

BALANCING PUBLIC MARKET BENEFITS AND BURDENS FOR SMALLER COMPANIES POST SARBANES-OXLEY

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Accumulating evidence suggests that several recent regulations enacted by Congress and the SEC, including the Sarbanes-Oxley Act,¹ have disproportionately burdened smaller public companies in a negative manner, such that many of these companies are exiting the public markets. This Article describes these regulations, reviews their effects, and proposes several options that the SEC might choose to address the imbalance of costs and benefits for small businesses. The simplest option would provide for a waiver or postponement of certain regulations imposed under the Sarbanes-Oxley Act. More significant possible measures include the expansion of the SEC's small business regulatory regime under Regulation S-B,² and the creation of a securities market for small-business issuers.

INTRODUCTION

The Securities and Exchange Commission has generally recognized the need to tailor its regulations not only to satisfy investor expectations but also to reduce costs on securities issuers. Ideally, the costs of the SEC's regulatory regime are balanced by its benefits to investors and issuers. However, a series of recent regulations has created an imbalance between these costs and benefits, particularly for small businesses. A few scholars have argued that the Public Company Accounting Reform and Investor Protection Act of 2002³ (more commonly known as the "Sarbanes-Oxley Act") imposes a disproportionately heavy burden on small businesses.⁴ However, two other

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1. Public Company Accounting Reform and Investor Protection Act of 2002, 15 U.S.C. § 7201 (2002) (hereinafter Sarbanes-Oxley Act).

2. 17 C.F.R. §§ 228.10-.702 (2004) (pertaining specifically to small businesses).

3. 15 U.S.C. § 7201.

4. See, e.g., Ellen Engel et al., *The Sarbanes-Oxley Act and Firms' Going-Private Deci-*

fairly recent SEC regulations—the application of the Exchange Act to over-the-counter bulletin-board companies (OTCBB) in 1999⁵ and the adoption of Regulation Fair Disclosure (Regulation FD) in 2000⁶—have also significantly affected the costs of access to the capital markets for many small companies.⁷ As a result, some companies have abandoned the public markets by “going private,” while others have “gone dark” by opting for lower-tier, less regulated markets such as the “Pink Sheets”⁸ (a quotation service for small or troubled companies).

The OTCBB eligibility rule, Regulation FD, and Sarbanes-Oxley were designed to respond to abuses of investor confidence, whether by fraudsters’ exploitation of the lightly regulated “bulletin boards,” by preferential treatment of large investors and analysts, or by the fraudulent accounting and gatekeeper failures that characterized the Enron and WorldCom debacles. Because the OTCBB eligibility rule

sions, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=546626 (Oct. 29, 2004).

5. See Self-Regulatory Organizations, National Associations of Securities Dealers, Inc., Relating to Microcap Initiatives-Amendments to NASD Rules 6530 and 6540, Exchange Act Release No. 34-40878, 64 Fed. Reg. 1255 (Jan. 4, 1999) (order granting approval of proposed rule change).

6. Regulation F-D, 17 C.F.R. § 243.100 (2004); see also Selective Disclosure and Insider Trading, Exchange Act Release Nos. 33-7881, 34-43154, IC-24599, 17 CFR §§ 240, 243, 249 (Aug. 15, 2000).

7. For the SEC, a small business is a public company with less than \$25 million in revenues and \$25 million in market capitalization. The Small Business Administration (SBA) generally defines a small business as a company with less than 500 employees. Size definitions vary by industry and may be found at the SBA’s Office of Size Standards website, www.sba.gov/size (last visited Feb. 1, 2005). In this Article, I do not use a single-size threshold to describe smaller companies, although I will note that the SEC’s definition of a small company in terms of market capitalization is less than a tenth the size of what brokers would call the smallest of small-cap companies. See Investopedia.com, *Market Capitalization Defined*, at <http://www.investopedia.com/articles/basics/03/031703.asp> (last visited April 26, 2005).

8. See Pink Sheets LLC, *About the Pink Sheets: Revolutionizing the OTC Markets*, at <http://www.pinksheets.com/about/index.jsp> (last visited Mar. 13, 2005).

The origins of the Pink Sheets go back to 1904, when the National Quotation Bureau began as a paper-based, inter-dealer quotation service linking competing market makers in OTC securities across the country. Since that time, the Pink Sheets and the Yellow Sheets have been the central resource for trading information in OTC stocks and bonds Today Pink Sheets provides broker/dealers, issuers and investors with electronic and print products and information services designed to improve the transparency of the OTC markets Pink Sheets is a source of competitive market maker quotations, historical prices and corporate information about OTC issues and issuers.

Id.

imposed the burdens of Exchange Act disclosure on many smaller firms, the privatization of certain firms as a result of the imposition of the OTCBB eligibility rule was probably an expected (if not intended) consequence, since the SEC anticipated that firms with something to hide would prefer to go private rather than provide disclosure. Regulation FD and Sarbanes-Oxley, on the other hand, likely were not expected to have a disproportionate effect on any issuers.⁹

Accumulating evidence suggests that the regulations described herein have disproportionately impacted smaller companies. As a result, the SEC has recently created a panel to examine the effects of Sarbanes-Oxley on small businesses,¹⁰ and the SEC is considering how its regulations might be tailored for companies of different sizes. I attempt here to consider several options that the SEC might choose to address the imbalance of costs and benefits for small businesses. Some of what I propose may properly be called “tailoring,” while some options would require significant restructuring of the SEC’s regulations and may require congressional action.

The Article proceeds in three parts. Part I describes the costs and benefits of being a public company under the SEC’s regulatory regime. Part II describes the OTCBB eligibility rule, Regulation FD, and Sarbanes-Oxley and then discusses how they have added to the regulatory burden on small businesses, such that the costs of being a public company often outweigh the benefits. Part III offers several solutions that would provide a better balance between the costs and benefits of being a small public company. The simplest possibility would provide for a waiver or postponement of certain regulations imposed under Sarbanes-Oxley for small businesses.¹¹ A more sweeping (and likely more effective) measure would involve expanding the scope of the SEC’s existing relief, set out in Regulation S-B,¹² to a more significant number of businesses. Finally, the SEC and existing exchanges could consider creating a securities market for small business issuers, comprised of a number of competitive exchanges. The incentive for such a securities market is that it would create a more balanced regulatory structure, while still operating within the

9. The intent of the SEC is less relevant with respect to Sarbanes-Oxley since Congress dictated the content and scope of much of the SEC’s Sarbanes-Oxley rulemaking.

10. See SEC Press Release 2004-174, SEC Establishes Advisory Committee to Examine Impact of Sarbanes-Oxley on Smaller Public Companies (Dec. 12, 2004).

11. As described below, the SEC has already done this with respect to some of the more costly regulations. See *infra* Part III.

12. 17 C.F.R. §§ 228.10-702 (2004).

self-regulatory organization (SRO) framework through which the SEC oversees larger exchanges such as the NYSE and NASDAQ.