Small public companies scored a number of victories with the enactment of Dodd-Frank Financial Reform Act of 2010. The most notable victory is their exemption from the now infamous Section 404 requirement enacted by the Sarbanes-Oxley Act of 2002 that management’s assessment of the reporting company’s internal controls be annually attested to by the firm’s independent auditor. Although so-called non-accelerated filers had not been subject to this requirement, the stream of delays in imposing Section 404 appeared unlikely to be continued. Congress stepped in and provided the exemption from the requirement in Section 989(G) of Dodd-Frank.1 This exemption, therefore, removed nearly 6,000 reporting companies, representing about 6 percent of U.S. equity capital, from the internal control attestation requirement.2 Moreover, the legislation also called on the SEC to study whether firms with a market capitalization of $75-200 million should also be exempted.3

1 Amending 15 U.S.C. §7201 et. seq. containing Section 404(c) of Sarbanes-Oxley; the other provisions related to internal controls remain including the Section 404(a)’s requirement that the issuer’s annual report include a report of management on the issuer’s internal control over financial reporting and management’s assessment of the effectiveness of such internal controls. These changes were implemented by the SEC in Internal Control Over Financial Reporting In Exchange Act Periodic Reports Of Non-Accelerated Filers, Securities Act Rel. No. 9142 (Sept. 15, 2010).

2 Cf. GAO, Sarbanes-Oxley Act, Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies 6 (April 2006)(reporting on the findings and recommendations of the SEC’s Advisory Committee on Smaller Public Companies).

3 Dodd-Frank section 989(b).
I. Dodd-Frank’s Dispensations

Small issuers also received favorable mention in other areas as well. Section 951(e) of Dodd-Frank authorizes the SEC to provide exemptions when it believes regulation would disproportionately burden small issuers. Listing requirements may also relax or eliminate independence requirements for compensation committees. More broadly, Dodd-Frank authorizes exchanges and FINRA to exempt categories of issuers, and mandates that they shall take into consideration the impact of their regulations on small issuers. Section 971, in providing a means for shareholders to nominate directors, not only delays for three years that provisions’ application to small issuers, but also requires the SEC to consider whether its application to small issuers will have a disproportionate impact on small issuers.

As a generalization, non-accelerated filers and more broadly yet, small cap companies (most market professionals consider a market capitalization of less than $1 billion to be small), have more limited product lines, possess fewer financial resources, trade in thin markets (frequently on the non-regulated OTCBB market), are followed by few, if any analysts, and enjoy a limited following among institutional investors. It is not surprisingly that the shares for this group of firms are widely believed to be valued inefficiently. This is an inefficiency that breeds opportunity both for investors, but also insiders. More positively, returns for small cap

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4 Dodd-Frank section 952(a).
5 Id.
firms historically are higher, reflecting their need to yield greater financial rewards to investors to compensate for their greater risk.⁶

It is hard to say that Section 404 was without material social benefits.⁷ For example, studies of accounting restatements consistently track significant increases in the number of accounting restatements following partial implementation of Section 404. The restatements peaked in 2006 with 1,564 [888] reporting issuers recording material restatements and have declined each year since that time to reach 630 [374] restatements in 2009.⁸ The numbers in brackets report the number of non-accelerated filers reporting restatements. The data reflects the well-documented phenomenon that the number of restatements are inversely related to market capitalization.⁹ Moreover, nearly 70% of firms reporting material weaknesses in their internal controls that have not been remediated were firms with market capitalizations less than $75 million.¹⁰ Moreover, in the years 2004-2007, the vast percentage of firms receiving a qualified audit opinion on their internal controls were firms with a market capitalization below $75 million and this group also experiences the highest percentage of auditor changes among all reporting companies.¹¹ Since there seems little basis to contest the notion that greater accuracy in financial reporting leads to improved pricing of the company’s securities, reduction in the number of

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⁶ See e.g., Fidelity Supplement to Small Cap Stock Fund, Fidelity Mid-Ca; Stock Fund and Fidelity Large Cap Stock Fund, June 29, 2005 (reviewing risks and returns of three major categories of indexed funds).
⁷ The SEC’s Chief Accountant during the early implementation period of the internal controls requirement observed, “I believe that, of all the recent reforms, the internal controls requirements have the greatest potential to improve the reliability of financial reporting. Our capital markets run on faith and trust that the vast majority of companies present reliable and complete financial data for investment and policy decision-making.” Donald T. Nicolaisen, Keynote Speech, 11th Annual Midwestern Financial Reporting Symposium (Oct. 7, 2004).
⁹ See e.g., Glass Lewis & Co., The Tide is Turning, 3 Charts 3 & 9 (Jan. 15, 2008).
¹⁰ Glass Lewis & Co., The Tide is Turning, 8 Tbl. 2 (Jan. 15, 2008).
¹¹ See Glass Lewis & Co., The Tide is Turning, Tbl. 4 at 9 and Tbl. 13 at 11.
Restatements should be viewed positively. Moreover, there is evidence that SOX introduced reporting requirements also reduced “financial slack” among complying firms where post-SOX implementation studies report that mandatory filers cut total CEO compensation (most through reductions in stock-based compensation), increased payouts to shareholders, and reduced investment and employment) relative to what occurred with comparable non-404 filers.\textsuperscript{12} Also, mandatory filers’ post compliance with Section 404 experienced longer maturities for their debt than was the experience for non-filers.

II. Some Data Points on the Profile of Non-Accelerated Issuers

While the earlier report that significant numbers of restatements occur with non-accelerated filers may suggest that restatements will be detected even though there is no mandated compliance with Section 404, there has long been a good deal of concern that absent formal independent assessment of a firm’s internal controls that weak financial reporting systems will exist and substantial numbers of reporting problems are going undetected.\textsuperscript{13} To be sure, not all reports of material weakness in internal controls elicit strong market adjustments; markets more likely adjust, and negatively, for matters that are less auditable, when the accompanying disclosures are vague, and when the reporting company is not audited by as Big 4 auditor.\textsuperscript{14} But


\textsuperscript{13} Glass Lewis & Co., The Tide is Turning (Jan. 15, 2008)(“If microcap companies disclosed this many material weaknesses on their own – without having to comply with SOX 404 – how many more material weaknesses would be discovered if independent auditing firms were required to conduct internal-control audits at these companies?”); Melissa Klein Aguilar, 404 Disclosure Show Dramatic Improvement 2 (Nov. 27, 2007)(quoting Mr. Robert Benoit, partner at Lord & Benoit an auditing firm which focuses on small issuers, “Almost none of the smaller public companies have done any SOX work.”). Available at http://www.complianceweek.com/index.cfm?printable=1&fuseaction=article.viewArticle&article_ID=3804.

the benefits of improving the quality and trustworthiness of financial reporting came at a significant cost. These costs were greater in the early years of Section 404, reflecting not just the “deferred maintenance” that had to be addressed with the SOX-imposed requirements, but also the poor implementation of Section 404 by the regulators and the auditors. There was plenty of problems in the early years of implementing Section 404 for accelerated filers. Indeed, it is likely that the now permanent exemption for small issuers, as well as the broader recognition that financial reporting regulation disproportionately impacts small issuers, would not have occurred had there been a less troubled experience in the early years of Section 404. In any case, concern for regulation and particularly that reporting requirements have a disproportionate impact on smaller companies is well document. For example, median audit fees in 2003 and 2004 that implemented internal control reports were 1.14% of reported revenues for non-accelerated filers but 0.13% for firms with a market capitalization greater than $1 billion. Interestingly, for non-accelerated filers not providing a report on internal controls had audit fees that were 0.35 less than their reporting cohort whereas this difference was 0.06 for filers with a market capitalization

See e.g., Charles River Associates, Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates From A Sample of Fortune 1000 Companies (April 2005)(reporting firms average cost to comply with the internal control requirement was $5.9 million). Of interest here is the now much discredited SEC estimate of compliance cost averaging $91,000 per issuer. SEC, Final Rule: Management’s Report on Internal Controls Over Financial Reporting And Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Rel. No. 8238 (Aug. 14, 2003). Internal controls attestation contribute substantially to the audit fees during the first year’s of compliance, but on a declining basis. See R. Mithu Dey & Mary W. Sullivan, What Will Non-Accelerated Filers Have to Pay for the Section 404 Internal Control Audit, Working Paper April 16, 2009 (median cost of internal control assessment for previously non-accelerated filers represented 42% of total audit fees in 2006 and declined modestly to 37% in 2007 with the introduction of Auditing Standard No. 5).

GAO, Sarbanes-Oxley Act, Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies 16, Fig. 1 (GAO-06-361, April 2006). The study reflects ever diminishing median costs as a percentage of revenues as company size increases. See also id. Tbl. 4 (reflecting the same relationship between size of revenues and direct IPO expenses). See also Finance Executives International Annual Survey and The 404 Cost Study (Sept. 2009)(U.S. companies with revenues exceeding $5 billion spent 0.06% of revenue on Sarbanes-Oxley compliance while companies with less than $100 million in revenue spent 2.55% (in 2004 these cost represented about 40% of total audit fees and had declined to approximately 32.5% in 2007).
greater than $1 billion. Thus, it was no surprise that while cost of being a reporting company
was identified prior to Sarbanes-Oxley by 12 percent of the companies as a reason for
deregistering that percentage jumped to 62 percent in 2005.17 Interestingly, less than 20 percent
of the companies deregistering were listed on either the NYSE or NASDAQ; the largest
percentage traded on the OTCBB (36.9%) or had no formal market (24.8%).18

Of special concern for reporting in small companies is that among public companies with
a market capitalization of $125 million or less, the SEC Office of Economic Analysis reports that
insiders own an average of 30 percent of the company’s shares. To the extent one of the goals of
financial reporting is to diminish opportunities for opportunistic behavior by managers versus
outside owners, the smaller firm may well be seen as posing greater risks because of the
significant interest held by managers. There has long been concern in small companies that their
large block holders can reap rewards at the expense of outside owners through a variety of
strategies. One such strategy is going private. Many have reported that the number of going
private transactions increased following the passage of Sarbanes-Oxley. Share prices of firms
announcing in their Section 13(e) filing that they would be going private increased. This
prompted some to reason that the observed increase reflected, at least in part, the cost of being a
public firm.19 Another interpretation is part of the price change is the cost so-called unresolved

17 Id. at 22. There is, however, a good deal of evidence that SOX was a rationalization for other reasons for
companies going dark.
18 Id. at 25, Fig. 3.
19 See Ellen Engel, Rachel M. Hayes & Xue Wang, The Sarbanes-Oxley Act and Firms’ Going Private Decisions,
27 J. Law and Econ. (2006). There are other explanations, namely the increase in the number of private equity
firms and the availability of low interest loans for such transactions. Moreover, the pattern observed in the U.S.
began before Sarbanes-Oxley was passed and paralleled the trend in Europe. See Christian Leuz, Was the Sarbanes-
Oxley Act of 2002 Really This Costly? A Discussion of Evidence from Event Returns and Going-Private Decisions, __
J. Accounting Research __ (2007). Professor Leuz makes the point that we need to distinguish going dark from
going private transactions such that the former are really more a response to heightened reporting costs, does
appear to be related to the passage of Sarbanes-Oxley, and this group of firms were smaller, more distressed, and
agency problems between the minority and controlling insiders. The going private transaction in effect reverses the valuation discounts that were caused by unresolved agency problems.\(^{20}\) There is a small but growing body of evidence that heightened reporting post Sarbanes-Oxley have improved the quality of disclosure and reduced the negative effects of unresolved agency costs. Examples of this work include studies reflecting declines in earnings management\(^{21}\) and reductions in the firms’ costs of capital.\(^{22}\)

Because of the substantial insider ownership that frequently exists among non-accelerated filers, there is greater challenges confronting activist investors seeking to alter prior practices that are believed to adversely impact shareholder value. This occurs not solely because the insider’s holdings pose a serious obstacle to wrestling control but also because the smallness of the firm combined with the insiders’ holdings likely tend to attract to the board friends and associates of the insiders rather than more independent representatives of the shareholders at large.\(^{23}\)

There is also evidence that firms not only exited Sarbanes-Oxley by going dark, but that many public firms have pursued strategies to remain non-accelerated filers. That is, firms below the $75 million market capitalization level have remained small by undertaking less investment, increasing their cash payouts to shareholders, reducing the number of shares held by non-affiliates, make more bad news announcements, and report lower earnings than a matched

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had weaker performance and governance than firms going private. \textit{Id.} Indeed, the increase in deregistrations post Sarbanes-Oxley was primarily driven by going dark rather than going private transactions.\(^{20}\) See Christian Leuz, Alexander Triantis & Tracy Wang, Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations, \textit{J. Accounting and Economics} (2007).


\(^{23}\) See \textit{e.g.}, Stephen Dsavis & Jon Lukomnik, How to Improve Governance at Small Companies, \textit{Compliance Week} (Aug. 10, 2010), available at \url{http://complianceweek.com/article/6104/how-to-improve-governance-at-small-companies} (discussing efforts of two shareholders to introduce change to a company whose yearly compensation was twice the cumulative profits of each of the preceding two years).
sample (control group) of firms.\textsuperscript{24} It also appears that firms more likely to pursue strategies to be a non-accelerated filer were more complex with more international operations so that they likely would incur greater internal control auditing costs than firms that crossed to become a mandatory filer. Interestingly, firms that “crossed” from being a non-accelerated filer to an mandatory filer and firms that remained a non-accelerated filer each increased their percentage of independent directors after the passage of Sarbanes-Oxley and also decreased the size of their boards.

A further reflection of the risk posed by small companies is the migration of non-accelerated filers away from Big 4 accounting firms to other auditors. This migration picked up pace after SOX and is in part identified as being a reflection of the Big 4 firms’ decision to manage their risks by ridding themselves of smaller companies that were believed to pose serious audit risks.\textsuperscript{25} This is not to suggest that second- or third-tier auditing firms are less professional, skillful or diligent than their Big 4 counterparts; the migration supports the view that firms discarded by the Big 4 are believed ex ante to pose risks that do not justify from the accounting firm’s perspective sufficient rewards to justify continuing the relationship.

III. Gap Fillings Through Governance

As seen, non-accelerated filers operate in an environment that is quite different from that of mandatory filers. Because of their small market capitalizations, they do not attract institutional owners and similarly are not closely followed by analysts. Thus, they do not operate in an environment that is as information rich as that of the larger mandatory filers. They trade largely in the more unregulated market of the OTCBB and overall there is reason to believe their

\textsuperscript{24} See Unintended Consequences of Granting Small Firms Exemptions from Securities Regulation: Evidence from the Sarbanes-Oxley Act, 47 J. Accounting Research __ (May 2009).

\textsuperscript{25} GAO, Sarbanes-Oxley Act, Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies 7 (GAO-06-361 April 2006).
securities are not priced efficiently. To be sure, such OTCBB traded companies are reporting companies, but those reports do not have the reassurance of the CPA’s attestation of internal controls. Moreover, for three years the non accelerated filers are immune from the proxy access proposals which make them less attractive to the disciplining forces of activist stockholders. We might wonder whether the proxy access provision will, like Section 404, meet a series of delays beyond the three-year introductory period. We have yet to see what other dispensations will be accorded small issuers.

The lacunae in external forces to strengthen the trustworthiness of financial reporting for non-accelerated filers invites us to consider what internal steps a company might pursue to address these gaps? As the pre-Dodd-Frank history reflects, many non-accelerated filers voluntarily subjected themselves to Section 404 and we also are aware that many companies have voluntarily embraced “say on pay” procedures and even adopted procedures for shareholders to nominate directors. The following reviews other steps that should be considered by non-accelerated filers to address concerns that the regulatory dispensations came at a price of posing greater risks for their investors.

The first line of defense in assuring the reliability of financial reports is the annual audit. After Sarbanes-Oxley the audit committee is the linchpin that joins the outside auditor to the financial reports released to investors. Each audit committee of an accelerated filer should measure its value by assuring itself annually that the firm obtains a first-rate audit. Efforts should be focused first on the risks posed by the firm and not on whether this year’s audit costs more or less than last years. Unfortunately, during the economic maelstrom of the last few years, stories abound that firms are “squeezing” their auditors to reduce their charges. This is not money well saved. In seeking a high quality audit, the audit committee must bear in mind that the sine qua
non for the auditor to attest to any item in the financial reports is assuring herself there are adequate internal controls. That is, internal controls have been a core requirement of auditing for as long the task of auditing as existed. To be sure, extra steps were introduced into the assessment of internal controls by Section 404’s mandate that auditors formerly attest to management’s assessment of the adequacy of internal controls. Nonetheless, significant steps in evaluating internal controls are a core feature of auditing long before the introduction of a formal attest function.

Thus, just as the audit committee is required to discuss with the auditor the critical estimates, assumptions, choices and judgments that underlie management’s financial statements, the audit committee needs to similarly engage the auditors on their assessment of the firm’s control environment. More particularly, the auditors should identify the risks that surround the reporting environment and provide assurance to the audit committee how the audit was able to move forward in light of these risks. Good corporate governance requires nothing less than the members of the audit committee satisfying themselves that the base on which audit procedures are carried out, namely the presence of adequate internal controls, does in fact exist.

A second step in this process is for the audit committee to render a report on the steps it has taken to assure that the audit secured was a good audit. Thus, the annual report by the audit committee should be included in the annual report. This report would include a general affirmation that the audit committee has fulfilled its duties and had an active dialogue with the auditors on the critical accounting estimates, assumptions, choices and judgments, and addition to that probed the auditor on the steps to assure there was an adequate control environment.
A necessary third step for non-accelerated filers is to inventory their corporate governance practices. There are ample review sheets for the board and board committees to annually assess themselves against. The most critical aspect of this self-assessment will be judgment whether the board is sufficiently independent of management. This is a much greater challenge for small companies. Minimally, this requires a strong subgroup of the board with a clear mandate to assure board independence. There may well be a place here for “term limits” on board members. But the over arching point is that with fewer external forces to police and even discipline managers, the effort must come from within the firm.

A fourth step is for the management and board to maintain good communications with shareholders. Increased transparency, particularly with respect to the directors’ efforts to monitor the firms’ financial performance and position naturally invites input from significant holders. The board should pursue steps to receive the input from such holders regarding their concerns regarding the board’s oversight and generally the direction of the company. Minimally such input should be an important consideration in the directors’ self assessment and decisions related to the future composition of the board of directors.

Fifth, the financial compensation of senior executives must be right-sized and hewn to sustainable profits. History continues to document the wisdom that individuals manage what gets measured. And there is no measurement that captures the attention like the metrics for executive compensation. A very deliberate, thoughtful, and transparent incentive plan is worth a thousand votes on say on pay. This proposal complements the preceding step; there is likely no better barometer for whether the board has announcement the right incentives than how it is received among those who have maintained a substantial stake in the company. Thus, executive
pay, and more particularly, incentives for management should be the point for conversation with substantial shareholders on a regular, not episodic, basis.