The Jumpstart Our Business Startups Act Takes the Bite Out of Sarbanes–Oxley: Adding Corporate Governance to the Discussion

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ABSTRACT: The Jumpstart Our Business Startups Act ("JOBS Act"), which became law in April 2012, made significant deregulations to the United States' securities law. One such deregulation essentially eliminated the outsider audit mandated by the Sarbanes–Oxley Act of 2002 ("SOX"). There are strong justifications for and arguments against the JOBS Act. However, one significant interest is missing from both sides of the discussion—corporate governance. Corporate governance is important because it furthers Congress's goals of job creation and economic growth. Because the outsider-audit requirement improves corporate governance practices, this Note proposes a different approach to the controversial outsider-audit requirement. Instead of exempting most companies from SOX section 404(b)'s outsider-audit provision, Congress should retain section 404(b), provide a limited exception for businesses that are both small and young (i.e., businesses with a market capitalization of less than $75 million and are less than ten years old), and encourage businesses to voluntarily strengthen their corporate governance frameworks. Retaining section 404(b) and implementing a limited exception for small, young businesses will allow the United States to reap the benefits of job creation and economic growth that strong corporate governance furthers and the JOBS Act seeks to obtain.

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I. INTRODUCTION

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act ("JOBS Act"), which is one of the most important pieces of securities-regulation legislation in the past decade.[1] The JOBS Act purports to promote job creation through significant deregulation of provisions governing public offerings in the United States' capital market.[2] One such deregulation essentially removes the most controversial provision of the corporate-governance-focused Sarbanes–Oxley Act of 2002 ("SOX"). SOX section 404(b) ("section 404(b)") requires an outside auditor to "attest to, and report on, the assessment made by the management of the issuer."[3] Ten years after SOX's enactment, Congress enacted section 103 of the JOBS Act ("section 103"), which removed SOX section 404(b)'s outsider-audit requirement for essentially *all* companies. Specifically, through the JOBS Act, Congress removed SOX section 404(b)'s requirement for 98% of all companies that have gone public since 1970.[4]

When making securities regulation changes of this magnitude, there are several recognized and important interests that Congress should consider. These interests include: (1) consumer protections; (2) informational needs of investors; (3) overcoming inadequate incentives for companies to disclose; (4) allocative efficiency (in other words, accuracy of prices); (5) corporate governance; (6) economic growth; and (7) maintaining a competitive market.[5] Many of these interests surfaced in the debate surrounding section 103 of the JOBS Act—but not all. There was little consideration of how section 103 would affect corporate governance,[6] which will shed new light on the JOBS Act debate.

This Note adds corporate governance to the mix. Before analyzing how section 103 affects corporate governance, Part II of this Note provides an overview of SOX and the JOBS Act to give this issue context. Part III analyzes

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1. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.).

2. *See infra* Part II.B (discussing the JOBS Act's motivations, purpose, and provisions).

3. Sarbanes–Oxley Act of 2002 § 404(b), 15 U.S.C. § 7262(b) (2012). Under section 404(a), each annual report filed with the Securities and Exchange Commission ("SEC") must contain a report on the company's internal controls. *Id.* § 7262(a). Section 404(b) provides a check on the company's report, as a "registered public accounting firm" must evaluate the report and vouch for its accuracy. *Id.* § 7262(b).

4. Robb Mandelbaum, *In Latest Jobs Bill, a Billion-Dollar Business Is Now Small*, N.Y. TIMES (Mar. 13, 2012, 7:00 AM), http://boss.blogs.nytimes.com/2012/03/13/in-latest-jobs-bill-a-billion-dollar-business-is-now-small/.

5. JOHN C. COFFEE, JR. ET AL., SECURITIES REGULATION 1–8 (Robert C. Clark et al. eds., 10th ed. 2007).

6. Corporate governance is the "[p]rocedures and processes according to which an organisation is directed and controlled." *Glossary of Statistical Terms: Corporate Governance*, OECD (July 13, 2005), http://stats.oecd.org/glossary/detail.asp?ID=6778; *see infra* Part IV (discussing why corporate governance is important and the benefits it provides).

the debate surrounding section 103 of the JOBS Act. Part IV analyzes the missing consideration of corporate governance, including what corporate governance is, why it is important, and how section 103 of the JOBS Act affects it. Part V of this Note argues that section 103 does not achieve the right balance after considering corporate governance—between highly regulated, expensive outsider audits to protect consumers and address informational needs of investors, and no outsider-audit requirement to help stimulate the economy—and then proposes a different approach. Rather than exempting most companies from SOX section 404(b)'s outsider-audit provision, Congress should retain section 404(b)'s outsider-audit requirement, provide a limited exception for businesses that are both small and young (i.e., businesses with a market capitalization of less than $75 million and are less than ten years old), and encourage businesses to voluntarily strengthen their corporate governance frameworks.

II. General Overview of the Sarbanes–Oxley Act of 2002 and the Jumpstart Our Business Startups Act

Before analyzing section 103 of the JOBS Act, this Part briefly introduces SOX and the JOBS Act in a slightly broader context beyond sections 404(b) and 103, respectively, in order to understand the overarching motivations driving each piece of legislation. Congress passed SOX in 2002, following the notable corporate scandals of companies like Enron and WorldCom.[7] These scandals caused drastic drops in market stock prices and investor confidence.[8] Therefore, the general motivations behind SOX were investor protection and corporate governance.[9] In 2012, following the recession caused by the global financial crisis, Congress passed the JOBS Act.[10] Thus, Congress's general motivation behind the JOBS Act was to spur economic activity.[11] By understanding the different motivations

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7. Robert Prentice, *Sarbanes–Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703, 705 (2007).

8. *Id.* at 712.

9. *See* Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 745 (stating the purpose behind SOX).

10. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.) (providing the date passed). The global financial crisis originated in the United States in 2006 when the housing bubble burst, causing the securities tied to the housing market (e.g., mortgage-backed securities) to plummet. Barry Bosworth & Aaron Flaaen, The Brookings Inst., America's Financial Crisis: The End of an Era 2 (Apr. 21, 2009) (unpublished manuscript), *available at* http://www.brookings.edu/~/media/research/files/papers/2009/4/14%20financial%20crisis%20bosworth/0414_financial_crisis_bosworth.pdf. This, in turn, caused damage to financial institutions as a whole. *Id.* Due to the United States' global financial influence, the harm to the domestic financial market spread to global financial markets, and caused a deep recession in many countries. *Id.* at 1.

11. Jumpstart Our Business Startups Act, 126 Stat. at 306 (stating the purpose behind the Act).

behind each piece of legislation, this Note can better analyze whether the JOBS Act's reversal of SOX's corporate governance protections achieves a better balance of securities-regulation interests.[12]

A. *REVISITING THE SARBANES–OXLEY ACT OF 2002*

The outburst of corporate scandals in the early 2000s—highlighted by Enron and WorldCom[13]—prompted a need for stricter corporate internal financial controls.[14] Corporate scandals drastically affected investor confidence and caused the stock market to plummet—the Dow Jones Industrial Average dropped 25%, while the Standard & Poor's 500 and NASDAQ dropped 40% and 70%, respectively.[15] In response, Congress passed SOX "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws."[16] This Subpart briefly describes SOX's main provisions that regulate internal financial controls and the relevant recent legislative changes to section 404(b).

SOX has three main provisions regulating internal financial controls.[17] First, section 302(a)(2) requires a company's chief financial officer ("CFO") to certify that reports filed or submitted to the Securities and Exchange Commission ("SEC") do "not contain any untrue statement of a material fact or omit to state a material fact."[18] Second, section 906(a) imposes criminal penalties on a CFO who certifies a report "knowing that the periodic report accompanying the statement does not comport with all the requirements set forth."[19] The third and most controversial provision is section 404.[20] Section 404(a) requires a company's internal control report to "contain an assessment . . . of the effectiveness of the internal control structure and procedures."[21] Section 404(b) requires an outside auditor to "attest to, and report on, the assessment made by the management of the issuer."[22]

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12. *See infra* Part V (proposing a better balance of these interests).

13. *See generally* LYNNE W. JETER, DISCONNECTED: DECEIT AND BETRAYAL AT WORLDCOM (2003) (describing the corporate scandal at WorldCom); BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (2003) (describing the corporate scandal at Enron).

14. Prentice, *supra* note 7, at 705–06.

15. *Id.* at 712.

16. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 745.

17. *See* Prentice, *supra* note 7, at 705–06 (describing SOX's regulations for internal financial controls).

18. Sarbanes–Oxley Act of 2002 § 302(a)(2), 15 U.S.C. § 7241(a)(2) (2012).

19. Sarbanes–Oxley Act of 2002 § 906(a), 18 U.S.C. § 1350(c)(1) (2012).

20. *See Sarbanes–Oxley: A Price Worth Paying?*, ECONOMIST (May 19, 2005), http://www.economist.com/node/3984019 (calling section 404 "[t]he law's most complained-of provision").

21. Sarbanes–Oxley Act of 2002 § 404(a)(2), 15 U.S.C. § 7262(a)(2).

22. Sarbanes–Oxley Act of 2002 § 404(b), 15 U.S.C. § 7262(b).

Due to strong opposition arguing that the costs of section 404(b) compliance were too high, Congress has scaled back regulations for internal financial controls since section 404(b)'s inception.[23] After providing numerous extensions to section 404(b)'s compliance date for both accelerated filers, generally a firm with a public float[24] of more than $75 million, and non-accelerated filers, generally a firm with a public float of less than $75 million,[25] Congress passed a permanent exemption for non-accelerated filers under the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd–Frank Act").[26] In addition, with the passage of the JOBS Act in April 2012, Congress made another significant change to the SOX legislation.[27]

B. Introducing Title I of the Jumpstart Our Business Startups Act

Congress's stated purpose of the JOBS Act is "[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."[28] The JOBS Act has seven titles that largely deregulate securities-regulation legislation in hopes of achieving this stated purpose.[29] This Note primarily deals with Title I, which is the main source of the JOBS Act's deregulations.[30]

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23. *See* SEC. & EXCH. COMM'N, STUDY AND RECOMMENDATIONS ON SECTION 404(B) OF THE SARBANES–OXLEY ACT OF 2002 FOR ISSUERS WITH PUBLIC FLOAT BETWEEN $75 AND $250 MILLION, 14–25 (2011), *available at* http://www.sec.gov/news/studies/2011/404bfloat-study.pdf.

24. A "public float" is "[t]he portion of a company's outstanding shares that is in the hands of public investors, as opposed to company officers, directors, or stockholders that hold controlling interests." *Public Float*, PRAC. L. CO., http://us.practicallaw.com/6-382-3723 (last visited Nov. 17, 2013).

25. *See* SEC. & EXCH. COMM'N, *supra* note 23, at 12–13.

26. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 989G, 124 Stat. 1376, 1948 (2010) (codified as amended at 15 U.S.C. § 7262). For arguments in favor of this "small business" exemption to section 404(b), see generally Joseph A. Grundfest & Steven E. Bochner, *Fixing 404*, 105 MICH. L. REV. 1643 (2007); Ginger Carroll, Note, *Thinking Small: Adjusting Regulatory Burdens Incurred by Small Public Companies Seeking to Comply with the Sarbanes–Oxley Act*, 58 ALA. L. REV. 443 (2006); 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). *But see* John L. Orcutt, *The Case Against Exempting Smaller Reporting Companies from Sarbanes–Oxley Section 404: Why Market-Based Solutions Are Likely to Harm Ordinary Investors*, 14 FORDHAM J. CORP. & FIN. L. 325 (2009) (arguing against a "small business" exemption to section 404(b)).

27. *See infra* note 59 and accompanying text (describing section 103 of the JOBS Act).

28. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.)

29. This Note acknowledges that deregulation can stimulate business and job creation through decreased administrative and compliance costs. *See generally* OECD, REGULATORY REFORM FOR RECOVERY: LESSONS FROM IMPLEMENTATION DURING CRISES 3 (2010), *available at* http://www.oecd.org/gov/regulatory-policy/44955878.pdf. However, the deregulation must be weighed against any increase in fraud and corruption, among other risks, to determine whether the deregulation's benefits outweigh its costs. This Note analyzes the costs and benefits of the JOBS Act section 103 to determine whether the deregulation of the outsider-audit

In Title I of the JOBS Act, Congress creates a new category of issuers[31] called "emerging growth companies" ("EGC").[32] An EGC is an issuer with less than $1 billion in annual gross revenue.[33] A company remains an EGC until whichever of the following happens first: (1) the last day of the fiscal year in which the company made less than $1 billion in annual gross revenues where a company's annual revenue exceeds $1 billion; (2) the last day of the fiscal year that marked "the fifth anniversary of the date of the first sale of common equity securities"; (3) the date that marked a three-year period when the company issues more than $1 billion in non-convertible debt; or (4) when the company becomes a large accelerated filer.[34]

Companies that maintain EGC status can take advantage of a more deregulated initial public offering ("IPO") process. First, the JOBS Act reduces disclosure requirements for EGCs. Before the JOBS Act, the Dodd–

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provision truly would stimulate economic growth and improve the U.S. capital market. *See infra* Part III.

30. The remaining titles, which are beyond the scope of this Note, provide similar deregulating provisions to the Securities and Exchange Acts in hopes of increasing economic growth. Some of the key titles include Title II, III, IV, and V. Title II allows for general solicitation and general advertising for initial public offerings under Rule 506 of Regulation D and Rule 144A of the Securities Act of 1933 ("Securities Act"). Jumpstart Our Business Startups Act § 201 (codified as amended at 15 U.S.C. § 77d) (providing that the provision allowing general solicitation or general advertising is subject to "all purchasers of the securities [being] accredited investors"). Title III amends the Securities Act to create a crowdfunding provision. *See id.* §§ 301–305 (codified as amended in sections of 15 U.S.C.) (calling Title III the "CROWDFUND Act," which provides an entirely new provision allowing private companies to raise up to $1 million over a twelve-month period from small investors in exchange for equity in the company). Title IV creates a new exemption from the registration requirements under the Securities Act for companies that sell less than $50 million in securities over a twelve-month period. *Id.* § 401(b)(2) (codified as amended at 15 U.S.C. § 77c). Title V increases the number of shareholders a company needs before the SEC requires registration under Section 12(g) of the Exchange Act from 500 persons to 2000 persons or 500 persons who are not accredited investors. *Id.* § 501 (codified as amended at 15 U.S.C. § 78*l*); *see also* GIBSON DUNN, JUMPSTART OUR BUSINESS STARTUPS (JOBS) ACT CHANGES THE PUBLIC AND PRIVATE CAPITAL MARKETS LANDSCAPE 11 (2012), *available at* http://www.svb.com/Publications/Best_Practices/Public_Policy/Jobs-Acts/ (describing how the provisions changed previous legislation).

31. With some exceptions not relevant to this Note, an issuer is defined as "any person who issues or proposes to issue any security." 15 U.S.C. § 78c(a)(8).

32. Jumpstart Our Business Startups Act § 101 (codified as amended in sections of 15 U.S.C.). A company that started its initial public offering on or before December 8, 2011 is not eligible for EGC status. *Id.*

33. *Id.*

34. *Id.* A large accelerated filer is an issuer: (1) with an "aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $700 million or more"; (2) subject to requirements under section 13(a) or 15(d) (found in 15 U.S.C. § 78m or 15 U.S.C. § 78o(d), respectively); (3) filed at least one annual report under section 13(a) or 15(d); and (4) not eligible to use the requirements for smaller reporting companies. 17 C.F.R. § 240.12b-2 (2013). For more information on EGCs, see *Jumpstart Our Business Startups Act Frequently Asked Questions: Generally Applicable Questions on Title I of the JOBS Act*, SEC. & EXCH. COMM'N (Apr. 16, 2012, May 3, 2012 & Sept. 28, 2012), http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.

Frank Act[35] amended the Securities Exchange Act of 1934 ("Exchange Act")[36] to require companies to comply with "say-on-pay,"[37] "say-on-pay-frequency,"[38] and "say-on-golden-parachute"[39] requirements. However, the JOBS Act amended the Securities Act of 1933 ("Securities Act")[40] and the Exchange Act[41] to provide an exemption for EGCs from complying with each of these requirements.[42]

Second, the JOBS Act promotes information sharing and communication between EGCs and prospective investors through two significant deregulations. The JOBS Act promotes research by allowing a broker or dealer to publish and distribute a "research report" about an EGC.[43] A "research report" includes "a written, electronic, or oral communication that includes information, opinions, or recommendations" about the EGC or its securities.[44] The SEC will not regulate these reports even if the broker or dealer participates in the offering of the EGC's securities.[45] The JOBS Act's deregulation of research sharing marks a change from previous rules that strictly regulated how companies distributed research about their offerings.[46] Similarly, the JOBS Act makes another significant change by allowing communication between EGCs and certain types of potential investors—qualified institutional buyers ("QIB") or

35. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in sections of 2, 5, 7, 11–12, 15–16, 18–20, 22, 25–26, 28–31, 41–42, 44, 49, 112 U.S.C.).

36. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78pp (2012).

37. The "say-on-pay" provision under the Dodd–Frank Act requires a public company to give its shareholders an advisory vote on executive compensation. *SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd–Frank Act*, SEC. & EXCH. COMM'N (Jan. 25, 2011), http://www.sec.gov/news/press/2011/2011-25.htm.

38. The "say-on-pay-frequency" provision under the Dodd–Frank Act requires a public company to give its shareholders "an advisory vote on the desired frequency of say-on-pay votes." *Id.*

39. The "say-on-golden-parachute" provision under the Dodd–Frank Act requires a public company to give its shareholders "an advisory vote on compensation arrangements and understandings in connection with merger transactions." *Id.*

40. Securities Act of 1933, 15 U.S.C. §§ 77a–77bbbb.

41. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78pp.

42. Jumpstart Our Business Startups Act § 102, Pub. L. No. 112-106, 126 Stat. 306, 308–10 (2012) (codified as amended in sections of 15 U.S.C.). For a discussion of the JOBS Act disclosure obligations and a proposal to change the legislation, see Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 IND. L.J. 151 (2013).

43. Jumpstart Our Business Startups Act § 105 (codified as amended at 15 U.S.C. § 77b).

44. *Id.* § 105(a) (codified as amended at 15 U.S.C. § 77b).

45. *Id.*

46. GIBSON DUNN, *supra* note 30, at 6. Before the JOBS Act, a broker or dealer could not distribute or publish research on a security where it was participating in the offering. *See id.* (describing this change as a "dramatic departure from what has previously been permitted").

institutional accredited investors.[47] This important change could provide EGCs with valuable insight, as an EGC can "test the waters" for market interest prior to its public offerings.[48]

Third, the JOBS Act allows an EGC to submit confidential draft registration statements to the SEC prior to its initial public offering date.[49] This is an important change because an EGC can now submit "sensitive or confidential" information without fearing disclosure to the public "until it has greater confidence in the likely success of the offering."[50]

Finally, the JOBS Act reduces financial reporting and auditing requirements for EGCs. Before the JOBS Act, the Securities Act and the Exchange Act required companies to file three years of audited financial statements, as well as five years of specified financial data, with the SEC.[51] Further, before the JOBS Act, SOX required companies to have an outside auditor assess and report on the companies' internal control structure.[52] Now, the JOBS Act simply requires an EGC to submit two years of audited financial data and exempts an EGC from the requirement to provide specified financial data until its earliest audited period.[53] Moreover, the JOBS Act exempts EGCs from complying with new rules adopted by the Public Company Accounting Oversight Board "unless the Commission determines that the application of such additional requirements is necessary or appropriate in the public interest."[54] The JOBS Act also exempts EGCs from complying with the outsider audit that SOX requires, which is the focus of this Note.[55]

Within the ten-year span between the enactment of SOX in 2002 and the enactment of the JOBS Act in 2012, Congress passed section 404(b) that required all companies to comply with the outsider-audit requirement, created numerous exemptions to the provision, and then scaled back section 404(b) to encompass only a small percentage of public companies.[56] After the JOBS Act became law, companies with up to $1 billion in annual

47. Jumpstart Our Business Startups Act § 105 (codified as amended at 15 U.S.C. § 77e). For the definitions of QIBs and institutional accredited investors, see 17 C.F.R. § 230.144A(a)(1) (2013); *id.* § 230.501(a).

48. Jumpstart Our Business Startups Act § 105 (codified as amended at 15 U.S.C. § 77e); GIBSON DUNN, *supra* note 30, at 6.

49. Jumpstart Our Business Startups Act § 106 (codified as amended at 15 U.S.C. § 77f).

50. GIBSON DUNN, *supra* note 30, at 8.

51. *See id.* at 2–3 (describing the provisions of the JOBS Act, including how the provisions changed other legislation).

52. Sarbanes–Oxley Act of 2002 § 404(b), 15 U.S.C. § 7262(b); *supra* note 3 and accompanying text.

53. Jumpstart Our Business Startups Act § 102(b) (codified as amended at 15 U.S.C. § 77g).

54. *Id.* § 104 (codified as amended at 15 U.S.C. § 7213).

55. *Id.* § 103 (codified as amended at 15 U.S.C. § 7262).

56. *See supra* text accompanying notes 4, 23–27, 55.

revenues—EGCs—are exempt from complying with SOX section 404(b)'s outsider audit unless they lose their EGC status.[57] This shift in legislation regarding section 404(b) compliance has sparked substantial debate from both those who support and those who oppose Congress's latest deregulation.

III. THE JOBS ACT DEBATE: THE CONSIDERATIONS IN SUPPORT OF AND IN OPPOSITION TO SECTION 103

The JOBS Act has been hotly debated. This section reviews the common arguments supporting and opposing section 103 of the JOBS Act, which exempts EGCs from the required outsider audit under SOX section 404(b).[58]

A. *SUPPORTERS OF SECTION 103 OF THE JOBS ACT*

The supporters of section 103[59] commonly argue that it will increase job creation, reduce the cost of regulatory compliance, and improve the competitiveness of the U.S. capital market.

Job Creation. As previously stated, the main goal of the JOBS Act is to "increase . . . job creation and economic growth."[60] According to the IPO Task Force,[61] companies that have undergone IPOs employ about 11% of U.S. workers in the private sector.[62] Moreover, "92% of job growth [within a company] occurs after [that] company's [IPO]."[63] Therefore, IPOs are an important source of job creation in the United States.

57. Jumpstart Our Business Startups Act § 103 (codified as amended at 15 U.S.C. § 7262). For a list of the various ways EGCs can lose their status, see *supra* note 34 and accompanying text.

58. Section 103 of the JOBS Act states: "Section 404(b) of the Sarbanes–Oxley Act of 2002 (15 U.S.C. 7262(b)) is amended by inserting, 'other than an issuer that is an emerging growth company (as defined in section 3 of the Securities Exchange Act of 1934),' before 'shall attest to.'" Jumpstart Our Business Startups Act § 103 (codified as amended at 15 U.S.C. § 7262).

59. Supporters of the JOBS Act include the Small Business & Entrepreneurship Council, the National Small Business Association, the United States Chamber of Commerce, the International Franchise Association, and the Biotechnology Industry Organization. RENA S. MILLER & GARY SHORTER, CONG. RESEARCH SERV., U.S. INITIAL PUBLIC STOCK OFFERINGS AND THE JOBS ACT 11 (2012) (released on Mar. 23, 2013).

60. Jumpstart Our Business Startups Act, 126 Stat. at 306 (codified as amended in sections of 15 U.S.C.); *see supra* note 28 and accompanying text (stating the purpose of the JOBS Act).

61. The IPO Task Force is a group of "venture capitalists, experienced CEOs, public investors, securities lawyers, academicians and investment bankers" that "examine[d] the conditions leading to the IPO crisis and . . . provide[d] recommendations [to the U.S. Department of Treasury] for restoring effective access to the public markets for emerging, high-growth companies." IPO TASK FORCE, REBUILDING THE IPO ON-RAMP: PUTTING EMERGING COMPANIES AND THE JOB MARKET BACK ON THE ROAD TO GROWTH 1 (2011), *available at* http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.

62. *Id.* at 5.

63. *Id.*

However, in the past decade, IPOs have faltered as the number of venture-backed companies going public has dropped from almost 2000 in the 1990s to less than 500 in the 2000s.[64] More specific to job creation within *small* companies,[65] the number of small-company IPOs dropped from an average of 165 IPOs per year between 1980 and 2000 to an average of 72 IPOs per year after 2000.[66] With this drop in IPOs, there was a corresponding drop in job creation.[67]

The IPO Task Force and other JOBS Act supporters argue that the JOBS Act will encourage more companies to go public because the IPO Task Force and Congress designed the provisions of the JOBS Act to make the IPO process more attractive to EGCs.[68] Thus, the JOBS Act supporters argue that the JOBS Act will increase the number of IPOs, which in turn will increase job creation through the growth of companies after they have gone public.[69]

Cost of Regulatory Compliance. One of the JOBS Act's supporters' common arguments, which pertains to section 103's exemption from SOX section 404(b), is the cost of regulatory roadblocks governing the IPO process.[70] According to a survey conducted by the IPO Task Force, "the average cost of achieving initial regulatory compliance for an IPO [is] $2.5 million, followed by an ongoing compliance cost, once public, of $1.5 million per year."[71] Specifically, there is wide variance in the estimated cost of the outsider audit that SOX section 404(b) requires. One report stated that the average cost of compliance for a public company in 2004 was $4.36

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64. *Id.* at 6.

65. There are various definitions of a "small company." It can be defined in terms of either the number of employees, the amount of annual revenues, or market capitalization. For the purposes of this Note, a "small company" generally is one with a market capitalization of less than $75 million. Market capitalization is "[t]he total dollar market value of all of a company's outstanding shares." *Market Capitalization*, INVESTOPEDIA, http://www.investopedia.com/terms/m/marketcapitalization.asp (last visited Nov. 17, 2013).

66. MILLER & SHORTER, *supra* note 59, at 16 & n.70 (defining "small companies" as "firms with pre-IPO sales of less than $50 million, using inflation-adjusted, 2009 purchasing power"). Furthermore, "[b]efore 1998, according to observers, smaller IPOs constituted about 80% of the total number of yearly IPOs, but since 1998, that percentage has been in the 20% range." *Id.*

67. *See* IPO TASK FORCE, *supra* note 61, at 7 (estimating that the drop in IPOs caused the American population to lose "up to 22 million jobs" (quoting DAVID WEILD & EDWARD KIM, GRANT THORNTON, A WAKE-UP CALL FOR AMERICA 2 (2009)) (internal quotation marks omitted)).

68. *See id.* at 8 (describing higher costs as one of the problems that led to the reduced supply of companies in the IPO process).

69. *See id.* (arguing that EGCs that go public "generate new jobs through their subsequent growth").

70. *See id.* (describing that the increased costs reduced the supply of EGCs going public).

71. *Id.* (footnote omitted); *see id.* at 36 app. C (compiling results from pre-IPO and post-IPO surveys of CEOs).

million.[72] According to another study conducted two years later, the average cost of compliance for a public company decreased to $4 million for large firms and $1.2 million for small firms.[73] According to a 2012 study, the costs of compliance further decreased, as most companies spent between $100,000 and $500,000 annually.[74] These costs have decreased largely because companies became more knowledgeable about SOX regulation and more experienced with their internal compliance procedures.[75]

Despite these decreasing compliance costs, supporters of section 103 argue that the IPO process is still too expensive and administratively burdensome for many small companies, which could explain the drop in small business IPOs.[76] Therefore, to achieve the overall purpose of job creation, the JOBS Act's supporters argue that some of the most expensive regulatory provisions, like SOX section 404(b), should be eliminated.[77]

Declining Competitiveness of the U.S. Capital Market. Another concern for supporters of the JOBS Act is the competitiveness of the U.S. capital market, especially in comparison to foreign capital markets. One study found that the ratio of U.S. IPOs to global IPOs in the 1990s was approximately 1-to-4, but the ratio of U.S. IPOs to global IPOs since 2000 is only about 1-to-7.[78]

Furthermore, according to the Committee on Capital Markets Regulation, the "main factor contributing to the loss of competitiveness of U.S. public and private markets is the differences in legal rules and regulations governing U.S. public markets and foreign and private

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72. Prentice, *supra* note 7, at 725 (citing COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 15 (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

73. *Id.* at 725–26 (citing *Regulating Business: The Trial of Sarbanes–Oxley*, ECONOMIST (Apr. 20, 2006), http://www.economist.com/node/6838442 (defining small companies as companies with a market capitalization between $75 million and $700 million)).

74. PROTIVITI, 2012 SARBANES–OXLEY COMPLIANCE SURVEY: WHERE U.S.-LISTED COMPANIES STAND: REVIEWING COST, TIME, EFFORT AND PROCESSES 14 (2012), *available at* http://www.protiviti.com/en-US/Documents/Surveys/2012-SOX-Compliance-Survey-Protiviti.pdf; *see also* SEC. & EXCH. COMM'N, *supra* note 23, at 49–63 (stating the results of the SEC study that found declining costs of compliance with SOX section 404(b), especially after the 2007 reforms).

75. Once companies gained more experience with SOX compliance, they were able to determine the key internal controls that SOX imposed. PROTIVITI, *supra* note 74, at 20. This experience also likely led to decreasing costs as companies became more efficient in complying with SOX. *See id.*

76. *See* IPO TASK FORCE, *supra* note 61, at 6–12 (describing higher costs and regulatory burdens as some of the problems that led to the almost 75% drop in IPOs since the 1990s).

77. *See id.* (stating that higher costs decreased the supply of companies in the IPO process and recommending that the legislature eliminate such costs to increase the number of IPOs).

78. MILLER & SHORTER, *supra* note 59, at 17 (citing Craig Doidge et al., *The U.S. Left Behind: The Rise of IPO Activity Around the World* (Nat'l Bureau of Econ. Research, Working Paper No. 16916, 2011), *available at* http://www.nber.org/papers/w16916.pdf). For 2011 in particular, the United States' share of IPOs around the world was 8.6%. Ed Royce, *Sarbanes–Oxley Has Devastated the U.S. IPO Market*, U.S. REPRESENTATIVE ED ROYCE (July 28, 2012), http://royce.house.gov/news/documentsingle.aspx?DocumentID=304994.

alternatives."[79] Therefore, supporters of the JOBS Act believe that provisions such as section 103 that change the regulations governing U.S. public markets will improve the competitiveness of the U.S. capital market in comparison to these other foreign alternatives,[80] increasing both the number of IPOs and job creation.[81]

B. *Opponents of Section 103 of the JOBS Act*

The opponents of section 103[82] commonly argue that almost all EGCs can afford the compliance costs, exemptions for those companies that struggle to pay the compliance costs already exist, the IPO market crashed before Congress passed SOX, the benefits of the external audit outweigh its costs, the external audit improves investor confidence and prevents fraud, and the external audit prevents social deadweight losses.

Almost All EGCs Can Afford the Costs of Compliance. According to former SEC Chief Accountant Lynn Turner, "98[%] of all initial public offerings since 1970 would have qualified as emerging growth companies."[83] Barbara Roper, Director of Investor Protection at the Consumer Federation of America, agreed: "A billion dollars in gross revenue is nearly everybody. You're talking about allowing most companies that go public to go public without meeting . . . basic standards."[84] Moreover, opponents contend, most of the companies within the EGC category, specifically those with a public float of more than $250 million, have "the resources and infrastructure to comply with [pre-JOBS Act] U.S. securities regulations."[85] Therefore, opponents argue that the JOBS Act deregulation of section 404(b) is not

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79. Letter from R. Glenn Hubbard, Co-Chair, John L. Thornton, Co-Chair & Hal S. Scott, Director, Comm. on Capital Mkts. Regulation, to The Honorable John A. Boehner, Speaker of the U.S. House of Representatives & The Honorable Nancy Pelosi, Democratic Leader of the U.S. House of Representatives 1 (Mar. 26, 2012), *available at* http://capmktsreg.org/pdfs/2012.03.26_JOBS_Act.pdf (citing COMM. ON CAPITAL MKTS. REGULATION, *supra* note 72, at 1).

80. *See id.* at 1–2 ("[The Report] concluded that improving the regulation of U.S. public markets is critical to better attract venture investments.").

81. *See supra* notes 60–79 and accompanying text (describing how more IPOs can increase job creation through decreased regulations and cost of compliance).

82. Opponents of the JOBS Act include the North American Securities Administrators Association (NASAA) and the American Association of Retired Persons (AARP). MILLER & SHORTER, *supra* note 59, at 13.

83. Mandelbaum, *supra* note 4.

84. Edward Xia, *The JOBS Act: Risks for Investor Protection*, COLUM. BUS. L. REV. ONLINE (Apr. 15, 2012, 11:51 PM), http://cblr.columbia.edu/archives/12083 (internal quotation marks omitted).

85. *See* Michael Cohn, *Small Business Bill Would Weaken Audit Protections*, ACCT. TODAY (Mar. 21, 2012), http://www.accountingtoday.com/news/Small-Business-Bill-Weaken-Audit-Protections-62072-1.html ("The Council [of Institutional Investors] noted that some of the most knowledgeable and active advocates for small business capital formation have in the past agreed that a company with more than $250 million of public float generally has the resources and infrastructure to comply with existing U.S. securities regulations.").

necessary because most EGCs have the resources to comply with pre-JOBS Act regulations.

Exemptions Already Exist. Opponents of section 103 of the JOBS Act argue that EGCs already had adequate exemptions to SOX section 404(b) before the JOBS Act. SEC Chairman Mary Schapiro highlighted these exemptions before Congress enacted the JOBS Act: "IPO companies already [had] a two-year on-ramp period . . . before [compliance with section 404(b) was] required. In addition, the Dodd–Frank Act permanently exempted smaller public companies . . . from the audit requirement, which . . . cover[ed] approximately 60[%] of reporting companies."[86] These exemptions to SOX section 404(b) in place before the JOBS Act was effective did not improve the number of small-company IPOs.[87] Moreover, some opponents argue that these pre-JOBS Act exemptions for small businesses are ill-advised.[88] Thus, opponents to section 103 of the JOBS Act believe that the exemption to SOX section 404(b) during the five-year on-ramp period is unnecessary.

IPO Market Crash Before SOX. Supporters of section 103 of the JOBS Act "blame economic stagnation and job loss" on the regulations that arose out of the stock-bubble burst and the corporate scandals of the early 2000s.[89] Opponents claim, however, that regulations such as SOX and the Dodd–Frank Act cannot be the cause of "economic stagnation and job loss"[90] because the IPO market started to dissipate in 1997—well before Congress passed SOX in 2002.[91] One study found that SOX actually led to a 40% *increase* in the stock market after the fall from the stock-bubble burst and the

86. Letter from Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n, to Senator Tim Johnson, Chairman, Comm. on Banking, Hous., & Urban Affairs & Senator Richard C. Shelby, Ranking Member, Comm. on Banking, Hous., & Urban Affairs 3 (Mar. 13, 2012), *available at* http://www.aicpa.org/advocacy/issues/downloadabledocuments/404b/3-13-12_sec_chm_schapiro_letter_to_johnson.pdf.

87. MILLER & SHORTER, *supra* note 59, at 20 (citing *Spurring Job Growth Through Capital Formation While Protecting Investors, Part I: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 61-66 (2011) (Statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School)). Moreover, exemptions beyond the current level are unwarranted because a majority of EGCs have "the resources and infrastructure to comply with [pre-JOBS Act] U.S. securities regulations." Cohn, *supra* note 85. Thus, since a majority of EGCs have the resources to comply, section 404(b) generally should not prevent companies from launching IPOs.

88. *See* Orcutt, *supra* note 26, at 413–14. After performing an in-depth analysis, the SEC also advised against extending the exemption to companies with public floats between $75 million and $250 million. SEC. & EXCH. COMM'N, *supra* note 23, at 107–13.

89. John C. Coffee, Jr., *The Political Economy of Dodd–Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1077–78 (2012).

90. *Id.* at 1078.

91. *Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 30 (2011) (statement of David Weild, Senior Advisor, Grant Thornton LLP).

scandals at Enron and WorldCom.[92] Additionally, SOX's regulations are not the cause of job loss for small companies because "[c]ompanies under $75 million in market capitalization have *never* had to implement SOX 404(b) so it cannot be the reason such companies have not gone public."[93] Therefore, opponents of the JOBS Act section 103 argue that changing regulations to provide an exemption to the outsider-audit mandate for EGCs will not improve job creation within small businesses, as the JOBS Act aims to accomplish, because these regulations were never the source of the problem in the first place.[94]

Benefits of the Outsider Audit Outweigh the Decreasing Costs of Compliance. With the declining costs of section 404(b) compliance,[95] opponents of 103 of the JOBS Act highlight that the benefits of the outsider-audit regulation outweigh the costs.[96] Some of the benefits of an outsider-audit requirement include: increased efficiency,[97] increased profits,[98] more accurate financial reporting,[99] reduced cost of capital,[100] and stronger internal controls.[101] Further, stronger internal controls lead to improvements in corporate governance,[102] management characteristics,[103] and management forecasts.[104]

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92. Thomas Healey & Robert Steel, *Sarbanes–Oxley Has Let Fresh Air into Boardrooms*, FIN. TIMES, July 29, 2005, at 17, *available at* http://www.ft.com/intl/cms/s/1/537b39f0-ff95-11d9-86df-00000e2511c8.html#axzz29mGTaA9g.

93. *Spurring Job Growth Through Capital Formation While Protecting Investors, Part II: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs* 16 (2012) (statement of Lynn E. Turner) (emphasis added), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=5aaabb66-36eb-4b1e-8195-3cbeda832814.

94. For an alternative explanation of why small businesses are declining to enter the IPO process, see XIAOHUI GAO ET AL., SEC. & EXCH. COMM'N, WHERE HAVE ALL THE IPOS GONE? 29 (2012), *available at* http://www.sec.gov/info/smallbus/acsec/acsec-backgroundmaterials-090712-ritter-article.pdf (arguing "that the more fundamental problem [for why IPOs for small companies have dropped] is the deterioration in the profitability of small companies").

95. *See supra* notes 71–76 and accompanying text (describing how the costs of complying with SOX 404(b) have declined since 2004).

96. However, most of SOX's benefits come at the beginning of the compliance cycle and slowly decline as a company matures in the compliance process and improves its internal controls. *See* PROTIVITI, *supra* note 74, at 26–28 (describing the benefits of SOX compliance).

97. *See* Orcutt, *supra* note 26, at 337–40 ("Better financial disclosure by reporting companies should lead to more efficient securities markets . . . .").

98. *See id.* at 340 (stating that SOX section 404(b) "led either to direct cost savings . . . or to improved loss avoidance" (quoting COMM. ON CAPITAL MKTS. REGULATION, *supra* note 72, at 119)).

99. *See id.* at 335–37 ("The primary objective of Section 404 is (presumably) to improve the accuracy of the financial disclosure made by reporting companies.").

100. *See id.* at 337–40 ("Better financial disclosure by reporting companies should lead to . . . a lower cost of capital for issuers.").

101. *See id.* at 355–57 (suggesting that small companies need to comply with SOX section 404(b) to improve their internal controls).

102. *See* Vishal Munsif et al., *Internal Control Reporting and Audit Report Lags: Further Evidence*, 31 AUDITING: J. PRAC. & THEORY 203, 205 (2012) (citing a study performed and summarized in Karla Johnstone et al., *Changes in Corporate Governance Associated with the Revelation of Internal*

Moreover, small companies have the greatest need for these benefits, as studies show that "smaller firms are less likely to have strong internal controls."[105] Small companies are also the most likely to have problems with registration statements.[106] Therefore, opponents of section 103 of the JOBS Act argue that providing an exemption to SOX section 404(b) is a mistake because small companies need the benefits that the outsider-audit requirement offers,[107] especially since these benefits are beginning to outweigh the quickly declining costs of compliance.

Investor Confidence and Potential Fraud. Possibly, opponents' most significant concern with section 103 of the JOBS Act is the potential for fraud. Opponents argue that fraud—"[t]he research scandals of the dot-com era and the collapse of the dot-com bubble"—caused the fall of the U.S. IPO market.[108] Congress designed regulations such as SOX section 404(b) to prevent fraud and protect investors.[109] These protections instill confidence in investors and are important to the growth of the IPO market. John Coates, a Harvard law professor, warns that without these protections "[i]t's not just a possibility; I guarantee that someone will in fact do worse than Enron as a result of this bill . . . . There will just be outright fraud."[110] Therefore, opponents believe that the JOBS Act deregulation of the outsider

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Control Material Weaknesses and Their Subsequent Remediation, 28 CONTEMP. ACCT. RES. 331 (2011)).

103. *See id.* (citing a study performed and summarized in Johnstone et al., *supra* note 102).

104. *See id.* (citing a study performed and summarized in Mei Feng et al., *Internal Control and Management Guidance*, 48 J. ACCT. & ECON. 190 (2009)).

105. *Id.* Generally, smaller firms have weaker internal controls because they have less expertise and less financial resources to dedicate toward improving internal controls. *See* Jeffrey Doyle et al., *Determinants of Weaknesses in Internal Control over Financial Reporting*, 44 J. ACCT. & ECON. 193, 195 (2007) (stating companies that are "smaller, younger, financially weaker, more complex, growing rapidly, and/or undergoing restructuring" have the weakest internal controls). This is especially true when the firm is young or pursuing growth strategies. *See id.* (stating that the factors that cause companies to have weaker internal controls include the company's youth and policies of rapid growth).

106. Orcutt, *supra* note 26, at 356 ("A 2007 study on restatement trends by Glass Lewis & Co. found that restatements by companies with market capitalizations of less than $75 million constituted 50% of financial restatements by reporting companies in 2005 and 62% in 2006."). A restatement is "[t]he revision and publication of one or more of a company's previous financial statements [because the] previous statement contains a material inaccuracy. The need to restate financial figures can result from accounting errors, noncompliance with generally accepted accounting principles, fraud, misrepresentation or a simple clerical error." *Restatement*, INVESTOPEDIA, http://www.investopedia.com/terms/r/restatement.asp (last visited Nov. 17, 2013).

107. *See supra* notes 97–104 and accompanying text (listing the potential benefits of an outsider audit).

108. Justin P. Grant, *JOBS Act Would Ease Sarbox Standard, but Might Pave Way for Fraud*, CFO (Mar. 26, 2012), http://ww2.cfo.com/management-accounting/2012/03/jobs-act-would-ease-sarbox-standard-but-might-pave-way-for-fraud/ (internal quotation marks omitted).

109. *See supra* note 16 and accompanying text (providing the purpose of SOX).

110. Grant, *supra* note 108 (quoting a prediction made by Coates).

audit will cause an increase in fraud, which in turn, will only hurt the IPO market.

Prevention of Social Deadweight Losses. Fraud affects parties beyond just the investors in a company. Fraud also affects creditors, suppliers, customers, employees, competitors, and society as a whole.[111] For instance, when corporations provide fraudulent financial information, "lenders underprice credit, employees make career and retirement decisions based on a false picture of their firm's prosperity, and rivals make business decisions on a distorted playing field."[112] In general, "fraudulent financial reporting misallocates capital and labor among firms, producing social deadweight losses."[113] As a safeguard against fraudulent financial reporting, SOX section 404(b) helps to prevent these resulting social deadweight losses. By deregulating section 404(b), opponents of the JOBS Act argue that section 103 could lead to increased social deadweight losses.

IV. WHY CORPORATE GOVERNANCE IS AN IMPORTANT CONSIDERATION WHEN DEBATING THE JOBS ACT SECTION 103

There is an important consideration for the U.S. capital market's regulations that is unaccounted for in both of the JOBS Act section 103 supporters' and opponents' arguments. The JOBS Act supporters and opponents do not give great weight to section 103's effect on corporate governance, which this Note argues is not only relevant, but an important consideration.[114]

Corporate governance is a vital component in modern business and is defined as the "[p]rocedures and processes according to which an organisation is directed and controlled."[115] To help corporations determine the appropriate procedures and processes, the Organisation of Economic Co-operation and Development ("OECD") developed four principles[116]:

111. Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887 (2013).

112. *Id.* at 1892.

113. *Id.* at 1908 n.88. Social deadweight losses are "[t]he costs to society created by market inefficiency. . . . [such as] an inefficient allocation of resources." *Deadweight Loss*, INVESTOPEDIA, http://www.investopedia.com/terms/d/deadweightloss.asp (last visited Nov. 17, 2013).

114. One author agrees, "commentators have not yet paid much attention to the JOBS Act's potential corporate governance implications." John J. Jenkins, *Collision on the IPO On-Ramp: Could the JOBS Act Dent the Corporate Governance Industry's Claims to Legitimacy?*, CORP. GOVERNANCE ADVISOR, July/Aug. 2012, at 1, 2.

115. *Glossary of Statistical Terms: Corporate Governance*, *supra* note 6 (defining corporate governance as a "structure [that] specifies the distribution of rights and responsibilities among the different participants in the organisation—such as the board, managers, shareholders and other stakeholders—and lays down the rules and procedures for decision-making").

116. The OECD is a "forum where the governments of 34 democracies with market economies work with each other, as well as with more than 70 non-member economies to promote economic growth, prosperity, and sustainable development." *What Is the OECD?*, U.S. MISSION ORG. ECON. COOPERATION & DEVELOPMENT, http://usoecd.usmission.gov/mission/overview.html (last visited Nov. 17, 2013). The OECD's four corporate governance principles

(1) Fairness–“equitable treatment of all shareholders”[117]

(2) Transparency–“timely and accurate disclosure [of] all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company”[118]

(3) Accountability–“effective monitoring of management . . . and [of] the board’s accountability to the company and the shareholders”[119]

(4) Responsibility–“[recognition of] the rights of stakeholders established by law or through mutual agreements”[120]

This Part highlights the importance of corporate governance and the OECD’s four principles with a brief summary of the Enron scandal. This Part then discusses why corporate governance is an important consideration and explains why the JOBS Act section 103 does not improve corporate governance.

A. Enron: An Illustration of Poor Corporate Governance

The four principles of corporate governance—fairness, transparency, accountability, and responsibility—were severely lacking in the infamous scandals of the early 2000s. Enron and WorldCom (as well as others like Qwest Communications and Global Crossing)[121] each had poor corporate governance measures. Their scandals and subsequent collapses resulted in profound effects on the U.S. economy and led to greater corporate governance regulations with the passage of SOX.[122] This Subpart briefly discusses Enron’s poor corporate governance measures and their consequences.

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are “an international benchmark for policy makers, investors, corporations and other stakeholders worldwide.” OECD, OECD PRINCIPLES OF CORPORATE GOVERNANCE 3 (2004), *available at* http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf.

117. OECD, *supra* note 116, at 18, 20; *see* Holly J. Gregory, *Building the Legal and Regulatory Framework: Discussion*, *in* CONFERENCE SERIES 44: BUILDING AN INFRASTRUCTURE FOR FINANCIAL STABILITY 67, 74–75 (Eric S. Rosengren & John S. Jordan eds., 2000) (summarizing the OECD principles).

118. OECD, *supra* note 116, at 22 (emphasis omitted); *see* Gregory, *supra* note 117, at 75 (summarizing the OECD principles).

119. OECD, *supra* note 116, at 24 (emphasis omitted); *see* Gregory, *supra* note 117, at 75 (summarizing the OECD principles).

120. OECD, *supra* note 116, at 21 (emphasis omitted); *see* Gregory, *supra* note 117, at 76 (summarizing the OECD principles).

121. For more information on the Qwest Communications and Global Crossing scandals, see Lawrence A. Cunningham, *The Sarbanes–Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 932–36 (2003).

122. *See supra* notes 7–9 and accompanying text (discussing the motivations behind SOX).

Enron, an energy company, was the seventh-largest company in the United States[123] and named *Fortune Magazine*'s "Best Managed and Most Innovative Company" in 2000.[124] In early 2001, Enron reported revenues of more than $100 billion, which was more than seven times its reported revenue in 1996.[125] Enron greatly increased its reported revenues by hiding "troubled assets" and "losses on those assets" in special purpose enterprises ("SPE").[126]

Generally, companies had to disclose their SPEs as subsidiaries on their financial statements.[127] However, the Financial Accounting Standards Board[128] guidelines provided an exception for reporting SPEs if an outside investor owned more than 3% of a SPE.[129] Enron avoided disclosing its SPEs on its financial statements by inducing outside investors to invest in more than 3% of an SPE in exchange for shares of stock in Enron.[130]

By the end of 2001, however, Enron revealed that it would have to restate its reported net income for the past four years to reflect its interest in the SPEs,[131] which were "previously 'deemed immaterial'"[132]:

Year[133]	Reported (in millions)	Restated (in millions)	Decline
1997	$105	$28	73%
1998	$703	$133	81%
1999	$893	$248	72%
2000	$979	$99	90%

123. Michael W. Stocker & Kendra Schramm, *Return to Enron?*, ACCT. TODAY (Nov. 1, 2012), http://www.accountingtoday.com/ato_issues/26_11/Return-to-Enron-64470-1.html.

124. Jeff Miller, PowerPoint Presentation: Corporate Scandals and Their Macroeconomic Impact, at slide 5 (Apr. 27, 2005), *available at* http://www.bizethics.org/files/Corporate_Scandals_and_Macroeconomic_Impact.ppt.

125. Stocker & Schramm, *supra* note 123.

126. J. Timothy Sale, PowerPoint Presentation: Accounting, Auditing and Corporate Governance: Impact of Enron Accounting Scandal and Sarbanes–Oxley Act, at slide 7 (2004), *available at* http://www.cba.uc.edu/faculty/sale/Impact%20of%20Enron%20and%20SOX.ppt.

127. *Id.* at slide 6.

128. The Financial Accounting Standards Board is an independent organization that establishes the financial accounting standards for private organizations. *Facts About FASB*, FIN. ACCT. STANDARDS BOARD, http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495 (last visited Nov. 17, 2013). The SEC recognizes these accounting standards. *Id.*

129. Sale, *supra* note 126, at slide 6.

130. *Id.* at slide 7.

131. Stocker & Schramm, *supra* note 123.

132. Sale, *supra* note 126, at slide 11.

133. *Id.* This table is a replica of the table produced in Dr. Sale's PowerPoint presentation, which shows how significant Enron's net-income misstatements were.

These misstatements of net income were a result of poor corporate governance. Enron's board of directors approved the SPE transactions and required an internal audit committee to review them.[134] However, the internal audit committee did not fully understand the SPE transactions.[135] Enron also had an external auditor, the accounting firm Arthur Andersen.[136] However, this external auditor was not independent of Enron and the two organizations had an extensive relationship.[137] Enron was Arthur Andersen's second-largest client, producing over $50 million in fees.[138] Arthur Andersen was also Enron's internal auditor that kept staff on Enron's premises, and many of Enron's executives were former Arthur Andersen executives.[139] Thus, Enron's auditing procedures were ineffective to prevent corporate corruption and fraud, since the organization had weak transparency and accountability measures—two of the OECD corporate governance principles—within its corporate governance framework.

As a result, Enron's stock plummeted from about $90 per share to under $1 per share[140] (a total loss of $73 billion), more than 20,000 people lost their jobs, and Enron filed one of the largest bankruptcies in history.[141] Investor confidence also took a hit. Enron, in addition to the other companies involved in the wave of corporate scandals, caused publicly traded companies to lose $7 trillion in stock market value between 2000 and 2002.[142] Moreover, the U.S. gross domestic product decreased by 0.34%, or $35 billion, in the first year after the Enron scandal.[143]

B. Corporate Governance Is an Important Consideration

If a corporation embraces the four principles of corporate governance, then the corporation, its investors, and society will avoid the negative consequences that the Enron anecdote illustrates. Further, by embracing these four principles, a corporation, its investors, and society will reap the significant benefits of efficient use of corporate resources, increased access to financing and lower cost of capital, reduced corruption and adherence to

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134. *Id.* at slide 17.

135. *Id.*

136. *Id.* at slide 18.

137. *See id.* (providing reasons to call Arthur Andersen's independence from Enron into question).

138. *Id.*

139. *Id.*

140. Stocker & Schramm, *supra* note 123.

141. Miller, *supra* note 124, at slide 9.

142. Edward Iwata, *Enron's Legacy: Scandal Marked Turning Point*, USA TODAY (Jan. 29, 2006, 11:04 PM), http://usatoday30.usatoday.com/money/industries/energy/2006-01-29-enron-legacy-usat_x.htm.

143. Miller, *supra* note 124, at slide 34.

laws and regulations, ability to recover from financial shocks and competitive shocks, improved corporate performance, and job creation.

Efficient Use of Resources. Strong corporate governance improves efficient use of resources within a corporation as well as within society at-large by creating a system that replaces incompetent and corrupt leaders.[144] Strong corporate governance also encourages investment in goods and services with the highest return.[145]

Increased Access to Financing and Lower Cost of Capital. Corporate governance policies, such as transparency and shareholder participation, provide investors with confidence.[146] When investors feel confident, they are more willing to provide financing.[147] Therefore, corporations with stronger governance have increased access to financing compared to corporations with weaker governance.[148] Not only are investors more willing to invest, but they are also willing to pay more to invest in corporations with strong governance—thus, lowering the cost of capital for the corporation.[149]

Reduced Corruption and Adherence to Laws and Regulations. Strong corporate governance reduces corrupt practices within a company by providing an important "check on the power of . . . individuals . . . who control large aggregates of other people's money."[150] Moreover, corporate governance is linked with stronger adherence to laws and regulations.[151]

Ability to Recover from Financial and Competitive Shocks. Studies show that strong corporate governance can improve a corporation's performance

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144. Gregory, *supra* note 117, at 70; *see* Stijn Claessens, *Corporate Governance and Development*, 21 WORLD BANK RES. OBSERVER 91, 103 (2006) ("Better corporate governance can add value by improving the performance of firms, through more efficient management, better asset allocation, better labor policies, or similar efficiency improvements.").

145. Gregory, *supra* note 117, at 70; *see* Claessens, *supra* note 144, at 103 (arguing that strong corporate governance leads to "better asset allocation").

146. *See* Gregory, *supra* note 117, at 70 ("[A]t its heart corporate governance concerns the means by which a corporation assures investors that it has well-performing management in place and that corporate assets provided by investors are being put to appropriate and profitable use.").

147. *See* John R. Graham, Campbell R. Harvey & Hai Huang, *Investor Competence, Trading Frequency, and Home Bias*, 55 MGMT. SCI. 1094, 1105 (2009) (finding that "investors who feel more competent tend to trade more frequently than investors who feel less competent").

148. *See* Claessens, *supra* note 144, at 102 ("Outsiders are less willing to provide financing and more likely to charge higher rates if they are less assured that they will earn an adequate rate of return.").

149. *See* Gregory, *supra* note 117, at 71 & n.7 (citing a study that found investors are willing to pay more than 10% more for a corporation with strong governance).

150. *Id.* at 72.

151. *See* Philip Armstrong, *Getting Emerging Economies Up to Standard*, *in* CORPORATE GOVERNANCE: THE INTERSECTION OF PUBLIC AND PRIVATE REFORM 36, 40 (Eric Hontz & Aleksandr Shkolnikov eds., 2009) ("Successful corporate governance entails effective and consistent enforcement of regulations and discipline in observing laws and internal regulations."); Gregory, *supra* note 117, at 71–72 (implying that stronger corporate governance could lead to better adherence to laws and customs).

during a financial crisis[152] and its ability to respond to competition in the marketplace.[153] This is because strong corporate governance leads to better information about the company.[154] Companies with better information can improve their weaknesses and react to market forces faster and more efficiently, and, thus, reduce the effect of financial shock and competitive forces. The financial market also benefits from strong corporate governance by limiting the volatility of stock prices.[155]

Improved Corporate Performance. Evidence shows that stronger corporate governance leads to stronger corporate performance, including greater return on equity, higher valuation of the corporation, and increased profits.[156] Improved corporate performance benefits not only the corporation itself, but also its investors and society as a whole.

Development and Job Creation. Due to previously stated benefits that accrue to a corporation itself (e.g., efficient use of resources, increased access to financing, decreased corruption), strong corporate governance also helps to achieve broader developmental goals within a country, such as economic growth, decrease in poverty, and job creation.[157] This is an important consideration because job creation is the central goal of the JOBS Act.[158]

Corporate governance also has global implications: the extensive effects of strong corporate governance make it "as important [a consideration] in the world economy as the government of countries."[159] Therefore, the JOBS Act supporters and opponents overlooked a significant consideration in

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152. *See* Claessens, *supra* note 144, at 18–21 (citing studies and anecdotal evidence from the United States, such as Enron, WorldCom, Tyco, and Arthur Andersen).

153. Mario Daniele Amore & Alminas Zaldokas, Corporate Governance and International Trade Shocks 12–14 (Aug. 2, 2011) (unpublished manuscript), *available at* http://www.eea-esem.com/files/papers/eea-esem/2011/2301/corpgov_FTA.pdf.

154. *See* Donal Byard et al., *Corporate Governance and the Quality of Financial Analysts' Information*, 25 J. ACCT. & PUB. POL'Y 609, 611 (2006) (finding "that better corporate governance is ultimately associated with better firm information environments from a user's (e.g., analysts') perspective").

155. *See* Claessens, *supra* note 144, at 106 (citing studies as support); *see also supra* note 140 and accompanying text (discussing Enron's dramatic drop in stock price).

156. Claessens, *supra* note 144, at 103; *see* Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 107 (2003) ("We find that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions."); *see also* Gregory, *supra* note 117, at 72 (noting that corporate governance is not a guarantee for stronger performance, "but it should make it more likely").

157. Aleksandr Shkolnikov & Andrew Wilson, *From Sustainable Companies to Sustainable Economies: Corporate Governance as a Transformational Development Tool*, *in* CORPORATE GOVERNANCE: THE INTERSECTION OF PUBLIC AND PRIVATE REFORM, *supra* note 152, at 8, 10–34.

158. *See supra* note 28 and accompanying text.

159. Gregory, *supra* note 117, at 68 (quoting James D. Wolfensohn, *A Battle for Corporate Honesty*, *in* THE ECONOMIST: THE WORLD IN 1999, at 38 (1998)).

their debate of whether SOX section 404(b) positively or negatively affects the U.S. capital market, economy, and job creation.

C. The JOBS Act Section 103 Does Not Improve Corporate Governance

The JOBS Act section 103 fails to improve corporate governance as measured by OECD's four principles. Instead, it strips away the improvements that SOX section 404(b) implemented ten years before. SOX section 404(b) improved corporate governance by furthering OECD's transparency and accountability principles. SOX section 404(b)'s outsider-audit requirement ensures the accuracy of available corporate information and that the corporate officers take their public reporting responsibilities seriously. One study by GovernanceMetrics International affirmed SOX's positive effect on corporate governance, finding that SOX's reforms led to a 10% increase in corporate governance performance.[160] Without SOX section 404(b), these significant improvements in corporate governance, which have the effect of increasing corporate performance and job creation, among other benefits, would not exist.

V. The Better Balance After Adding Corporate Governance to the Discussion

Like SOX, the JOBS Act quickly passed through Congress without Congress considering all significant interests. Following the passage of SOX, many analysts supported Secretary of the Treasury Henry Paulson's statement that "often the pendulum swings too far and we need to go through a period of readjustment."[161] Congress quickly readjusted SOX's

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160. Healey & Steel, *supra* note 92; *see also* Prentice, *supra* note 7, at 714 ("SOX 404's contribution to this improvement cannot be precisely parsed out, *but* improved formal governance structures mean little if they do not create more reliable information upon which managers and investors can act." (emphasis added)). There are a few scholars that believe SOX is "quack corporate governance." *See* Roberta Romano, *The Sarbanes–Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1603 (2005) (stating that "Congress committed a public policy blunder in enacting SOX's corporate governance mandates"). However, this is strongly rebutted by academic literature and empirical evidence. *See* Robert A. Prentice & David B. Spence, *Sarbanes–Oxley as Quack Corporate Governance: How Wise Is the Received Wisdom?*, 95 GEO. L.J. 1843, 1908 (2007) ("[T]he empirical evidence that Professor Romano and others emphasize does not justify a description of SOX as 'quack corporate governance.'"). SOX also improved corporate governance on a global scale as foreign companies frequently cross-list their securities on the United States' market to improve their corporate governance. *See generally* John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 674 (1999) (discussing the idea of "bonding"—companies cross-listing in order to improve perception of strong corporate governance). Therefore, foreign companies gained the same benefit of improved corporate governance as domestic companies. However, the potential effect that the JOBS Act section 103 has on the global corporate governance is beyond the scope of this Note.

161. Edward Luce, *Paulson in Plea for Reform of Benefits*, FIN. TIMES (Aug. 1, 2006), http://www.ft.com/intl/cms/s/0/b1137504-2178-11db-b650-0000779e2340.html#axzz29mGTaA9g (internal quotation marks omitted).

reforms by providing extensions for compliance and eventually introducing an exemption for companies with a market capitalization of less than $75 million.[162] Thus, Congress changed its "one-size-fits-all" approach and made important adjustments to the securities regulatory scheme to encourage economic growth and job creation.

Similarly, the JOBS Act swings the pendulum too far in the opposite direction. The JOBS Act section 103 essentially creates a new "one-size-fits-all" approach because almost all companies are exempt from the outsider-audit requirement provided in SOX section 404(b).[163] Although Congress recognizes the importance of finding the right regulatory balance,[164] it has yet to do so. To reach this critical balance all significant interests need to be considered—instead of omitting one as crucial as corporate governance.

In addition to the benefits stated above, strong corporate governance is extremely important to the life of the U.S. capital market because it helps to prevent financial catastrophes like that experienced in the early 2000s with the Enron scandal. Another such event would be disastrous to the United States' competitiveness with other global capital markets. Decision makers also need to look beyond the easily measurable and decreasing costs of outsider audits and look at the wide-ranging benefits, including the JOBS Act's central goal of job creation.[165] Instead of "deregulating, hoping for the best, and then rushing to reregulate after the next scandalous financial collapse"[166]—which would kill investor confidence and crush the U.S. capital market—decision makers should factor in corporate governance and adjust the JOBS Act section 103 accordingly. Considering the benefits of strong corporate governance, decision makers such as Congress would be able to develop a better approach that comes closer to achieving the right regulatory balance, rather than continuing to swing the pendulum. One

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162. *See supra* note 86 and accompanying text (describing the exemption for small companies with a market capitalization of less than $75 million). However, soon this exemption will not stand, as the costs of compliance continuously decrease. *See supra* notes 72–74 and accompanying text (describing the decreasing compliance costs).

163. *See* Mandelbaum, *supra* note 4 (quoting former SEC Chief Accountant Lynn Turner's estimate that the new exemption includes 98% of companies that went public since 1970).

164. *See Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, *supra* note 91, at 30) (statement of David Weild, Senior Advisor, Grant Thornton LLP) ("I see getting the regulation right-sized for the company size to be absolutely critical.").

165. Costs are easy to focus on because they are easily measurable. Benefits, on the other hand, are more difficult to measure. Moreover, costs seem significant because they are present and short-term compared to benefits, which are in the future and long-term. Even though benefits are not easily quantifiable, they are still extremely important to the regulatory decision.

166. *Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Sec., Ins. & Inv. of the S. Comm. on Banking, Hous., and Urban Affairs* (2011) (testimony of John C. Coates IV & John F. Cogan, Jr., Professors of Law and Economics, Harvard Law School), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=1d24b42e-3ef8-4653-bfe8-9c476740fafa.

such approach would reverse the effects of the JOBS Act section 103 and change the underlying definition of the small business exemption.

Simply stated, corporate governance furthers Congress's goal of job creation and economic growth while ensuring investor confidence.[167] SOX section 404(b) encourages strong corporate governance. This revocation should apply to a majority of small businesses because: (1) the main argument of the proponents' of the JOBS Act section 103 and the large exemption from SOX section 404(b), that the outsider audit produces high compliance costs, is weakening as costs continue to decrease;[168] (2) small businesses are frequently the worst offenders of financial misstatements and could benefit the most from outsider audits;[169] and (3) corporate governance improvements benefit corporations of all sizes and society as a whole.[170]

However, some small businesses should continue to receive the exemption since small businesses—those with a market capitalization of less than $75 million—are most adversely affected by SOX section 404(b)'s compliance costs. Those small businesses that should continue to receive the exemption are ones that are also young. Recent studies found that young businesses (defined as businesses less than ten years old), *not* small businesses, create the most new jobs.[171] By keeping the exemption for young, small businesses, Congress will further the JOBS Act's overall goal of job creation, while also capturing section 404(b)'s many benefits described above. Therefore, Congress should adjust its exemption for small businesses to businesses that have a market capitalization of less than $75 million *and* are less than ten years old.

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167. *See supra* notes 144–60 and accompanying text (discussing the benefits of corporate governance).

168. *See supra* notes 73–75 and accompanying text (discussing how costs have decreased over time).

169. *See supra* note 106 and accompanying text (stating that small businesses are responsible for a majority of financial misstatements).

170. *See supra* Part IV.B (discussing the benefits of strong corporate governance).

171. *See* Mirit Eyal-Cohen, *Down-Sizing the "Little Guy" Myth in Legal Definitions*, 98 IOWA L. REV. 1041 (2013) (citing studies performed and summarized in David Neumark et al., *Do Small Businesses Create More Jobs? New Evidence for the United States from the National Establishment Time Series*, 93 REV. ECON. & STAT. 16, 27 (2011); John C. Haltiwanger et al., *Who Creates Jobs? Small vs. Large vs. Young* 28–31 (Nat'l Bureau of Econ. Research, Working Paper No. 16300, 2010), *available at* http://www.nber.org/papers/w16300.pdf; Michael Mundaca, *Startup America: How a Small Business Tax Cut Will Support Innovative, High-Growth Companies*, U.S. DEP'T TREASURY (Feb. 1, 2011), http://www.treasury.gov/connect/blog/Pages/Startup-America-How-a-Small-Business-Tax-Cut-will-Support-Innovative,-High-Growth-Companies.aspx; Martin A. Sullivan, *Start-Ups, Not Small Businesses, Are Key to Job Creation*, TAX ANALYSTS (Jan. 10, 2012, 10:36 AM), http://www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/UBEN-8QCQT6; Martin A. Sullivan, *New Research Weakens Case for Small Business Tax Relief*, TAX ANALYSTS (Jan. 4, 2012, 10:11 AM), http://www.taxanalysts.com/taxcom/taxblog.nsf/Permalink/UBEN-8Q7JUJ).

In addition to regulatory changes, the United States needs to improve its voluntary and market corporate governance mechanisms. For instance, if businesses better understand the benefits reaped from strong corporate governance systems, they may be more likely to voluntarily adopt mechanisms such as an outsider audit. Also, if creditors and shareholders better understand the benefits, they may also be an external market force that encourages corporations to adopt stronger corporate governance measures. While voluntary and market corporate governance mechanisms are important and can further Congress's overall objective, some evidence suggests that voluntary and market corporate governance mechanisms have limited effectiveness when a country's regulations for corporate governance are weak.[172] Therefore, strong corporate governance regulations, such as the new approach suggested above, are necessary for an overall effective system.

VI. Conclusion

The effect of corporate governance on the stock market is clear, as poor corporate governance regulations were a main factor in the stock market collapse in the early 2000s. Corporate governance is a significant business interest that must be accounted for when considering changes to securities-regulation legislation, not just for its own sake, but also for the many benefits it brings to corporations and society overall. Since government regulation of corporate governance is necessary for even voluntary corporate governance to be effective, and SOX section 404(b) was a government regulation that improved corporate governance, it is a mistake for the JOBS Act section 103 to essentially eliminate the outsider-audit requirement and disregard its benefits. By limiting the exemption from SOX section 404(b)'s outsider-audit requirement to small and young companies and by improving mechanisms to encourage voluntary adoption of strong corporate governance measures, Congress would achieve the regulatory balance that best promotes the principles of corporate governance and the resulting benefits of economic growth and job creation.

172. Claessens, *supra* note 144, at 109–14.