Oxley Section 404: New Evidence on the Cost for Small Companies*, SEC. EXCH. COMM'N., Dec. 12, 2007, <http://www.sec.gov/news/testimony/2007/ts121207cc.htm> (last visited Apr. 5, 2010).

22. *Advisory Committee Report*, *supra* note 14, pp. 1-2.

More generally, the Advisory Committee was charged with evaluating whether the overall regulatory structure's benefits were commensurate with small businesses' compliance costs.²³ Further, the Advisory Committee was asked to find ways to minimize costs and maximize benefits.²⁴ The Advisory Committee was tasked to keep in mind the SEC's goals—investor protection, fair capital markets, and capital formation—but with a particular focus on small businesses.²⁵ The SEC required the Advisory Committee to define small businesses and to provide “recommendations as to where and how the Commission should draw lines to scale regulatory treatment for companies based on size.”²⁶ Of particular relevance to this Article's thesis is that the Advisory Committee was advised to evaluate the effect of the financial regulatory structure on both publicly-held and privately-held business, and the Advisory Committee “[was] not limited to considering regulations applicable to public companies.”²⁷ However, the SEC desired that the Advisory Committee “would focus primarily on public companies, because of the apparent need for prompt attention to that area of concern, especially in view of problems in implementing the Sarbanes-Oxley Act of 2002.”²⁸ For smaller, privately-held businesses, the attention to their needs, as exemplified by the Advisory Committee's report, likely is welcome given the four-year delay between Sarbanes-Oxley's passage and the Advisory Committee's report.²⁹

The SEC has employed three approaches to lessen Sarbanes-Oxley's impact on small businesses subject to SEC regulation: delayed compliance dates,³⁰ recommending exemptions for certain businesses³¹ and to a lesser extent, education.³² However, under these approaches, the regulations have impacted small businesses outside of the SEC's jurisdiction—the trickle down effect caused small businesses to change

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.*

27. *Advisory Committee Report, supra* note 14, pp. 1-2.

28. *Id.*

29. *Id.* The Sarbanes-Oxley Act was passed on July 24, 2002. *See* 148 Cong. Rec. H 5375, H 5393 (2002). The Advisory Committee Report was published on April 23, 2006. *See supra* note 14.

30. *See* Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, Exchange Act Release No. 33-8731, 34-54942 (August 9, 2006) *available at* www.sec.gov/rules/proposed/2006/33-8731.pdf.

31. *Id.* at 4-7.

32. *See* Comm. of Sponsoring Org. of the Treadway Comm'n., Internal Control over Financial Reporting—Guidance for Smaller Public Companies (2006), *available at* www.coso.org/documents/SB_FAQs.pdf.

their practices.³³ Using the Dodd-Frank Act's corporate governance, executive compensation, and risk management provisions, this Article explicates the potential impacts on both publicly traded and privately-held small businesses. This Article suggests that small business owners should be educated about the purpose of the Dodd-Frank Act and the potential impacts and benefits. In particular, the SEC should lead the charge to educate small business owners regarding corporate governance, executive compensation and risk management impacts. Further, the SEC should emphasize that the disclosure standards are devised to get business to consider more carefully their corporate governance, executive compensation and risk management practices. Moreover, the SEC should emphasize that while the costs of regulation are easier to quantify than the benefits, the benefits are real.

In determining whether the benefits of regulation outweigh the costs, regulators should consider that business practices may change in response to or even ahead of changes in the law. Regulators, including the SEC and the Small Business Administration may consider providing tax incentives or better loan terms to small businesses that implement corporate governance, compensation and risk management practices.

The Article proceeds as follows. Section II describes Sarbanes-Oxley's impact on both publicly-traded and privately-held small businesses. This section details the consequences that arose from the implementation of certain corporate governance provisions in Sarbanes-Oxley. Section III uses the lessons learned from Sarbanes-Oxley's implementation to make predictions about how the Dodd-Frank Act reforms may impact both publicly-traded and privately-held businesses. Section IV discusses ways in which positive outcomes may be obtained for both publicly-traded and privately-held small businesses. Section V concludes the paper.

II. SMALL BUSINESSES AND SARBANES-OXLEY

Scholarship has documented the history of the Sarbanes-Oxley Act's ("Sarbanes-Oxley") passage, the rationale behind its provisions and the statute's costs for publicly-traded businesses—both large and small.³⁴ Prior to the act's passage, writers analyzed whether the statute

33. Paul D. Broude & Richard L. Prebil, Foley & Lardner, LLP, *The Impact of Sarbanes-Oxley on Private and Nonprofit Companies*, Presented Before National Directors Institute (March 10, 2005), available at <http://www.directorsandboards.com/ndi.pdf> (citing research indicating that 87% of small business and non-profit executives believe that Sarbanes-Oxley has impacted their businesses).

34. See, e.g., Lyman P.Q. Johnson & Mark A. Sides, *Corporate Governance and the Sarbanes-Oxley Act: The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL

would correct the various causes of the financial and accounting scandals in 2002.³⁵ This scholarship focused on the roles and responsibilities of the major players in the publicly-traded securities world—accounting firms, ratings agencies, investment banking securities analysts, chief executive and chief financial officers at publicly-traded firms, corporate boards, independent board directors, board committees, self-regulatory organizations, the SEC, state courts, and shareholders.³⁶

The Sarbanes-Oxley scholarship principally addresses the legislation's impact on publicly-held companies because Sarbanes-Oxley explicitly regulates those companies.³⁷ The scholarship focused much less so on the impact of Sarbanes-Oxley on privately-held companies because the act did not explicitly apply to those companies.³⁸ However, a survey in 2005, three years after Sarbanes-Oxley's enactment, indicated that Sarbanes-Oxley had a significant impact on privately-held

L. REV. 1149 (2004); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005); Joseph A. Castelluccio III, Note, *Sarbanes-Oxley and Small Business: Section 404 and the Case for a Small Business Exemption*, 71 BROOK. L. REV. 429 (2005); Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 OHIO N.U. L. REV. 381 (2005); Tamar Frankel, *Using the Sarbanes-Oxley Act to Reward Honest Corporations*, 62 BUS. LAW. 161 (2006); J. Robert Brown, Jr., *Criticizing the Critics: Sarbanes-Oxley and Quack Corporate Governance*, 90 MARQ. L. REV. 309 (2006); Samuel C. Thompson, Jr., *The Missing Link in Sarbanes-Oxley: Enactment of the "Change of Control Board" Concept, or Extension of the Audit Committee Provisions to Mergers and Acquisitions*, 63 BUS. LAW. 81 (2007); James Fanto, *Corporate Governance Five Years After Sarbanes-Oxley: Is there Real Change*, 52 N.Y. L. SCH. L. REV. 517 (2007); Robert A. Britton, Note, *Making Disclosure Regulation Work in the Nonprofit Sector*, 2008 U. ILL. L. REV. 437 (2008); Joseph D. Piotroski & Suraj Srinivasan, *Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings*, 46 J. ACCT. RES. 383 (2008); Peter V. Letsou, *The Changing Face of Corporate Governance Regulation in the United States: The Evolving Roles of the Federal and State Governments*, 46 WILLAMETTE L. REV. 149 (2009); James S. Linck, Jeffry M. Netter & Tina Yang, *The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors*, 22:8 REV. FIN. STUD. 3287 (2009); Joan T.A. Gabel, Nancy R. Mansfield, Paul Von Nessen, Austin W. Hall & Andrew Jones, *Evolving Regulation of Corporate Governance and the Implications for D&O Liability: The United States and Australia*, 11 SAN DIEGO INT'L L.J. 365 (2010); Arthur R. Pinto, *An Overview of United States Corporate Governance in Publicly Traded Corporations*, 58 AM. J. COMP. L. 257 (2010).

35. See e.g., Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law after Enron*, 80 WASH. U. L.Q. 449 (2002); Matthew J. Barrett, *Sarbanes-Oxley, Kermit the Frog, and Competition Regarding Audit Quality*, 3 J.BUS. & TECH. L. 207 (2008)

36. *Id.*

37. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002); see also Broude, *supra* note 33, at 2.

38. See Broude, *supra* note 33, at 2.

businesses.³⁹ As one example, Sarbanes-Oxley's internal controls mandates have created expectations that privately-held businesses will implement new business practices with respect to internal controls, even though Sarbanes-Oxley's internal control provisions do not apply to private companies and implementing the provisions may prove costly.⁴⁰ A second example stems from accounting firm responsibilities under Sarbanes-Oxley and the Public Company Accounting Oversight Board ("PCAOB") rules.⁴¹ Accounting firms may apply a higher level of scrutiny to closely-held businesses than in the past because accounting firms desire to improve credibility and because regulators more closely scrutinize audit firm practices.⁴² A third example concerns board governance practices. Statutory and self-regulatory organization requirements shaped publicly-held company governance norms.⁴³ These business practices trickled down to closely-held companies, even though closely-held firms may not have been in a position to implement all of the Sarbanes-Oxley corporate governance mandates.⁴⁴

A. *What is a Small Business Under Sarbanes-Oxley?*

Many of the Sarbanes-Oxley provisions impacting corporate governance and corporate disclosure requirements were enacted as amendments to the Securities and Exchange Act of 1934 ("Exchange Act").⁴⁵ Under the Exchange Act regulations that require periodic financial reporting for publicly-traded companies—that is, companies whose shares are traded on an exchange or are held by a large number of investors—a "small business" is defined as a corporation that:

39. *See id.*

40. *Id.*

41. *Id.*; *see also* U.S. Securities and Exchange Commission, Public Company Accounting Oversight Board (PCAOB) (2006), *available at* <http://www.sec.gov/answers/pcaob.htm>.

42. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 102-108, 116 Stat. 745, 753-768 (2002); *see also Lessons Learned from Enron's Collapse: Auditing the Accounting Industry: Hearing Before the Comm. on Energy and Commerce*, 107th Cong. 87 (2002) (statement of Bala G. Dharan, Professor, Rice University); Dorothy A. Feldmann & William J. Read, *Auditor Conservatism after Enron*, 29 *AUDITING: J. PRAC. & THEORY* 267 (2010).

43. The American Stock Exchange, the Financial Industry Regulatory Authority, the New York Stock Exchange, and the Depository Trust and Clearing Corporation are examples of financial industry self-regulatory organizations. *See* U.S. Securities and Exchange Commission, Other Links (2009), <http://www.sec.gov/links.shtml#selfreg> (last visited September 19, 2010).

44. *See* U.S. Chamber of Commerce, U.S. Chamber of Commerce Center for Capital Markets Competitiveness Costs of SOX 404 Survey (2007), <http://www.uschamber.com/reports/cost-sox-404-survey> (last visited October 10, 2010).

45. *See* 15 U.S.C. §§ 78(a)–78(pp) (2010).

has revenues of less than \$25,000,000;

is a U.S. or Canadian issuer [of stock];

is not an investment company and is not an asset-backed issuer . . . ;
and

if a majority owned subsidiary, the parent corporation is also a small business issuer.

Provided however, that an entity is not a small business issuer if it has a public float (the aggregate market value of the issuer's outstanding voting and non-voting common equity held by non-affiliates) of \$25,000,000 or more.⁴⁶

Another category of small business is the “smaller reporting company,” defined as:

an issuer that is not an investment company, an asset-backed issuer . . . or a majority-owned subsidiary of a parent that is not a smaller reporting company and that:

Had a public float of less than \$75 million as of the last business day of its most recently completed second fiscal quarter . . . ; or

In the case of an initial registration statement under the Securities Act or Exchange Act for shares of its common equity, had a public float of less than \$75 million as of a date within 30 days of the date of the filing of the registration statement . . . ; or

In the case of an issuer whose public float as calculated under [the previous two] paragraph[s] of this definition was zero, had annual revenues of less than \$50 million during the most recently completed fiscal year for which audited financial statements are available.

46. See 17 C.F.R. § 240.12(b)(2) (2009) [hereinafter Exchange Act Rule 12b-2] (The definition is similar under the Securities Act of 1933 (“Securities Act”), which governs the registration of securities and the disclosure of information for the purpose of selling the securities to the public); see also 15 U.S.C. § 78(a)–78(pp) (2010). (Under the Securities Act, a small business issuer is defined as: a United States or Canadian issuer (1) that had less than \$25 million in revenues in its last fiscal year, and (2) whose outstanding publicly-held stock is worth no more than \$25 million); see also U.S. Securities and Exchange Commission, Q&A: Small Business and the SEC (2009), <http://www.sec.gov/info/smallbus/qasbsec.htm> (last visited August 2, 2010).

Determination: Whether or not an issuer is a smaller reporting company is determined on an annual basis.⁴⁷

For purpose of comparison, larger publicly-traded businesses fall into two categories: accelerated filers and large accelerated filers.⁴⁸ An issuer is an accelerated filer if at the end of its fiscal year:

The issuer had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of \$75 million or more, but less than \$700 million, as of the last business day of the issuer's most recently completed second fiscal quarter;

The issuer has been subject to the [periodic financial reporting] requirements of section 13(a) or 15(d) of the Act for a period of at least twelve calendar months;

The issuer has filed at least one annual report pursuant to section 13(a) or 15(d) of the Act; and

The issuer is not eligible to use the requirements for smaller reporting companies . . . for its annual and quarterly reports.⁴⁹

An issuer is a large accelerated filer if at the end of its fiscal year:

The issuer had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of \$700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter;

The issuer has been subject to the requirements of section 13(a) or 15(d) of the Act for a period of at least twelve calendar months;

The issuer has filed at least one annual report pursuant to section 13(a) or 15(d) of the Act; and

The issuer is not eligible to use the requirements for smaller reporting companies . . . for its annual and quarterly reports.⁵⁰

Initially, Sarbanes-Oxley applied by its express terms to all publicly-traded businesses.⁵¹ However, Congress authorized the SEC to

47. 17 C.F.R. § 240.12(b)(2) (2009).

48. *Id.*

49. *Id.*

50. *Id.*

51. *See* Broude, *supra* note 33, at 2.

exempt certain classes of issuers from Sarbanes-Oxley's mandates.⁵² Publicly-traded companies—large and small—and their service providers, policy makers, investors, and scholars contested the application of certain Sarbanes-Oxley provisions, and the exemption of certain companies from those provisions. These debates are described further below.

B. Sarbanes-Oxley's Section 404 and Privately-held Companies

Sarbanes-Oxley section 404 requires that senior executives assess and attest to the effectiveness of financial reporting.⁵³ Under a separate Sarbanes-Oxley section, an auditor must make its own assessment of and attest to the effectiveness of its corporate client's internal controls.⁵⁴ Further, an auditor must "evaluate the presentation of the elements that management is required, under the SEC's rules, to present in its annual report on internal control over financial reporting."⁵⁵ Further, "[i]f the auditor determines that the required disclosure about a material weakness is not fairly presented in all material respects,"⁵⁶ the auditor should describe "the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness" and report the auditor's conclusions to the board's audit committee.⁵⁷

The PCAOB is authorized to work with audit and accounting organizations to define standards for auditors to use in assessing and attesting to internal controls.⁵⁸ The SEC approved An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements (Audit Standard No. 2, or "AS2"), an audit standard developed by the PCAOB in conjunction with industry

52. See Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, *supra* note 30, at 31 ("Specifically, the Advisory Committee recommends that certain smaller public companies be exempted from the management report requirement and from external auditor involvement in the Section 404 process under certain circumstances. . .").

53. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404(a), 116 Stat. 745, 789 (2002).

54. See *id.*

55. Public Accounting Oversight Board, Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, ¶ 72, SEC Release No. 34-56152, (2007).

56. *Id.* at ¶ C2.

57. *Id.* at ¶ 91.

58. See Public Company Accounting Oversight Board (PCAOB), SEC (CCH) (2006), available at <http://www.sec.gov/answers/pcaob.htm> (last visited Aug. 10, 2010).

groups.⁵⁹ The standard provided criteria for auditors to use when determining if internal controls are and management's assessment of internal controls are fair and accurate.⁶⁰ However, the SEC indicated that companies could perform their assessment of internal controls in accordance with a recognized standard and suggested that the Committee of Sponsoring Organizations ("COSO") framework would meet the requirements as a recognized standard.⁶¹ The COSO framework provides principles to guide and criteria to assess internal controls.⁶² It does not provide guidance to management on how to document the process used to test internal controls or how to correct deficiencies.⁶³ COSO published additional guidance in October 2005.⁶⁴ However, the additional guidance failed to meet many companies' expectations, as the guidance did not necessarily decrease the implementation costs or increase the perceived benefits of Section 404 compliance.⁶⁵

With the deadline for Section 404 looming, many companies turned to AS2 for guidance on how to implement, test, assess and improve internal controls even though AS2 laid out the criteria for auditors to perform an assessment of internal controls and not for management to implement effective internal controls.⁶⁶ Audit costs and company resources devoted to the financial audit increased as some companies struggled to understand the new requirements, to assess internal controls

59. See An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, SEC Release No. 34-49884, (June 17, 2004), *superseded by* Public Accounting Oversight Board, Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, SEC Release No. 34-56152, (July 27, 2007). Auditing Standard No. 5 eliminated unnecessary audit procedures, focused the audit on items most important to assessing internal control effectiveness, encouraged auditors to scale audits to the complexity of the business audited, and simplified audit reporting requirements, see Securities and Exchange Commission, Public Company Accounting Oversight Board: 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, 4-5, Rel. No. 34-56152 (2007).

60. *Id.* at 2.

61. Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release No. 33-8238, § II.A.3.A. (Aug. 28, 2008), available at <http://www.sec.gov/rules/final/33-8238.htm>.

62. See SOX-Online: The Vendor-Neutral Sarbanes-Oxley Site, The New Coso Cube, 2006, available at http://www.sox-online.com/coso_cobit_coso_cube-new.html.

63. *Id.*

64. See Grant Thornton, *Tone at the Top: COSO Releases Guidance for Smaller Public Companies in Complying with Section 404*, 3 CORP. GOVERNOR, No. 2 (2005).

65. See Grant Thornton, *Tone From the Top: COSO Releases Guidance for Smaller Public Companies in Complying with Section 404*, 3 CORP. GOVERNOR, No. 2 (2005).

66. See Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release No. 33-8238 *supra* note 59 at § II.

and to revise or to create new controls.⁶⁷ Furthermore, many companies decried the potential benefits of a new focus on effective internal controls, especially in light of the costs of the reforms.⁶⁸ In their view, only a few companies had engaged in accounting fraud, yet all publicly traded companies were made to suffer the consequences.⁶⁹ Moreover, the benefits of improved work processes related to gathering and analyzing financial data were difficult for companies to quantify unless those processes resulted in measurable outcomes, such as increased sales prospects, or inventory efficiencies. Companies already had made the cost-benefit decision to devote only so many resources to attempting to improve those processes. The question for companies became why try to improve processes that had worked satisfactorily and therefore were not broken?

Accelerated filers and large accelerated filers were required to comply with Section 404 by the end of the fiscal year on or after June 15, 2004.⁷⁰ Small businesses and smaller reporting companies were expected to comply by the end of the fiscal year on or after April 15, 2005.⁷¹ Due to the difficulties faced by companies in attempting to comply with Section 404, the SEC extended the compliance dates to the end of the fiscal year on or after November 15, 2004 for accelerated and large accelerated filers.⁷² The SEC gave further extensions to small businesses and smaller reporting companies, pushing out the compliance date to July 15, 2005,⁷³ then to July 15, 2006,⁷⁴ then to July 15, 2007,⁷⁵

67. *Id.*

68. See Thomas E. Hartman, The Cost of Being Public in the Era of Sarbanes-Oxley, 1-2 (June 15, 2006), available at http://www.foley.com/files/tbl_s31Publications/FileUpload137/3420/ndi%202006%20public%20study%20FINAL.pdf.

69. See, e.g., Thomas E. Hartman, The Cost of Being Public in the Era of Sarbanes-Oxley, 4 (June 16, 2005), available at <http://business.illinois.edu/sandrett/Foley%20Cost%20of%20Being%20Public.pdf>.

70. See Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release No. 33-8238, *supra* note 59, § II.

71. *Id.* at § VII.

72. See Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release No. 33-8392 § Dates, available at <http://www.sec.gov/rules/final/33-8392.htm>.

73. *Id.*

74. See Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers, SEC Release No. 33-8545, available at <http://www.sec.gov/rules/final/33-8545.pdf>.

75. See Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies that are Not Accelerated Filers, SEC Release No. 33-8618, available at <http://www.sec.gov/rules/final/33-8618.pdf>.

then to December 15, 2007 for the management's report over internal controls and June 15, 2010 for the auditor's attestation.⁷⁶

At a practical level, section 404 implementation costs are higher than the costs to implement other sections of Sarbanes-Oxley.⁷⁷ Section 404 implementation costs include "direct costs such as employee and consultant time, expenditures for new technology, and increased auditor fees for internal control testing."⁷⁸ Less obvious, indirect costs include "reassigning people and resources away from other, business-specific roles" to focus on the internal control audit and attestation.⁷⁹ These costs may be disproportionately burdensome for small businesses and smaller reporting companies. For example, in April 2006, the Government Accountability Office (GAO) released a report analyzing Sarbanes-Oxley's impact on smaller businesses.⁸⁰ The GAO reported that "the cost of compliance has been disproportionately higher" for smaller publicly-traded companies, "particularly with respect to the internal control reporting provisions in Section 404 and related audit fees."⁸¹ Smaller companies faced disproportionately higher indirect costs, such as the cost of using resources for compliance activities as opposed to other business activities.⁸² Interestingly, the report notes

[t]his situation was also impacted by the fact that many companies documented their internal control for the first time and needed to make significant improvements to their internal control as part of their first year of implementing section 404, despite the fact that most have been required by law since 1977 to have implemented a system of internal accounting controls.⁸³

Also, section 404 has proved to be the most difficult for companies to implement. Not only do many studies indicate that Section 404 is the

76. See Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, SEC Release No. 33-8760 § Summary, available at <http://www.sec.gov/rules/final/2006/33-8760.pdf>.

77. Joseph A. Castelluccio III, Note, *Sarbanes-Oxley and Small Business: Section 404 and the Case for a Small Business Exemption*, 71 BROOK. L. REV. 429, 457-58 (2005).

78. *Id.*

79. *Id.*

80. See GAO-06-361, REPORT TO THE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP, U.S. SENATE GOVERNMENT ACCOUNTABILITY OFFICE (GAO), SARBANES-OXLEY ACT: CONSIDERATION OF KEY PRINCIPLES NEEDED IN ADDRESSING IMPLEMENTATION FOR SMALLER PUBLIC COMPANIES, (2006), available at <http://www.gao.gov/new.items/d06361.pdf> [hereinafter GAO Report].

81. *Id.* at Highlights.

82. *Id.* at 5.

83. *Id.*

most costly Sarbanes-Oxley provision,⁸⁴ but section 404 may be the most burdensome in terms of corporate compliance.⁸⁵

By granting extensions for small businesses and smaller reporting companies, the SEC recognized that Section 404's "real-world" costs may outweigh the benefits to small businesses and smaller reporting companies.⁸⁶ As discussed further in Section III.A.6 of this article, Section 989G of the Dodd-Frank Act expressly exempts small businesses and smaller reporting companies from the auditor attestation of internal controls over financial reporting.⁸⁷ However, small, publicly-traded businesses may choose to assess and attest to internal controls for the same reasons that smaller, privately-held businesses may follow section 404's mandates.

Smaller, privately-held businesses are not required to assess the effectiveness of internal controls under Sarbanes-Oxley.⁸⁸ Also, the chief executives of smaller companies are not required to attest to the effectiveness of internal controls, nor are they subject to Sarbanes-Oxley's enhanced penalty provisions for failure to attest or for restatements of their companies' financial data.⁸⁹ However, privately-held businesses have been impacted by Section 404's requirements. First, a publicly-held company that acquires a privately-held target company must integrate the target company's financial statements into

84. See Ken Small et al., *Size Does Matter: An Examination of the Economic Impact of Sarbanes-Oxley*, ENTREPRENEUR, 2007, available at http://www.entrepreneur.com/tradejournals/article/165359569_1.html (discussing the costs of Sarbanes-Oxley compliance, the difficulties of measuring the costs and benefits, and reporting the results of an empirical study of the costs of compliance in different-sized companies).

85. See Stephen Wagner and Lee Dittmar, *The Unexpected Benefits of Sarbanes-Oxley*, HARV. BUS. REV., Apr. 2006, at 2-3 (asserting that compliance with section 404 strengthens the control environment).

86. Press Release, Securities and Exchange Comm'n, SEC Begins Small Business Costs and Benefits Study of Sarbanes-Oxley Act Section 404 (Feb. 1, 2008), available at <http://www.sec.gov/news/press/2008/2008-8.htm>.

87. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 989G, 124 Stat. 1376:

Sec. 989G. Exemption for Nonaccelerated Filers.

(a) Exemption.—Section 404 of the Sarbanes-Oxley Act of 2002 is amended by adding at the end the following:

“(c) Exemption for Smaller Issuers.—Subsection (b) shall not apply with respect to any audit report prepared for an issuer that is neither a ‘large accelerated filer’ nor an ‘accelerated filer’ as those terms are defined in Rule 12b-2 of the Commission (17 C.F.R. 240.12b-2).”

88. See Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 33-8238, Exchange Act Release No. 34-47986, Sec. II 68 Fed. Reg. 36,636 at 36,638 (Jun. 18, 2003), available at <http://www.sec.gov/rules/final/33-8238.htm>.

89. See *id.*

the public company's consolidated financial statements and attest to the effectiveness of the target company's internal controls.⁹⁰ As noted, the cost of compliance with Sarbanes-Oxley section 404 may be significant.⁹¹ An acquirer may be willing to acquire a company that has not attempted to understand and follow COSO principles, but only at a reduced acquisition price.⁹² Alternatively, an acquirer may be unwilling to purchase a company that has not assessed its internal controls.⁹³ As a result, even relatively small companies are paying attention to Sarbanes-Oxley Section 404, although these companies weigh the costs of implementing internal control audits versus the likelihood of a payoff in terms of enhancing company value as an acquisition target.⁹⁴

Second, although many privately-held businesses are focused on the exigencies of staying in business, particularly during these tough economic times, other privately-held businesses see value in paying attention to internal controls.⁹⁵ These businesses see a competitive

90. *Id.*

91. See Joseph A. Castelluccio III, *Sarbanes-Oxley and Small Business: Section 404 and the Case for a Small Business Exemption*, 71 BROOK. L. REV. 429, 458 (2005); see also Committee of Sponsoring Organizations, *Internal Control over Financial Reporting—Guidance for Smaller Public Companies* (June 2006), available at www.coso.org/documents/SB_FAQs.pdf.

92. See William Gienke, *Small Companies Also Can Benefit from Sarbanes-Oxley*, BIZTIMES.COM, Feb. 22, 2008, <http://www.biztimes.com/news/2008/2/22/small-companies-also-can-benefit-from-sarbanes-oxley> (last visited Oct. 14, 2010). Gienke recommends that:

[p]rivately held companies considering a buyout by a publicly held company should consider how efficient their internal controls are before an opportunity arises. Strong internal controls ensure the privately held company does not create a material weakness for the public buyer, which could become a barrier to completing a transaction. Strong internal controls also add confidence to the acquiring company during the courting process.

Id.

Sarbanes-Oxley compliance may also benefit companies seeking an initial public offering. According to the GAO Report:

[w]hile [Sarbanes-Oxley] does not impose new requirements on privately held companies, companies choosing to go public must realistically spend time and funds in order to demonstrate their ability to comply with the act, section 404 in particular, to attract investors who will seek the assurances and protections that compliance with section 404 provides.

GAO Report, at 7.

93. See Gienke, *supra* note 89.

94. See Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, Securities Act Release No. 33-8731, Exchange Act Release No. 34-54295, 71 Fed. Reg. 47,060 (proposed Aug. 15, 2006), available at <http://www.sec.gov/rules/proposed/2006/33-8731.pdf>.

95. Fifty percent of privately held start-ups fail in the first five years. Also, only thirty percent of privately held business have a succession plan or engage in long range

advantage in having better control over workflow and processes that result in accounting ledger inputs or financial statement notes.⁹⁶ The attention to internal controls has produced a wealth of data that may be helpful to these businesses.⁹⁷ In fact, these companies are able to adopt Sarbanes-Oxley transparency, accountability and responsibility principles that fit the size of their enterprises but need not adopt all of the provisions and need not pay the costs of full compliance. Moreover, these companies are not subject to penalties for non-compliance and thus do not bear the risk of litigation for failure to comply with the act⁹⁸ Therefore, COSO principles and internal control audits have taken hold as these companies increasingly adopt internal control assessment criteria and strategies to address deficiencies in internal controls. As this article discusses in Section IV, the SEC should be instrumental in encouraging small business owners to adopt reforms that result in value for the business.⁹⁹

C. *Changes in Accounting Firm Practices*

Sarbanes-Oxley requires that public accounting firms register with the PCAOB; the PCAOB would monitor firms, perform assessments of firms, and set guidelines and standards for the conduct of audit business.¹⁰⁰ In addition to internal controls assessment and attestation per PCAOB-sanctioned standards, Sarbanes-Oxley required that firms performing audits

report to the audit committee of the issuer—

- (1) all critical accounting policies and practices to be used;

planning, despite evidence that succession and long range planning are integral to the viability of privately held businesses.

96. See *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*, *supra* note 88.

97. See *id.*

98. Companies that are not required to comply with Sarbanes-Oxley's provisions would not be liable under Sarbanes-Oxley for failure to comply with the act's provisions. However, to the extent that Sarbanes-Oxley may establish governance norms, failure to comply with those norms may give rise to a cause of action under state law. See, generally, Regina F. Burch, *Director Oversight and Monitoring: The Standard of Care and the Standard of Liability Post-Enron*, 6 WYO. L. REV. 481 (2006).

99. See William Gienke, *Small Companies Also Can Benefit from Sarbanes-Oxley*, BIZTIMES.COM, Feb. 22, 2008, <http://www.biztimes.com/news/2008/2/22/small-companies-also-can-benefit-from-sarbanes-oxley> (last visited Oct. 14, 2010).

100. See 15 U.S.C. § 7213 (2006).

(2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and

(3) other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.¹⁰¹

Such policies, practices, treatments of financial information and material written communications may include criteria for determining the effectiveness of internal controls.¹⁰²

Legislators anticipated that the auditors' assessment of internal controls would be included in the engagement to assess a company's financial reporting. In fact, the Senate Committee Report noted that "high quality audits typically incorporate extensive internal control testing."¹⁰³ And AS2 provided guidance on what a high quality audit would entail. Legislators expected that auditors would improve audit quality for all companies subject to the statute.

Legislators and businesses anticipated that audit costs would rise as a result of the internal controls requirements.¹⁰⁴ However, audit costs rose more than anticipated.¹⁰⁵ Perhaps in the late 1980s and early 1990s, as audit companies faced increasing pressure from clients to minimize audit fees, and audit partners faced pressure to generate consulting business, auditors minimized audit fees in the expectation that a satisfied

101. Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act of 2002, Pub. L. No. 107-204, § 204, 116 Stat. 745, 773 (amending 15 U.S.C. §§ 78 (j-1)). Critical accounting policies includes how certain transactions are accounted for under Generally Accepted Accounting Principles that provide accounting alternatives. A management letter is written by the auditor, accompanies the audit, and contains conclusions about the internal controls, treatments of financial information and the audit itself.

102. See Order Approving Proposed Audit Standard No. 5, *An Audit of Internal Control over Financial Reporting That Is Integrated With an Audit of Financial Statements*, Exchange Act Release No. 34-56152, 72 Fed. Reg. 42141 (July 27, 2007), available at <http://www.sec.gov/rules/pcaob/2007/34-56152.pdf>.

103. Sarbanes-Oxley Committee Report, S. REP. NO. 107-205, at 31 (2002).

104. See *Sarbanes Oxley Drives Up Large Companies' Audit Costs by \$1.4 Billion*, INS. J., Apr. 28, 2005, <http://www.insurancejournal.com/news/national/2005/04/28/54393.htm> (last visited Oct. 10, 2010); see also Susan W. Eldrige and Burch T. Kealey, *SOX Costs: Auditor Attestation under Section 404* (Working Paper Series, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=743285.

105. See *Sarbanes Oxley Drives, supra* note 104.

audit client would be more willing to pay higher consulting fees. This may have produced some sacrifices in terms of audit quality—a deterioration in the level of scrutiny of the financial statements' accuracy and fairness, and in the auditor's assessment of the quality of the processes that needed to be in place to ensure that the financial statements fairly and accurately reported the financial conditions of corporations.

Legislators did not anticipate that audit companies would tend to take a uniform approach under AS2.¹⁰⁶ Furthermore, auditors focused on testing processes that are concretized in information technology.¹⁰⁷ As a result, some auditors tested computer systems that had little to no impact on financial statement integrity.¹⁰⁸ The implication for privately-held businesses is two-fold. First, auditors' tendency to take a uniform approach during public company audits may carry over to audits of privately-held businesses. Privately-held businesses may have fewer and less complex computer system-based financial information controls and processes than exist at publicly-held businesses. Prior to Sarbanes-Oxley, auditors may have tailored their audits to account for the relative simplicity of privately-held businesses' financial information systems and processes. However, after Sarbanes-Oxley, auditors may scrutinize processes and technology more closely at privately-held businesses than before Sarbanes-Oxley. The internal controls assessment and the attestation may seem to go beyond that warranted by the size of the business. Thus it may appear that the internal controls audit's cost far outweighs any benefit. On the other hand, prior to Sarbanes-Oxley it appears that too little was done with respect to internal controls at both publicly-held and privately-held businesses.¹⁰⁹ Second, small business owners may respond to the anxiety produced by too little guidance for small businesses with respect to internal control audits by purchasing and implementing new computer technologies without much guidance or knowledge of the expected benefit, thus defeating the purpose of picking and choosing from Sarbanes-Oxley best practices.

A potentially less costly accounting firm best practice is the requirement that the outside auditors report to the board of directors'

106. See Advisory Committee Report, *supra* note 14, at 28-32; see also *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*, *supra* note 88.

107. See Advisory Committee Report, *supra* note 14, at 32.

108. See *id.*

109. See *id.* at 25-28 (explaining why Section 404 was originally implemented and the original result it hoped to achieve).

audit committee.¹¹⁰ Small businesses may reap benefits from this corporate governance practice, assuming that an audit committee exists. As discussed in Section IV, the SEC should work with the Small Business Administration and accounting firm industry groups representing smaller accounting firms to better understand best practices in internal financial controls for small businesses and to provide benefits for early adopters of the best practices.

D. *Changes in Corporate Governance Practices*

A number of corporate governance mandates in Sarbanes-Oxley were best practices at public corporations prior to Sarbanes-Oxley's enactment.¹¹¹ The regulation's critics challenged the wisdom of mandating corporate governance structures for several reasons.¹¹² First, critics pointed out the "one-size fits all" nature of the requirements and suggested that the provisions should be opt-in or voluntary.¹¹³ Also, critics highlighted the fact that many companies had adopted these requirements prior to the accounting scandals and the scandals still occurred.¹¹⁴ Further, empirical studies sought to determine whether companies with such corporate governance provisions in place had better shareholder value, better board governance, or better corporate governance.¹¹⁵ Although empirical research conclusions are still evolving, to date the evidence is inconclusive.¹¹⁶

Nonetheless, a 2005 survey of private business and non-profit executives found that 87% of respondents believed that Sarbanes-Oxley and the subsequent corporate governance reforms had impacted their

110. Privately held companies increasingly are using outside directors and independent audit committees. A 2003 Financial Executives Research Foundation, Inc. question posed to a listserv generated a consensus that "today's private companies are adding outside directors to their boards, and some are even establishing audit committees." William M. Sinnett, *Even Private Company Boards of Directors are Changing*, FIN. EXECUTIVE, Oct. 2003, available at <http://www.lonerganpartners.com/resources/for-bod/Even%20Private%20Company%20Boards%20are%20Changing.pdf>.

111. See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 165, 952, 957, 971, 972, 116 Stat. 745 (These sections reflect the changes that were required in terms of corporate governance.).

112. See Fanto, *supra* note 34; Thompson, *supra* note 34; Linck, Netter & Yang, *supra* note 34.

113. See Advisory Committee Report, *supra* note 14, at 40-42.

114. See *id.*

115. See Romano, *supra* note 34; Frankel, *supra* note 34; Fanto, *supra* note 34; see also Paul D. Broude & Richard L. Prebil, *The Impact of Sarbanes-Oxley on Private and Nonprofit Companies*, NAT'L DIRECTORS INST. (Foley & Lardner LLP, Chicago, Ill.), Mar. 10, 2005, 2, available at <http://www.directorsandboards.com/ndi.pdf>.

116. *Id.*

businesses.¹¹⁷ Also, the survey's respondents "generally believe in the principles guiding corporate governance regulation and in many areas are increasingly adopting corporate governance reforms as best practices."¹¹⁸ The respondents had implemented relatively inexpensive reforms, including "CEO/CFO financial statement certification, appointment of independent directors, adopting a corporate ethical code, establishing whistle blower procedures, and approval of non-audit services by the board."¹¹⁹ Implementing these requirements may be less costly than implementing internal control audits. Further, the downside risk is limited.¹²⁰

The topic of small business adoption of these Sarbanes-Oxley provisions appears to have reached the mainstream. Even Microsoft recommends that small businesses adopt four Sarbanes-Oxley principles:

- (1) have more than one accounting firm—do not have the same accounting firm do audits and provide consulting staff;
- (2) have an audit committee that oversees "some system of internal checks and balances that includes interactions with management";
- (3) institute whistleblower protections; and
- (4) make your board of advisors truly independent.¹²¹

III. THE DODD-FRANK ACT AND SMALL BUSINESSES

The late spring of 2007 and the fall of 2008 witnessed a period of worldwide bank collapse, extreme volatility in the global financial markets, the bursting of the United States housing bubble, rapidly enacted and then abandoned regulatory solutions by state governments, international credit freezes, burgeoning unemployment, government bank takeovers and investments in formerly venerable Wall Street investment banks, below zero interest rates, a universal decline in stock market averages and billions in economic stimulus and bailouts. The term the "Great Recession" aptly defines this period in economic history. According to some, the Great Recession ended in mid-September

117. See Paul D. Broude and Richard L. Prebil, Foley & Lardner LLP, *The Impact of Sarbanes-Oxley on Private and Nonprofit Companies*, 2, 2005, National Directors Institute Executive Summary, available at <http://www.directorsandboards.com/ndi.pdf>.

118. *Id.* at 2.

119. *Id.* at 5.

120. *Id.*

121. See Small Business Legal Advice, Microsoft Small Business, <http://www.microsoft.com/smallbusiness/resources/finance/small-business-legal.aspx#PrivatecompanieslessonsfromSarbanesOxleyAct>.

2008,¹²² to others in mid-2009. Some opine that early 2010 saw the beginning of a sluggish economic recovery. However, others fear that the deep recession continues, especially for individuals who saw their standard of living decline over the last two decades.

Despite the troubling economic news and uncertainty about the source or the length of the recovery, new business startups have increased, especially among workers age 55 and older.¹²³ At first glance, this phenomenon may seem counterintuitive. However, some of these individuals lost their jobs in the Great Recession and have joined the ranks of the self-employed in order to “make ends meet.”¹²⁴ These individuals have the skills and contacts necessary to find clients or make connections to sell goods. Other individuals lost retirement income in the economic downturn and are no longer able to remain retired. Moreover, demographics factor into the increase in the number of 55 and older entrepreneurs. “The 55-and-overs are playing a larger role in entrepreneurship partly because the number of Americans in that age category is rising rapidly.”¹²⁵

A. *The Dodd-Frank Act Reforms*

Ongoing Congressional hearings attempted to pinpoint the many factors that caused the Great Recession and to inform the debate leading to the Dodd-Frank Act’s enactment.¹²⁶ The bursting of the debt-financed housing bubble, and “a breakdown in our financial system”¹²⁷ were the most visible causes.¹²⁸ In his speech upon signing the Dodd-Frank Act,

122. See Stephen C. Fehr, *The Great Recession: What’s in a name?*, NEWJERSEYNEWSROOM.COM, April 2, 2010, <http://www.newjerseynewsroom.com/nation/the-great-recession-whats-in-a-name> (last visited Mar. 6, 2011).

123. See Steven Greenhouse, *Starting Over at 55*, N.Y. TIMES, March 3, 2010, <http://www.nytimes.com/2010/03/04/business/retirementspecial/04WORK.html> (“More than five million Americans age 55 or older run their own businesses or are otherwise self-employed. . . . And the number of self-employed people ages 55-64 is soaring, the agency says, climbing 52 percent from 2000 to 2007.”) (last visited Mar. 6, 2011).

124. *Id.*

125. *Id.*

126. Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010).

127. See Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act, The White House, Office of the Press Secretary (July 21, 2010), available at <http://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act>.

128. See Congressional Debate, Wall Street Reform and Consumer Protection Act of 2009 H.R. 4173, 11th Congr. (2009); US Senate’s Restoring American Financial Stability Act of 2010, S. 3217, 111th Congr. (2009) (during the bill reconciliation process centered on predatory consumer lending practices, particularly in the mortgage industry, and on financial institution business practices).

President Obama stated, “[I]t was a crisis born of a failure of responsibility from certain corners of Wall Street to the halls of power in Washington.”¹²⁹ The financial system rules were “antiquated and poorly enforced . . . and allowed some to game the system and take risks that endangered the entire economy.”¹³⁰ In addition, “unscrupulous lenders locked consumers into complex loans with hidden costs.”¹³¹ President Obama emphasized consumer protection, financial markets stability, and investor empowerment.¹³²

The Dodd-Frank Act has several highlights that address these concerns. First, the Dodd-Frank Act includes consumer protections with respect to credit card and checking account fee abuses, mortgage industry predatory lending, student loans, and mutual fund information access.¹³³ The consumer protections include the establishment of a consumer protection watchdog to enforce the rules.¹³⁴ Second, the Dodd-Frank Act includes provisions purportedly designed to limit banks’ ability to engage in risky derivatives trading (e.g., credit default swaps) and to bring more transparency to derivatives trading.¹³⁵ Under the Federal Reserve Board’s new powers, major financial institutions may be ordered to divest businesses in order to avoid becoming too big to fail.¹³⁶ The Federal Depositary Insurance Corporation and the Federal Reserve Board have express authority to “insure that the failure of a major financial firm does not lead to chain-reaction failures through losses to unsecured creditors.”¹³⁷

The investor empowerment provisions seek to strengthen shareholder voice with respect to director nominations, executive compensation and other corporate internal affairs.¹³⁸ These provisions,

129. See Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act, The White House, Office of the Press Secretary (July 21, 2010), available at <http://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act>.

130. *Id.*

131. *Id.*

132. *Id.*

133. Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. §§ 1074, 1075, 1076, 1077, 1078 (2010).

134. *Id.* at § 1011; see also *id.* at §§ 1021, 1022, 1023, 1024, 1025, 1026, 1027, 1028, 1029 (2010) (explaining the powers and responsibilities of the bureau as established in the act).

135. *Id.* at Title VII.

136. *Id.* § 121 (2010).

137. *Id.* at § 165.

138. Posting of Steven Ramirez to Corporate Justice Blog, *Dodd-Frank IV: A Revolution in Corporate Governance?*, July 25, 2010 <http://corporatejusticeblog.blogspot.com/2010/07/dodd-frank-iv-revolution-in-corporate.html> (last visited Mar. 6, 2011).

and the risk management provisions that apply to large financial institutions but that may impact smaller, non-financial businesses, are analyzed below.

1. Shareholder Democracy Reforms

Section 971 deals with proxy access for shareholders—an issue on which “progress . . . has been glacial at best.”¹³⁹ Under this section, the SEC may promulgate rules requiring that companies’ proxy solicitations “include a nominee submitted by a shareholder to serve on the board of directors. . . .” The SEC may exempt issuers from proxy access requirements “tak[ing] into account, among other considerations, whether the requirement . . . disproportionately burdens small issuers.”¹⁴⁰ SEC rulemaking on proxy access has been in the works for some time, and the SEC has taken a fairly aggressive stance. In a blog post analyzing the Dodd-Frank major corporate governance provisions, Professor Steven Ramirez opined, “perhaps [section 971] can operate to break the log jam.”¹⁴¹

Section 957 abolishes the “broker may vote” rule. This rule allows broker discretionary voting on uncontested matters, including uncontested director elections, if the beneficial owner of the shares has not provided voting instructions by a certain date before a scheduled meeting.¹⁴² According to the Council for Institutional Investors, discretionary voting in uncontested director elections “skews voting results. . . . Approximately 85 percent of all shares in U.S. public companies are held in ‘street name,’ meaning they are held of record in bank or brokerage accounts for the ultimate beneficiary owners.”¹⁴³ Also, “about 20 percent of ‘street name’ shares are voted by brokers without instruction.”¹⁴⁴ Thus, the “broker may vote” rule was “akin to

139. See Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 971 (2010); see Ramirez, *supra* note 138.

140. Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 971 (2010).

141. See *id.*; see also Ramirez, *supra* note 138.

142. See Voting Procedure Without Instructions, New York Stock Exchange Rule 452, (available at http://nyserules.nyse.com/nysetools/PlatformViewer.asp?SelectedNode=chp_1_2&manual=/nyse/rules/nyse-rules/) (Rule 452 provides that a member organization may give a proxy to vote stock provided that: . . . it has not received voting instructions from the beneficial owner or from the beneficial owner’s designated investment adviser, by the date specified in the statement accompanying such material. . . .).

143. See Council of Institutional Investors, Broker Voting (2008), <http://www.cii.org/resourcesKeyGovernanceIssuesBrokerVoting> (last visited August 13, 2010).

144. *Id.*

stuffing the ballot box for management as broker votes almost always are cast in favor of management's proposals and candidates for board seats."¹⁴⁵

On July 1, 2009, the SEC approved a New York Stock Exchange rule proposal to essentially prohibit brokers from voting uninstructed proxies in uncontested director elections.¹⁴⁶ The Dodd-Frank Act section 957 takes the prohibition on broker discretionary voting at least one step further. Section 957 prohibits a broker from voting proxies in director elections, on executive compensation and other "significant matters," unless the broker has received instructions from the beneficial owner of the shares.¹⁴⁷ The Dodd-Frank Act Section 957, especially coupled with activist shareholder "withhold the vote" campaigns, has the potential to change the outcome of director elections.¹⁴⁸ Further it has the potential to tip shareholder advisory votes on executive compensation and on "other significant matters" related to investor voice. The SEC has

145. *Id.*

146. See Order Approving Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting for the Election of Directors, Except for Companies Registered under the Investment Company Act of 1940, and to Codify Two Previously Published Interpretations that Do Not Permit Broker Discretionary Voting for Material Amendments to Investment Advisory Contracts with an Investment Company, Exchange Act Release No. 34-60215, (July 1, 2009), available at <http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf>.

147. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 § 957 (2010).

148. See Broker Voting, *supra* note 146. According to the Council of Institutional Investors:

In 2009, many observers believed that excluding uninstructed broker votes might have tipped the outcome in director elections at Bank of America and Citigroup, resulting in one or more directors at each company not being re-elected. . . .

In 2008, activist shareowners pointed to the April 15 board elections at Washington Mutual as a textbook case for the way broker votes can taint elections. One director resigned after Washington Mutual reported that shareowners had withheld 49.9 percent of votes for her. Some Washington Mutual shareowners, however, suspect that one or more directors running for re-election would not have received majority support if uninstructed brokers had been excluded from the tally. CTW Investment Group, which had led a withhold campaign against two Washington Mutual directors because of risk management and executive compensation concerns, called on the board to demand the resignation of any directors who failed to win majority votes. The Council sent a letter to Washington Mutual asking the board to clarify the preliminary vote totals for the director elections by promptly disclosing the results excluding uninstructed broker votes.

authority to define “other significant matters” through rulemaking,¹⁴⁹ and thus has the authority to effect other changes empowering investors.¹⁵⁰

2. Say-on-Pay, Say-on-Golden-Parachutes, Pay versus Performance Disclosure, and Clawbacks

Section 951 includes the “say on pay” provision giving shareholders a non-binding vote on executive compensation.¹⁵¹ Also, section 951 requires companies to disclose “golden parachute” payments that would be awarded on completion of a merger, acquisition or sale, and provides for a non-binding shareholder vote on the golden parachute payments.¹⁵² The purpose of these provisions is to “give shareholders a powerful opportunity to hold accountable executives of the companies they own, and a chance to disapprove where they see the kind of misguided incentive schemes that threatened individual companies and in turn the broader economy.”¹⁵³ The rule takes effect in January of 2011, and the SEC has authority to promulgate rules to exempt issuers from the say-on-pay and golden parachute requirements.¹⁵⁴ Specifically, “[i]n determining whether to make an exemption . . . the Commission shall take into account, among other considerations, whether the [say-on-pay and say-on-golden parachutes] requirements . . . disproportionately burdens small issuers.”¹⁵⁵

The say-on-pay and say-on-golden-parachutes provisions suffer somewhat from the fact that the shareholders’ vote is not binding on corporate boards¹⁵⁶. Nonetheless, the regulation has value if it results in more scrutiny—and correction—of executive compensation practices that are entrenched in corporate culture and have proven detrimental to global economic health.

149. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 § 957 (2010).

150. See Ramirez, *supra* note 138.

151. *Id.*

152. *Id.* A golden parachute is a clause in an executive’s contract specifying that he/she will receive large benefits in the event that the company is acquired and the executive employment is terminated.

153. See Sen. Christopher Dodd, *Summary: Restoring American Financial Stability: Create a Sound Economic Foundation to Grow Jobs, Protect Consumers, Rein in Wall Street, End Too Big to Fail, Prevent Another Financial Crisis*, Senate Committee on Banking, Housing, and Urban Affairs, (2009), available at http://banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf.

154. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 § 951 (2010).

155. See *id.*

156. See *id.*; Dodd, *supra* note 153.

Section 953 directs the SEC to promulgate disclosure rules to create more transparency regarding senior corporate officers' pay versus corporate performance.¹⁵⁷ Companies must disclose in proxy statements and consent solicitations "clear descriptions" of financial information, including "information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends . . . and distributions."¹⁵⁸

Finally, section 954 requires the SEC to promulgate rules requiring companies to implement clawback policies. The clawback policy (1) would require disclosure of the incentive-based compensation policy and (2) in the event of a financial restatement due to "material noncompliance of the issuer with any financial reporting requirement under the securities law," require the issuer to:

recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.¹⁵⁹

The executive compensation clawback provision may not dissuade executives from taking excessive risks that were not well understood and then failing to disclose the stark reality that the risks were not well understood. Even if the executive's compensation is subject to clawback, the executive only loses compensation over the amount that otherwise would have been earned (there is no penalty for the executive) and the damage already has been done.

3. Compensation Committees

Reminiscent of Sarbanes-Oxley's audit committee independence rules, Section 952 essentially requires the SEC to promulgate rules requiring that listed companies (i.e., companies traded on a national stock exchange) have an independent compensation committee and requires the SEC to define independence.¹⁶⁰ Also, when choosing a "compensation consultant, legal counsel, or other advisers to the

157. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 § 953 (2010).

158. *Id.*

159. See *id.* at § 954.

160. See *id.* at § 952.

compensation committee,” the compensation committee must consider whether the adviser is independent.¹⁶¹ In addition, reminiscent of Sarbanes-Oxley’s mandate regarding the relationship between the audit committee and the auditor, section 252 gives the compensation committee the authority to hire, “in its sole discretion,” compensation committee advisers, and mandates that the compensation committee is “directly responsible for the appointment, compensation, and oversight of the work of “the advisers.”¹⁶² Further, companies must disclose in proxy statements or in solicitations for shareholder consent whether the compensation committee sought and received advice from compensation advisers, and whether any conflicts of interest existed on the part of the advisers.¹⁶³ Finally, section 952 authorizes the SEC to allow the national exchanges to consider the rule’s costs versus the benefits for smaller issuers and to devise exemptions if appropriate.¹⁶⁴

Critics of Sarbanes-Oxley’s audit committee independence requirement questioned the requirements on a number of fronts. For example, many public corporations—including those corporations that had engaged in accounting fraud—already had independent audit committees and board members with accounting expertise; yet, the accounting frauds still occurred.¹⁶⁵ Another criticism is there should not be so much focus on requiring independence of audit committees, but rather the focus should be on ensuring experts are on the committee.¹⁶⁶ Many studies have shown that the presence of experts has led to positive earnings for a company, whereas no positive impact occurred when the committee simply was made up of independent individuals.¹⁶⁷ Finally, there has been some criticism about whether companies should actually have confidence in the work of these independent committees.¹⁶⁸ One commentator discussed the reliability of these committees by explaining that they have much less experience with and understanding of the businesses with which they work, which in turn could lead to business decisions that are not necessarily beneficial.¹⁶⁹

Similar critiques might develop with respect to the independent compensation committee provision. For example, the New York Stock

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.*

165. *See Romano, supra* note 34.

166. *Id.*

167. *Id.*

168. LARRY E. RIBSTEIN AND HENRY N. BUTLER, *THE SARBANES-OXLEY DEBACLE: WHAT WE’VE LEARNED; HOW TO FIX IT*, AEI Press (2006).

169. *Id.*

Exchange Listing Rules already require that compensation committees are composed entirely of independent directors.¹⁷⁰ Both before, during and after the Wall Street meltdown, independent compensation committees awarded large bonuses. Therefore, independent compensation committees may not be the answer to what is seen among law academics, economists and the general population as compensation greed and excess.¹⁷¹

Indeed, under this analysis, neither the independent compensation committee provision nor the executive compensation clawback provision discussed above goes far enough towards effecting real change in executive compensation practices and in business practices. However, the provisions are a sign of some progress in curbing excessive compensation. Finally Congress has waded into an area it was hesitant to enter in 2002 with Sarbanes-Oxley. Independent compensation committees, coupled with increased compensation disclosures, separating the CEO and board chair roles, heightened investor awareness and media exposure related to compensation practices and Congressional willingness to legislate in this area may result in a more conservative approach to executive compensation.

4. Separating the CEO and Board Chair Roles

Section 972 follows the Sarbanes-Oxley mechanism requiring disclosure on corporate governance issues as a way to effectuate certain business norms.¹⁷² Section 972 requires companies to disclose whether the chief executive officer and board chair roles are held by the same or by different individuals, and to disclose the reasons for implementing a particular governance structure.

170. See NYSE LISTED COMPANY MANUAL: LISTING REQUIREMENTS, SECTION 303A.01: INDEPENDENT DIRECTORS, available at <http://www.nysemanual.com/lcm>.

171. See generally Steven A. Ramirez, *Lessons from the Subprime Debacle: Stress Testing CEO Autonomy*, 54 ST. LOUIS U. L.J. 1 (2009); see also Ian Katz, *Feinberg Says Companies Should Adjust Pay Policies for "Crisis,"* BLOOMBERG, July 23, 2010, <http://www.bloomberg.com/news/2010-07-22/feinberg-said-to-cite-17-u-s-bail-out-recipients-for-unwarranted-payments.html> (last visited Aug. 14, 2010).

172. See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407, 116 Stat. 745, 790 (2002) (requiring disclosure of the number of financial experts serving on a company's audit committee); see also *id.* at § 406, 116 Stat. 745, 789 (2002) (requiring disclosure of whether the company has a code of ethics covering principal executive officers and chief financial officers).

5. Risk Management

Although the purpose of the Dodd-Frank Act section 165 is “to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions,” risk management lessons may be implemented on a smaller scale.¹⁷³ Under the Dodd-Frank Act section 165(h), nonbank financial companies supervised by the Federal Reserve Board of Governors (“Board of Governors”), publicly-traded bank holding companies with assets greater than \$10 billion must establish a risk committee.¹⁷⁴ The Board of Governors may require publicly-traded bank holding companies with assets less than \$10 billion to establish a risk committee.¹⁷⁵ The risk committee must be independent and must have at least one risk expert.¹⁷⁶ The committee would be responsible for oversight of the company’s “enterprise-wide risk management practices.”¹⁷⁷

6. Sarbanes-Oxley § 404 Exemption for Smaller Issuers

The Dodd-Frank Act section 989G makes permanent for smaller reporting companies (publicly-traded companies with a market capitalization under \$75 million) an exemption from Sarbanes-Oxley section 404(b)’s auditor attestation requirement.¹⁷⁸ Also, the SEC is directed to research ways to reduce compliance costs for accelerated filers while maintaining investor protections and promoting initial public offerings on United States stock exchanges.¹⁷⁹ Further Dodd-Frank section 989I directs the Government Accounting Office (“GAO”) to study the impact of the exemption on investor confidence, capital costs, and the number of restatements for smaller companies versus larger companies required to comply with Sarbanes-Oxley section 404.¹⁸⁰ Last, the GAO is required to analyze whether companies should disclose the lack of attestation and the costs and benefits of the attestation to smaller companies that voluntarily comply.¹⁸¹ Not surprisingly, smaller

173. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165(a), 124 Stat. 1376, 1423 (2010).

174. See *id.* at § 165(h)(2)(A).

175. *Id.* at § 165(h)(2)(B).

176. *Id.* at § 165(h)(3)(B)-(C).

177. *Id.* at 203 § 165(h)(3)(A).

178. *Id.* at § 989G(a).

179. *Id.* at §989G(b).

180. *Id.* at §989I.

181. See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller*

businesses have welcomed the current and prospective relief from mandatory compliance costs, especially in the current, weak economy.¹⁸²

A full critique of the provisions mentioned should involve analysis from a number of disciplines, including law, economics and cognitive sciences. Thus, a full critique of whether or not the provisions would “restore responsibility and accountability in our financial system” is beyond the scope of this Article.¹⁸³ Also, many of the provisions discussed above require that the SEC “undertake various initiatives, including rulemaking and studies touching on many areas of financial regulation.”¹⁸⁴ The final rules and standards may be flexible enough to soften reforms that otherwise may be unpalatable. For example, Dodd-Frank section 952 directs the SEC to exempt small businesses if the compliance costs would outweigh the benefits.¹⁸⁵ As another example, Dodd-Frank’s proxy access rule is delayed for three years for smaller business.¹⁸⁶ However, regardless of Dodd-Frank’s ultimate value, smaller businesses likely have begun to consider how the Dodd-Frank Act will impact them.

B. The Implications for Privately Held Businesses

The impact on small, privately-held businesses turns on the purpose of the particular regulation, the principles underlying the regulation, and the costs versus the benefits of adopting potentially new norms.

1. Permanent Exemption from Sarbanes-Oxley Section 404

Prior to the Dodd-Frank Act’s passage, small businesses were likely to adopt the less costly Sarbanes-Oxley reforms—compensation committees, risk management committees—and forego the more costly such as the Sarbanes-Oxley section 404 attestation requirement. However, small businesses recognized reasons to implement best

Public Companies, Apr. 13, 2006, <http://www.gao.gov/products/GAO-06-361> (last visited Aug. 14, 2010).

182. *See id.*

183. *See* Dodd, *supra* note 153.

184. *See* UNITED STATES SECURITIES AND EXCHANGE COMMISSION, *Public Comments on SEC Regulatory Initiatives Under the Dodd-Frank Act*, (Oct. 14, 2010), available at <http://www.sec.gov/spotlight/regreformcomments.shtml>.

185. *See generally* TIMOTHY F. GEITHNER & KAREN G. MILLS, REPORT TO THE PRESIDENT: SMALL BUSINESS FINANCING FORUM 18, 4-5 (2009), available at http://www.sba.gov/idc/groups/public/documents/sba_homepage/small_buss_finan_forum_report.pdf.

186. *See* Securities and Exchange Commission, Facilitating Shareholder Director Nominations, Release 33-9136 § “Compliance Dates,” available at <http://www.sec.gov/rules/final/2010/33-9136.pdf>.

practice internal controls and to seek auditor attestation. First, smaller businesses generally have weaker internal financial controls than publicly-traded companies.¹⁸⁷ This is not surprising given that small, privately-held businesses are not required to produce the extensive and detailed financial reports that must be produced by publicly-traded companies. Therefore, most privately-held businesses have little incentive to create information systems that would make producing such reports more efficient. Also, whereas most publicly-traded company owners (i.e., shareholders) are not involved in the day-to-day operations of companies, most small business owners are involved personally responsible for (1) attracting and retaining customers, (2) growing revenue, and (3) reducing taxes. Such responsibilities leave little time for administrative attention to business planning and processes. However, weak internal financial controls expose a business to risk, including fraud and restated financials.¹⁸⁸ These are avoidable crises that sap “management time and energy for strategizing and growing the business.”¹⁸⁹ Second, companies with stronger internal financial controls tend to experience a lower cost of capital.¹⁹⁰ Stronger internal financial controls tend to result in fewer intentional and unintentional errors in financial reporting, and consequently a decrease in the information risk faced by investors.¹⁹¹

Hopefully, the Dodd-Frank Act’s permanent exemption from section 404’s auditor attestation requirement for smaller publicly-traded companies will not undercut the very valid purpose of the internal controls requirement—companies should seek to improve work processes related to gathering and analyzing financial data. As discussed further in Section IV, small, privately held businesses that implement best practices in internal controls should be rewarded with easier access to equity and debt capital.¹⁹²

187. See Jean C. Bedard, Lynford E. Graham, Rani Hoitash, and Udi Hoitash, *Sarbanes-Oxley Section 404 and Internal Controls: A Look at Two Years of Compliance*, The CPA Journal Online, Oct. 2007, <http://www.nysscpa.org/cpajournal/2007/1007/essentials/p34.htm> (last visited Aug. 14, 2010).

188. See *id.*

189. *Id.*

190. *Id.*

191. See Hollis Ashbaugh-Skaife, Daniel W. Collins, William R. Kinney, Jr., Ryan LaFond, *The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity*, 47 J. ACCT. RES. 1 (2009).

192. See *infra* Section IV.

2. Independent Advisors

Small businesses with significant private equity investments are likely to have adopted at least independence principles and may have independent advisors for audit, accounting, compensation and risk management issues.¹⁹³ Smaller businesses may consider the purpose of the independence requirements. The underlying principle behind the independence requirement is that committee independence enhances oversight. Also, these provisions are less costly to implement. Even sole proprietor businesses financed with microloans may benefit from independent advisors.

Also, business structure matters. Separating the chief executive officer and board chair would not be possible in a sole proprietorship. However, some business owners that may not otherwise seek outside advice regarding managing a business and compensation may do so as business norms change.

3. Disclosure

In a closely-held business, a shareholders' agreement may govern compensation, appointment of executives and other matters usually within the discretion of the board of directors.¹⁹⁴ In addition, compensation in the event of a sale of the business would be covered in the agreement between the founders and early investors of the business and the acquirer. Therefore, to a certain degree, shareholders in closely held businesses already may have a say-on-pay and a say-on-golden-parachutes. To the extent that minority shareholders do not have access to information about compensation, the Dodd-Frank Act's say-on-pay and say-on-golden-parachute provisions establish disclosure norms that may empower minority shareholders in closely-held businesses.

Questions about executive compensation—such as whether it is excessive and whether it is tied to performance—may arise. As discussed in the previous section, independent advisors may go far to alleviate concerns regarding best practices and business norms in setting compensation.

193. See generally Glynn D. Key, *Private Company Corporate Governance: Closing the Gap with Public Companies* (2006), available at <http://www.wilmerhale.com> (type "Private Company Corporate Governance" into search box, then click on link entitled "keyblc107_cropped.pdf.")

194. See MODEL BUS. CORP. ACT § 7.32(a) (1984); see also DEL. CODE ANN. tit. 8, § 350 (2010).

4. The Shareholder Voting Franchise in a Closely-Held Business

Privately-held businesses do not face the same proxy access challenges as publicly-traded businesses face. Shareholder representation on boards would be negotiated by venture capital or private equity companies as part of the investment agreement. If a dispute arose between shareholders regarding who should serve on the board, the minority shareholders could argue that their nominee should be included on the ballot. However, the shareholders' agreement often controls the outcome if the case should go to court.¹⁹⁵ Further, the point may be moot unless the minority shareholders hold enough shares to elect the director.

IV. FACILITATING POSITIVE OUTCOMES FOR SMALL BUSINESSES

Approximately one year after the collapse of Lehman Brothers, President Obama invited Wall Street to participate in formulating financial industry reforms.¹⁹⁶ Shortly after President Obama's Federal Hall speech on Wall Street, small business advocates met with administration officials, including Treasury Secretary Timothy Geithner, members of Congress and lenders to find ways to help so-called Main Street businesses weather the tough economic times. Most of the recommendations from the Small Business Financing Forum dealt with funding mechanisms and tax credits.¹⁹⁷

The SEC acknowledges that small businesses may not be in the same position as larger businesses—that one size does not fit all.¹⁹⁸ However, the SEC should continue to go beyond acknowledgment and more actively consider that firms that it does not expressly regulate may be impacted by trickle-down. The SEC should use the tools it has used in the past to help regulated small businesses achieve positive outcomes under the new reforms. These tools include delaying compliance

195. *See generally* Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 53 A.2d 441 (Del. 1947) (analyzing an arbitrator's agreement governing shareholder voting rights).

196. *See* Barack Obama, President of the United States, Remarks by the President on Financial Rescue and Reform (Sept. 14, 2009), *available at* http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall).

197. *See generally* Ringling Bros.-Barnum & Bailey Combined Shows, 53 A.2d at 441 (1947).

198. *See generally* Nancy M. Morris, *Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies*, U.S. Securities and Exchange Commission Release No. 33-8731, 29-30 (Aug. 9, 2006), *available at* www.sec.gov/rules/proposed/2006/33-8731.pdf.

dates,¹⁹⁹ exempting certain businesses,²⁰⁰ communicating SEC and other initiatives to small business owners and interest groups, and learning about the needs of small businesses through forums.²⁰¹

Also, the SEC should work with other regulators in several ways to help nonregulated businesses achieve positive outcomes. For example, the SEC could work with the Small Business Administration (“SBA”) and accounting industry groups such as the American Institute of Certified Public Accountants to identify best practices in corporate governance for small businesses. Early adopters could be eligible for better SBA and bank loan terms²⁰². A second example is that the SEC could work with the Internal Revenue Service and the states to provide federal and state tax credits both to early adopters and to angel and other investors in early stage businesses.²⁰³ A variety of tax credit and earned tax credit transfer programs were discussed at the Small Business Financing Forum. The availability of the credit could be tied to compliance with corporate governance standards.

The Small Business Association has set up two different funding opportunities for qualified small businesses to enhance their company’s research and development.²⁰⁴ The two programs are the Small Business Innovative Research Program (SBIR) and the Small Business Technology Transfer Program (STTR).²⁰⁵ In order to qualify, the business must be American-Owned, for profit, and have no more than 500 employees.²⁰⁶ The SBIR program requires the principal researcher be employed by the small business, but the SBTT does not have that requirement.²⁰⁷ Both programs award three phases of funding based on

199. See Press Release, U.S. Securities and Exchange Commission, SEC Approves One-Year Extension for Small Businesses from Auditor Attestation Requirement in Sarbanes-Oxley Act, (June 20, 2008), available at <http://www.sec.gov/news/press/2008/2008-116.htm>; see also *supra* notes 71-73 and accompanying text.

200. See Kenji Taneda, *Sarbanes-Oxley, Foreign Issuers and United States Securities Regulation*, 2003 COLUM. BUS. L. REV. 715 (2003).

201. See *supra* note 16 and accompanying text.

202. See Richard Bendis post to Innovation America, *SBA and Treasury Small Business Financing Forum Recommendations*, Nov. 23, 2009, <http://innovationamerica.us/index.php/innovation-daily/1388-sba-and-treasury-small-business-financing-forum-recommendations> (last visited Mar. 6, 2011) (more than half of the states have created tax incentive programs to encourage high net worth individuals to invest in early stage companies).

203. See *id.*

204. See *SBIR-STTR*, U.S. Small Business Association (2010), <http://www.sba.gov/aboutsba/sbaprograms/sbir/sbirstir/index.html> (last visited August 18, 2010).

205. *Id.*

206. *Id.*

207. *Id.*

the small business' qualification, degree of innovation, technical merit and future market potential.²⁰⁸ Neither program currently takes into account a company's governance measures.²⁰⁹ Taking into account the state of our economy and the importance of small businesses to our economy, funding of this nature should take these measures into account. A small business that is not run properly should not be permitted to take funding opportunities from companies that have proper governance measures in place. Taking these measures into account would allow funding to be dispersed to the small business that truly will benefit our economy in the long run.

In an effort to lessen the financial burden of small businesses, President Obama has urged Congress to act on both the Small Business Lending Fund Act of 2010 (H.R. 5297) and the Small Business Jobs Tax Relief Act of 2010 (H.R. 5486).²¹⁰ Both bills undoubtedly would benefit small businesses. However, to what businesses would these benefits go? As it stands now, the bills do not look at a company's governance measures in any way.²¹¹ As has been previously discussed, a business with proper governance measures in place not only will benefit our economy, but also will be of less risk for lenders.²¹² One way to insert these thoughts into the bill would be to provide certain incentives for companies employing proper governance measures. These incentives could include easier standards for obtaining the loans and better rates and terms on those loans.²¹³ Taking these matters into account would be a great help for small businesses employing proper governance standards. In addition, the well-governed businesses would benefit the most.

Finally, the SEC could continue to use its forums to convey a message: financial regulatory reform has value beyond its express terms. It should promote greater scrutiny of corporate governance practices and provide tangible and intangible benefits. Small businesses not subject to

208. *Id.* (each small business applying for a program must submit a proposal discussing their customers and competition, their market and their plans for securing assistance/mentoring necessary to further their technological goals).

209. *Id.* (at this time the proposal has no requirement or acknowledgement of a company's governance measures).

210. *See* Small Business Lending Fund Act of 2010, H.R. 5297 (2010); Small Business Jobs Tax Relief Act of 2010, H.R. 5486 (2010).

211. *Id.*

212. *See* Sanjeev Bhojraj and Partha Sengupta, *Effect of Corporate Governance on Bond Ratings and Yields: The Role of Institutional Investors and Outside Directors*, 76 J. BUS. 3, 21(2003), available at <ftp://ftp.cba.uri.edu/Classes/Tong/phd/corpGovernance2.pdf> (discussing how companies with proper governance measures (proper stock holders and board members are getting better rates because they are found to be a lower risk).

213. *Id.*

the Dodd-Frank Act's requirements are uniquely situated to be able to adopt corporate governance practices that provide real benefits to shareholders and other stakeholders.

V. CONCLUSION

“No law can force anyone to be responsible. . . . Regulators will have to be vigilant in order for these new rules to be effective.”²¹⁴

In his speech upon signing the Dodd-Frank Act, President Obama emphasized that what happens on Wall Street—in the stock and credit markets—affects Main Street, and vice versa.²¹⁵ Similarly, Wall Street financial reforms impact Main Street business norms. When Sarbanes-Oxley was adopted, “many claimed that regardless of the intent of Congress, these guidelines would eventually permeate all businesses under the guise of best practices.”²¹⁶ This Article makes a similar claim about the Dodd-Frank Act and the regulation that will be promulgated under the statute. Many of the reforms will change best practices, or perhaps affirm that some practices already in place are indeed the best practices for all businesses—expressly subject to the reforms or not—to consider if not follow to the letter.

It is to be expected that regulation of the Dodd-Frank Act's size and scope will cause unforeseen reactions in the business community. The first unforeseen reaction occurred on July 22, 2010, one day after the Dodd-Frank Act was signed.²¹⁷ Effective July 22, the Dodd-Frank Act repealed Securities Act Rule 436(g) (“Rule 436(g)”) that exempted rating agencies from expert liability for untrue statements in registration statements.²¹⁸ “As a result, disclosure of a rating in a registration statement requires inclusion of the consent by the rating agency to be named as an expert.”²¹⁹ In effect, Rule 436(g) afforded asset-backed

214. See *Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act*, The White House, Office of the Press Secretary, July 21, 2010, available at <http://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act>.

215. See *id.*

216. See Paul D. Broude and Richard L. Prebil, Foley & Lardner LLP, *The Impact of Sarbanes-Oxley on Private and Nonprofit Companies*, 2, 2005 National Directors Institute Executive Summary, available at <http://www.directorsandboards.com/ndi.pdf>.

217. See Linda Lowell, *There Was a Surprise in the Dodd-Frank Act?*, HousingWire: Financial News for the Mortgage Market, (2010), available at <http://www.housingwire.com/2010/07/26/there-was-a-surprise-in-the-dodd-frank-act>.

218. See Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 939(g) (2010) (repealing Rule 436(g) under the Securities Act of 1933).

219. See Ford Motor Credit Company No-Action Letter, U.S. Securities and Exchange Commission, July 22, 2010, available at <http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm>.

securities (“ABS”) issuers (e.g., subprime loans) and other securities issuers an exemption from obtaining consent before using ratings from firms such as Moody’s Investor Service, Standard and Poor’s, and Fitch Ratings (collectively, the “NRSROs”).²²⁰ The NRSROs were aware of Rule 436(g)’s possible repeal for many months. However, the NRSROs reacted to Rule 436(g)’s repeal by continuing to rate new issues but refusing to consent to the use of the ratings in registration statements.²²¹ “A few non-mortgage public ABS deals already in the works were withdrawn by their sponsors and the usual suspects proclaimed Congress had achieved the *unintended consequence* of smothering the ABS market and stifling consumer credit.”²²² (Emphasis added.) The SEC responded to the “kerfluffle” by stating in a July 22, 2010 no-action letter to Ford Motor Credit Company LLC that the SEC will not enforce the “consent-and-disclose” rule if an ABS issuer omits the disclosure; the SEC’s no-action position expires after six months.²²³ Also, the SEC issued a handful of interpretations of exemptions to the consent requirement.²²⁴ Moreover, the SEC had issued a “concept release” in October 2009 that discussed the possibility of repealing Rule 436(g), the history of and rationale for the rule requiring experts to consent to the disclosure of their statements and opinions in registration statements, expert liability for untrue statements and omissions, and defenses that experts may raise.²²⁵ Going forward, the SEC “will require issuers to file the consent

220. See 15 U.S.C. § 436(g) (2006)

[T]he security rating assigned to a class of debt securities, a class of convertible debt securities, or a class of preferred stock by a nationally recognized statistical rating organization . . . shall not be considered a part of the registration statement prepared or certified by a person within the meaning of sections 7 and 11 of the Act.

(In effect, Rule 436(g) exempted rating agencies from liability for material misstatements and omissions in bond registration statements. The Dodd-Frank Act repeals this exemption, exposing rating agencies to liability for materially untrue ratings); see Gregory A. Fernicola, Stacy J. Kanter, Joshua B. Goldstein, *Dodd-Frank Act Rescinds Exemptions Under Rule 436(g)*, Skadden, Arps, Slate, Meagher & Flom LLP Publications, July 23, 2010, available at <http://www.skadden.com/Index.cfm?contentID=51&itemID=2172>.

221. See Linda Lowell, *There Was a Surprise in the Dodd-Frank Act?*, HousingWire: Financial News for the Mortgage Market (2010), available at <http://www.housingwire.com/2010/07/26/there-was-a-surprise-in-the-dodd-frank-act>.

222. *Id.*

223. See *Ford Motor Credit Company No-Action Letter*, *supra* note 219.

224. See *What’s New in the Division of Corporation Finance*, U.S. Securities and Exchange Commission (2009) available at <http://www.sec.gov/divisions/corpfin/cfnew.shtml>.

225. See *Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933*, U.S. Securities and Exchange Commission (October 7, 2009; October 22, 2009) available at http://sec.gov/rules/concept/conceptarchive/concept_arch2009.shtml.

of a rating agency named in a registration statement that includes credit rating information.”²²⁶

This paper does not seek to advise policy makers on managing unforeseen reactions such as the retaliatory measures adopted by the NRSROs in response to the repeal of Rule 436(g). Instead, it seeks to help policy makers, educators, entrepreneurs and service providers take steps now to ensure that the new reforms are implemented in a constructive manner and in a way that will serve to strengthen small businesses and ultimately our economy. The reaction of NRSROs to the Dodd Frank Act obfuscates the fact that the main value in the corporate governance provisions may be found “in the principles on which it is based.”²²⁷

226. See Fernicola, Kanter, & Goldstein, *supra* note 220.

227. Cheryl L. Wade, *Sarbanes-Oxley Five Years Later: Will Criticism of SOX Undermine its Benefits?*, 39 LOYOLA U. CHI. L. J. 595, 596 (2008).