Give Smaller Companies a Choice: Solving Sarbanes-Oxley Section 404 Inefficiency

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This Note argues that smaller public companies should have the option to opt out of Section 404 of the Sarbanes-Oxley Act of 2002. Optional compliance is economically preferable to the current approach of mandatory compliance. Companies that choose to comply with Section 404 will send a signal to the financial markets that their internal controls meet the high standards Section 404 demands, and investors will reward such companies if they actually value the benefit of that company’s additional controls. Similarly, companies that benefit less from additional internal accounting will be able to avoid Section 404’s high costs. To clarify the economics of this argument, this Note develops a framework that models the choice companies make when Section 404 compliance is optional. Under the proposed system, independent auditors would continue to certify Section 404 compliance, providing clarity and simplicity for investors. This Note also examines the issues of imperfect market information and agency costs, concluding that they are not as problematic as they initially appear, and that they are still preferable to the excessive costs and burdens Section 404 places on smaller public companies. Finally, this Note argues that the Securities and Exchange Commission has the legal authority to adopt optional Section 404 compliance given Sarbanes-Oxley’s text and legislative intent.

INTRODUCTION

Section 404 is a source of more agitation than any other requirement of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). Critics complain that its internal accounting controls, as currently implemented, are too onerous and costly. This Note argues that smaller public companies should be able to opt out of Section 404 compliance. A system of optional Section 404 compliance is economically preferable to the current approach of mandatory compliance. Companies that choose to comply with Section 404 will send a signal to the financial markets that their internal controls meet the high standards Section 404 demands, and investors.

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will reward such companies if they actually value compliance. Under the proposed system of optional internal controls, a company's independent auditors would continue to certify Section 404 compliance. Auditor certification lends clarity and simplicity to the markets, and signals that the certified company meets an acceptable standard.  

Part I of this Note introduces Section 404 and traces the major criticisms of it. This Part considers several proposed reforms and argues that none are fully satisfactory. In Part II, the Note argues that optional Section 404 compliance is economically preferable to mandatory compliance because it allows smaller companies to adopt the optimal level of internal control procedures. For those companies for which Section 404's internal controls are desirable, financial markets will reward compliance through higher stock prices. At the same time, market mechanisms will allow companies that benefit less from additional internal accounting to avoid Section 404's high costs. To clarify this argument, this Note develops an economic framework that models the choice companies make when Section 404 compliance is optional. Like all economic frameworks, this framework is an ideal. In the real world, markets may fall short of perfectly valuing internal controls, and agency costs can distort managerial incentives. This Note examines these issues and concludes that they are not as problematic as they initially appear, and that they are still preferable to the excessive costs and burdens Section 404 places on smaller public companies. Finally, Part III argues that the Securities and Exchange Commission (SEC) has the legal authority to adopt optional Section 404 compliance, given Sarbanes-Oxley's text and legislative intent.

I. THE CONTROVERSY AND PROPOSED REFORMS

This Part introduces the Section 404 controversy and the surprisingly high costs of implementing Section 404's mandatory internal controls. Part I.A gives an overview of these costs and the public criticisms of them. Part I.B briefly describes the various proposed reforms that have arisen in response to the costs problem.

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and concludes that none of these proposed reforms are fully satisfactory.

A. The Section 404 Controversy

Sarbanes-Oxley was enacted in the heated political climate following the accounting scandals of Enron and WorldCom. Congress hastily passed the Act without a clear understanding all of its provisions.³ Public criticism of Sarbanes-Oxley is widespread, prompting economist and former Chairman of the Federal Reserve Alan Greenspan to describe the Act as a “nightmare,” and conclude that most of its provisions should be scrapped as soon as possible.⁴ New York City Mayor Michael Bloomberg and New York Senator Charles Schumer are concerned that the costs of compliance are helping London and Hong Kong to become the markets of choice for companies making their first public offerings.⁵ Though Sarbanes-Oxley ushered in a range of new regulations, the provision that receives the most attention is Section 404. In the fall of 2006, a blue-ribbon group of prominent independent business executives and academics called for the SEC to ease Section 404’s restrictions, which it concluded are threatening the U.S.’s leadership position in the global capital markets.⁶

While Section 404 requires public companies to establish and maintain an “adequate control structure” and “procedures for financial reporting,” the statute leaves interpreting the meaning of this broad language means to the SEC through its rule-making process.⁷ On its face, the language of Section 404 does not appear to be too demanding:

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3. Romano, supra note 2.
(a) RULES REQUIRED—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Act of 1934 to contain an internal control report, which shall—

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting.

(2) contain an assessment . . . of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING—With respect to the internal control assessment required by subsection (a), each registered accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer.8

In practice, however, the accounting rules adopted under Section 404 have proven very costly. One study estimates that the total average cost of Section 404 compliance for accelerated filers was $2.9 million in 2006.9 This drastically exceeds the SEC's initial estimate that compliance would cost $91,000 per company.10 Although these costs have decreased over time,11 they are still out of line with initial expectations. Moreover, the costs of Section 404 extend beyond merely audit fees: Section 404 creates monitoring

10. Final Report of the Advisory Comm. on Smaller Public Companies to the U.S. Sec. & Exch. Comm'n, Exchange Act Release No. 8666, 71 Fed. Reg. 11090, 11099 (Apr. 23, 2006) [hereinafter Final Report]. The Committee on Capital Market Regulations estimates the costs of implementing and maintaining the internal controls required by Section 404 exceeds initial expectations by a factor of 35. INDEPENDENT COMMITTEE REPORT, supra note 6, at 126. Representative Michael Oxley, a co-drafter of Sarbanes-Oxley, said that compliance costs for companies have proved "more costly than anticipated." Sarbanes-Oxley Audits Too Costly, Regulator Says, INT'L HERALD TRIB., Sept. 20, 2006, at 14. SEC Chairman Cox conceded that the "greater than anticipated costs" of Section 404 compliance are "one notable exception" to the Sarbanes-Oxley's benefits. Id.
11. FEI Survey, supra note 9.
and opportunity costs throughout the corporate structure. Section 404 compliance redirects management from its primary task of generating earnings to the secondary task of overseeing a large accounting endeavor. Both directors and shareholders must spend more time ensuring that management is complying.

If corporate America is pained by the costs of Section 404 compliance, our smallest public companies feel the sharpest sting. Section 404 disproportionately burdens smaller public companies. Some estimate compliance costs smaller public companies 25 times more than it costs the largest public companies, when compliance costs are measured as a percentage of revenue. As a result, smaller companies may be driven out of the public markets by the costs of complying with Section 404. Emerging smaller private companies increasingly forgo a public offering, choosing instead to be sold privately or to list on foreign exchanges with less regulatory burden. Smaller companies that are already public

12. BUTLER & RIBSTEIN, supra note 2, at 50-51.
may choose to "go private" and enjoy regulatory cost savings, or to "go dark" and move to less regulated over-the-counter exchanges.

Thus, mandatory Section 404 compliance is inefficient because the costs of compliance distort companies' decisions about whether to be publicly traded or privately held. Being a public company can offer advantages. All else being equal, a company will prefer having the choice of whether to pursue or forgo those advantages in the public markets. Given these tradeoffs, companies will make the choice they believe maximizes their value. Some argue that if smaller companies cannot afford the costs of being public that Section 404 imposes, then perhaps they should not be public. But where the private costs imposed by Section 404 outweigh the public benefits, the additional costs of compliance can preclude a company from making an otherwise optimal choice about the relative advantages and burdens of being publicly traded. Additional and unnecessary transaction costs further distort this choice. In contrast, when the regulations that govern being a public company impose private costs equal to the public benefit, then the firm's self-interested choices will also be the optimal choices for society. Thus, the aim of Section 404 regulation should be to regulate internal controls only up to the point where private costs equal public benefits. As demonstrated in Part II, optional compliance is such a system.

B. Proposed Reforms

Several reforms have been suggested to address the shortcomings of Section 404. Assuming that legislative action is at best a remote possibility, this Part describes three basic options for regulatory reform: lowering the costs of compliance, increasing the

20. The advantages of being public include increased liquidity, access to future capital, increased public awareness and prestige, the ability to attract and retain employees with liquid stocks and options, and the ability to more easily sell and spread risks.
21. The burdens of being public include the costs of offering public securities, increased regulatory and public scrutiny, management's focus on short-term earnings, and potentially increased monitoring and agency costs.
22. See infra note 59.
benefits of compliance, and adjusting the scope of Section 404’s application.  

1. Lower the Costs of Compliance

One proposed reform is to lower the costs of compliance for smaller public companies. Three possible mechanisms to achieve this include revising the standards that companies and auditors must meet, improving the auditing process, or providing guidance to companies about how to comply in a cost-effective manner. The Government Accountability Office (GAO) and former SEC Chairman Christopher Cox recommend a cost-lowering approach, and the Public Company Accounting Oversight Board (PCAOB) rules attempt to reduce compliance costs through risk-based auditing.

However, cutting costs alone is insufficient to solve the problem. While changing the incentives that lead auditors to over-enforce is commendable, it is unlikely to be a complete solution. Neither is simply scaling back the internal control requirements, because even with reductions in the costs of compliance, significant costs will likely remain. More importantly, even if costs are reduced such that they are economically worthwhile for most public companies, they will not be economically worthwhile for all such companies.

23. See Rose, supra note 19, at 737-47 (discussing proposals to adjust the balance of smaller public companies' benefits and burdens post Sarbanes-Oxley).
25. See id. at 1667-69 (proposing procedures to offset auditors' incentives to push for overcompliance).
26. GAO REPORT, supra note 13, at 58.
27. Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Next Steps for Sarbanes-Oxley Implementation (May 17, 2006), http://www.sec.gov/news/press/2006/2006-75.htm (statement of Chairman Cox) ("By providing practical guidance to companies, by working with the [PCAOB] on their forthcoming revised standard for auditors, and by examining how the PCAOB inspection process is succeeding in increasing the efficiency and cost-effectiveness of the audit process, we will take a giant step toward 'getting it right' when it comes to Section 404 compliance.").
29. Professor Grundfest admits as much. He has said, "This may be a bell that can't be un-rung . . . The audit firms have already incorporated a lot of the inefficient 404 process into their integrated audits, and once audit firms have processes in place, it's very hard to persuade them to back off and ease up on those processes." Kara Scannell & Deborah Solomon, Business Wins Its Battle to Ease A Costly Sarbanes-Oxley Rule, WALL ST. J., Nov. 10, 2006, at A14.
This is true of business regulations generally: we often impose needless burdens on some companies because we believe that applying the regulation broadly is more beneficial, on the whole, than attempting to tailor the regulation more narrowly. However, as discussed in Part II, Section 404 presents a different situation. Here, where the market can reward or punish compliance through the company's share price, an optional compliance rule has the unusual benefit of narrowing the regulation's implementation to only the specific companies for which it is economically desirable.

2. Increase the Benefits of Compliance

Another proposed reform is to increase the benefits of compliance. This solution is not only inadequate, but also wishful thinking. It is inadequate for the reasons that the cutting costs approach is inadequate—increasing benefits in general is unlikely to increase the benefits for every company, and is unlikely to be enough to outweigh the costs. It is wishful thinking because significant increases in the benefits of compliance may not be possible for smaller companies. Internal control systems are essentially monitoring systems. Small companies are likely to benefit less from internal controls than their larger brethren because they have less need for internal monitoring. As the size of a company increases, it becomes more difficult for shareholders, executives, board members, and employees to monitor each other. Smaller companies, by contrast, are typically more close-knit, such that each participant is much more likely to know the actions of the others. In these situations, a monitoring system adds much less value.

3. Change the Companies to which Section 404 Applies

The third solution—and the solution most relevant for this Note—is to carve out exceptions for the companies to which Section 404 applies. The proposal by the SEC's Advisory Committee on Smaller Public Companies (the Advisory Committee) is perhaps the most noteworthy example of this approach. The SEC commissioned the Advisory Committee to investigate the impact of Sarbanes-Oxley on smaller public companies. The Advisory Committee's Final Report (Final Report) is a model for those who advocate exemptive relief to smaller public companies from Sec-

30. Rose, supra note 19, at 737-39.
tion 404's burden. The Final Report recommends, among other things, exempting smaller companies from Section 404 compliance.31 Toward this end, the Final Report identifies certain recommendations as "highest priority."32

These highest priority recommendations can be divided into two parts. The first is to establish a system of scaled regulations, where smaller public companies would be subjected to different regulatory requirements depending on their market size.33 The second is that microcap and smallcap companies, or companies with market capitalizations less than $787.1 million, should be exempted from the requirements of Section 404 compliance "[u]nless and until a framework for assessing internal control over financial reporting for [smaller public] companies is developed that recognizes the characteristics and needs of those companies."34

The Advisory Committee meant for its approach to complement any cost-reducing solutions, but the Final Report is cautious not to put too much faith in cost cutting. Consequently, it recommends that the SEC allow the small company exemption unless and until a cost-reducing solution becomes viable. The SEC has not yet followed the Advisory Committee's recommendation to exempt smaller public companies.

31. Final Report, supra note 10, at 11092-94. The independently organized Committee on Capital Markets Regulation endorsed a more narrow approach. INDEPENDENT COMMITTEE REPORT, supra note 6, at 133.
33. Id. at 11092 (data in table). Microcap companies, the smallest on the proposed scale, are those with a market capitalization of less than $128.2 million. Such companies represent 52.6 percent of all U.S. public companies and 1 percent of total U.S. equity market capitalization. Smallcap companies are those with a market capitalization between $128.2 million and $787.1 million (inclusive), representing 25.9 percent of all U.S. public companies and 5 percent of total U.S. equity market capitalization. Combined, the smaller public companies (i.e. microcap and smallcap companies) that the Committee recommends be given favorable treatment represent only 6 percent of the total U.S. equity market, but 78.5 percent of all the public companies in this country. Id. The Committee recommends lesser requirements for both microcap and smallcap companies.
34. Id. at 11093. Microcap companies would be afforded complete Section 404 exemption, while smallcap companies would be afforded "relief from external auditor involvement in the Section 404 process . . . ." Id. Skeptics cite the fact that four out of every five of public companies would be exempted under this proposal. This is a bit misleading: smaller public companies represent a far smaller risk to the economy that the number of companies suggests. "In all, the exemption would cover firms accounting for only 6 percent of total American stock market value, leaving 94 percent of public companies by value still subject to Section 404." The Trial of Sarbanes-Oxley, ECONOMIST, Apr. 22, 2006, at 60.
II. ECONOMIC ARGUMENT FOR AN OPT-OUT SYSTEM

Optional Section 404 compliance—that is, allowing each company to choose whether the internal control standards set by the PCAOB are appropriate for its situation—is economically preferable to mandatory compliance for smaller public companies. After reviewing the costs and benefits of Section 404 compliance, Part II.A develops an economic framework that explains a company's choice to comply when compliance is optional. In short, companies choose to comply when it maximizes their shareholders' benefits. Thus, mandatory compliance is unnecessary to protect the shareholders' interests. Moreover, optional compliance for individual companies is preferable regardless of the actual effect compliance has on share prices in the aggregate. Part II.B discusses how shareholders internalize the costs of Section 404 compliance. Because shareholders internalize compliance costs, they may exercise greater oversight over the management and thus alleviate some of the concerns that arise when the management's incentives diverge from those of the shareholders. Part II.C explains why auditor certification of a company's Section 404 compliance adds value and solves a market information problem that existed prior to the passage of Sarbanes-Oxley. Finally, Part II.D argues that optional compliance is best suited to smaller companies.

A. Choosing to Comply

The choice to comply with optional internal controls, as defined by the PCAOB, is an economic decision. Stated simply, companies balance the costs and benefits of compliance and pursue the choice that maximizes their share value. Investors need not worry because companies will choose to comply when the investors value it. This is, of course, a simplified view of the economics—it assumes away some of the thornier problems like agency costs or the possibility of a private solution. These various problems will be addressed in turn; the more nettlesome issues are best addressed, however, only after first laying a basic economic foundation.

The direct costs of compliance with Section 404 include creating, maintaining, and auditing internal controls. Indirect costs to society include companies delisting when regulations are too burdensome and losing companies who choose to list abroad.35 Opportunity costs exist too, as management's attention is diverted

35. BUTLER & RIBSTEIN, supra note 2, at 88.
from its core concerns of delivering strong earnings and innovation is lost because companies must channel resources into compliance. Though direct costs have fallen over time,\footnote{FEI Survey, supra note 9.} they are likely to remain significant.

Compliance also has its benefits. It is easier to monitor and prevent fraud when good internal controls are in place.\footnote{Although internal controls prevent fraud, we should not attempt to abolish all fraud—rather, there is an optimal amount of fraud. When the benefits of good internal controls are greater than the losses caused by fraud, then more and better accounting is desirable up until the benefits equal the costs. See Butler & Ribstein, supra note 2; Carney, supra note 16, at 1.} Shareholders are spared the trouble of investigating the company’s internal controls, and are able to rely on the auditor’s attestation that the controls meet at least a certain minimum standard. Thus, by themselves, good internal controls should make the company more valuable, and if the benefits of compliance outweigh the costs, the company’s share price will reflect it.

A company’s share price will reflect whether there is a net benefit or a net cost of compliance for that individual company. If the market values good accounting practices more than it costs to implement them, the share price will rise; if the costs outweigh the benefits, the share price will fall. In this way, the market disciplines managers to carefully decide whether to adopt internal control measures. Managers will respond to the wishes of the shareholders, and the market pays for compliance in precisely those companies that benefit from it the most.

Of course, the market will not always perfectly value compliance. Financial markets are prone at times to make mistakes—to over or underestimate the value of a change in the company. There is much literature on the degree to which markets really do incorporate new information, some of which suggests that markets do not seem to take notice of changes in corporate governance.\footnote{Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs, 17 J.L. Econ. & Org. 83 (2001) (arguing that the market does not seem to value antitakeover provisions in IPOs).} Addressing these issues is beyond the scope of this Note. However, the argument for optional Section 404 compliance only assumes that the markets roughly and approximately value good internal controls most of the time. It is fair to assume that the market will sometimes fail to fully value internal controls, and that some companies for which additional internal controls are undervalued by the market will not have the economic incentive to adopt otherwise socially beneficial internal controls. Nonetheless, if there are real economic costs when the markets fail to accurately value
internal controls, this Note assumes that such costs are outweighed by those associated with overregulating small companies with mandatory compliance.

If compliance is optional, the choice of whether to comply is an economic one. Familiar economic concepts help illustrate this choice. The analysis clarifies not only that mandatory compliance is inefficient, but also that optional compliance increases shareholder welfare. A series of graphs demonstrates the idea.

**Figure 1**

![Figure 1](image)

Figure 1 represents a company's internal control decision when there are no mandatory internal control regulations. Each firm has unique marginal cost and marginal benefit curves depending on their individual circumstances, denoted by MC and MB. Absent regulation, a firm will maximize its value and thus its share price where the marginal cost curve meets the marginal benefit curve. The benefit-optimizing equilibrium is denoted by $c^*$. This is the rational level of internal controls that a company will produce without regulation. This natural equilibrium could be more or less than the level of controls required by mandatory Section 404 compliance.

Internal controls can be inefficient, however, whenever a company maintains internal controls different from the equilibrium denoted by $c^*$ in Figure 1. While it is possible that a company could either over or underproduce internal controls, the latter is of little concern because a company underproducing internal controls will correct itself naturally, as it benefits from doing so. A

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39. At any point to the left of $c^*$, there is still a benefit to be gained by adding internal controls, because the marginal benefit of an additional control exceeds the marginal cost. At any point to the right, the marginal cost of each control exceeds the marginal benefit.
more serious concern arises where regulations, like mandatory Section 404 compliance, force a company to overproduce internal controls, but do not allow for a self-correction because they are mandatory.

Figure 2 illustrates the inefficiency of mandatory Section 404 compliance. The graph depicts two companies with the same marginal cost curve for internal controls, but different marginal benefit curves. The level of internal controls required by Section 404 is denoted by $c$. One of these companies, represented by $MB_1$, benefits greatly from internal controls. This company maximizes its benefits with internal controls exceeding those required by Section 404, and it will implement controls at that level. The other company, represented by $MB_2$, benefits much less from internal controls. This company's optimal level of internal controls is less than what is required by Section 404. The problem for this second company is that, unlike the first company, it cannot choose to implement controls at its natural equilibrium. The result is that Section 404 forces the second company to overinvest in internal controls. The same dynamic could also occur for two companies with different marginal cost curves. Because different companies have different costs and benefits associated with internal controls, mandatory compliance forces some companies to overinvest in internal controls, resulting in inefficient deadweight loss.

Since the optimal level of controls is different for each company, the SEC should create rules allowing each company to adopt a level of internal controls suited to their individual situation. In other words, under optional compliance each company will naturally tend to adopt internal controls at the economically optimal level.
Optional compliance for individual companies is desirable regardless of how Section 404 compliance actually affects aggregate share prices. The aggregate effect of Sarbanes-Oxley on share prices is an open empirical question. Some studies suggest that compliance has an overall positive effect on U.S. public share prices; others suggest the opposite conclusion. While we are short of a final answer, either conclusion supports the economic allure of an opt-out system. This is because the cost-benefit compliance decision is unique for each company, and it is difficult for an outsider like the SEC to determine where that optimal level of internal controls lies. Thus, optional compliance is desirable because it allows companies who are best able to assess the marginal costs and benefits of compliance to do so. Even if the overall effect of Section 404 compliance is downward pressure on share prices, some individual companies will still enjoy a share price increase. These companies will choose to comply.

B. Internalizing Compliance

Mandatory Section 404 compliance is not appropriate for small public companies. Mandatory rules are more efficient than optional rules only when an actor does not internalize the costs or benefits of its behavior and transaction costs preclude the parties from negotiating a resolution. A well-structured mandatory rule forces an actor to take a more socially desirable action than would otherwise be in their private interest. Optional rules, on the other hand, are preferred when an actor internalizes the consequences of its actions. When consequences are fully internalized, a com-

41. See Peter Iliev, The Effect of the Sarbanes-Oxley Act (Section 404) on Audit Fees, Accruals and Stock Returns 27 (Brown Univ. Working Paper, 2007), available at http://www.econ.brown.edu/econ/events/SoxA.pdf (finding evidence that small firms that filed Section 404 management reports had lower share prices). Other research has examined the empirical effect of Sarbanes-Oxley compliance on cross-listed foreign companies. Kate Litvak, Sarbanes-Oxley and the Cross-Listing, 105 MICH. L. REV. 1857, 1876-79, 1882 (2007) (finding evidence that compliance has had a net negative effect on the share prices of cross-listed foreign companies).
42. See Haidan Li, Morton P.K. Pincus & Sonja O. Rego, Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002 and Earnings Management, 51 J.L. & ECON. 111, 125-28 (2008) (finding evidence that compliance has had a stronger positive share price effect on companies previously engaged in greater levels of earnings management); Litvak, supra note 41 at 1897-98 (finding that evidence is consistent with the view that investors expected Sarbanes-Oxley to have greater costs than benefits, especially for smaller and already well-governed firms).
pany's self-interested choice whether to follow the optional rule will correlate with overall shareholder welfare. Before giving companies the choice about whether to comply, then, it is fair to ask whether is the company's decision has some costs externalized or some benefits not internalized. Even if such market distortions exist, it is fair to ask whether they outweigh the economic benefits of optional compliance, such that a mandatory rule would better serve shareholder interests.

The tradeoff between creating mandatory and optional rules of compliance can be described in terms of the relative benefits and costs of compliance. The total shareholder benefit of internal controls (TB) is a function of the level of internal controls. As the level of internal controls increases, total shareholder benefits increase. Similarly, the total cost of internal controls (TC) is also an increasing function of the level of internal controls. Economic theory tells us that the difference between the sum of benefits and the costs will be maximized at the point where MB equals MC, and thus that represents the optimal level of internal controls that the company will adopt. However, the concern is that without any other incentives, managers and shareholders of a company may have different TB curves for internal controls, such that a manager maximizes his net benefits at \( C_1 \) (where \( MB_1 \) intersects MC), while shareholders' optimal level of internal controls is at \( C_2 \) (where \( MB_2 \) intersects MC). Figure 3 illustrates this idea, with marginal benefit and cost represented as tangent lines to total benefit and cost. The fact that \( C_2 > C_1 \) indicates that there is an agency problem.

**Figure 3**

The structure of the shareholder-management relationship partially alleviates this concern. We might worry that management is
reluctant to adopt stringent internal controls voluntarily because these controls impose costs on management, while benefits accrue primarily to the shareholders. For shareholders, however, this is not a large concern. Shareholders have direct ownership of the company, and management’s compensation is typically tied to the company’s financial performance. Because of their direct ownership, shareholders internalize both the benefits of internal controls and the costs of fraud. Acting through the board of directors, shareholders will reward managers for implementing internal controls when the benefits to the shareholders outweigh the costs. That is the carrot. But shareholders also carry a stick: not only can they reward managers who increase the value of the company by adopting efficient controls, but they can also fire managers who do not. Additionally, shareholders are in a relatively strong position to reign in management through the proxy process and their board of directors to reduce any residual agency costs.

This is not to say that no transaction costs exist, or that shareholders are always able to quickly and easily remove non-compliant managers.Removing entrenched management can be a difficult battle, especially in companies without a dominant or controlling shareholder. The argument is only that shareholders do exert significant control over managers and they will use it to align management interests with their own. Put differently, it is too optimistic to think that the carrot and the stick mechanisms will create enough pressures for \( C_1 \) to equal \( C_2 \). More realistically, the carrot and the stick will put pressure on managers such that the gap between \( C_1 \) and \( C_2 \) is minimal, especially in smaller companies. It is unlikely that the costs of this gap will outweigh the other economic benefits of optional compliance.

C. Incomplete Information and the Private Market for Internal Controls

Auditor certification, as required by Section 404(b), solves a problem of incomplete market information. Internal controls are complicated. Learning about and making sense of a company’s

44. See, e.g., The Conference Bd. Comm’n on Pub. Trust and Private Enter., Findings and Recommendations 6 n.3 (2003) (on file with the University of Michigan Journal of Law Reform), available at http://www.conference-board.org/pdf_free/SR-03-04.pdf (“S&P data show that 79 percent of the increase in median CEO compensation from 1992 to 2000 was due to growth in long-term incentives, primarily stock options. In 1992 options were 27 percent of median CEO compensation, whereas by 2000 options were 60 percent of median CEO compensation.”).

controls is time-consuming and expensive. Thus the market often has incomplete information because investors cannot understand a company's internal controls without expending great resources. Consequently, the market cannot effectively price Section 404 compliance on its own. However, auditor certification adds value to the market because it serves as shorthand that internal controls are "good enough," signaling that they meet at least a minimum standard. It relieves the investors' burden of uncovering this information on their own, and it standardizes accounting in terms with which investors are familiar.46

Some free market-minded thinkers may ask why the SEC should be involved in certification at all. They might suggest that certification is superfluous: if the market values standardized markers of compliance, they would arise on their own—perhaps with private enterprises rating the quality of a company's internal controls.47

This argument is fallacious, despite the initial appeal of its logic, because it assumes that information about companies' internal controls is readily available, or at least that a private individual's effort to uncover and disseminate this information is just as effective as a public effort. This assumption is incorrect. Internal control accounting is complex and ambiguous, making it difficult to analyze, let alone price. Obtaining accounting data takes time and effort. The effort is inefficiently duplicated when multiple investors spend time independently uncovering the same information. Without expending individual resources to obtain and analyze this information, an investor will have incomplete information. An investor will not be willing to expend such resources if the value of the information is low relative to the costs of obtaining it. Certification is a signal to the market that ameliorates this information deficiency without promoting wasteful and duplicative


47. Bond-rating agencies may provide an approximate illustration of private internal controls ratings. However, it is a mistake to draw too close a comparison. Bond issuers themselves pay for the bond-rating agency's service. It is not clear that the same structural reasons exist for internal controls (public companies must have their bonds rated in order to sell them into the bond markets). Moreover, bond-rating agencies rely heavily on public information in calculating ratings; in sharp contrast, far less public information is available with regard to companies' internal controls.
private efforts. When internal control standards are publically certified, it lowers the information gathering costs for all investors.

Not only does the imperfect information about internal controls suggest SEC regulation is needed, but also asking the question about what prevented a private market from arising reveals the need for regulation of some companies. If standardized markers of good internal controls have market value, why did they not arise before Sarbanes-Oxley? One answer might be to simply deny the presumption that internal controls add any value to any companies. This stubborn tack is not in line with the evidence.\(^4\) Another answer might be to blame agency costs as the culprit, suggesting that management has perverse incentives to obstruct internal accounting reforms. This explanation is also unsatisfactory for the same reasons described in Part II.B related to how shareholders exert influence over management to encourage the adoption of internal controls. The third answer is that for some companies, the benefits of Section 404-type internal controls outweigh the costs, but market failures such as the availability of internal company information and the costs of private investigation, prevent this type of private market from arising on its own.\(^5\) Moreover, and perhaps most importantly, even if we assume arguendo that private systems of Section 404-like internal controls should have arisen on their own if the costs of creating such systems outweigh the total benefits companies choosing to comply would receive, the SEC simply does not have the authority to abolish the statute. Even if Section 404 were overall a bad policy, given the legal and political realities of this issue, optional compliance is the best approach for the SEC to adopt within its authority.

Companies' choices about whether to comply with Section 404 become more nuanced when we consider the signaling benefit of certification. As mentioned above, auditor certification adds value by curing an information deficiency and signaling to the market

\(^{48}\) See, e.g., Li et al., supra note 42.

\(^{49}\) There is an interesting fourth possibility—that although a system of internal controls was prohibitively expensive to create privately before Sarbanes-Oxley was enacted, it could now arise on its own if Sarbanes-Oxley was abandoned. The current system of Section 404 controls could serve as an effective research subsidy to private parties enacting a system of certified control. The current Section 404 controls were created at great expense by the SEC and PCAOB. It required a large investment of time and taxpayer money to create them. If Sarbanes-Oxley was abandoned, private parties could simply copy the controls the government has laboriously drafted. Also, we could arguably expect more parties to be interested in such internal controls now, as many have already paid the high initial fixed cost of implementing compliance, and would now only face the lesser variable cost of maintaining it. As such, it is at least conceptually possible that if Section 404 were repealed, private agencies could arise where they would not have arisen had Section 404 never been enacted. This remains a titillating possibility, but is not explored further in this Note.
that the company’s controls meet a certain minimum standard. The result is that a company’s marginal benefit jumps when it crosses the threshold of compliance; at the level of internal controls required for auditor certification, a momentary spike in the marginal benefit curve occurs as the market values the standardized signal. Figure 4 represents this jump.

**Figure 4**

![Marginal Benefit with Jump](image)

Figure 5 traces the same concept using total cost and benefit curves.

**Figure 5**

![Total Cost and Benefit](image)

Certifying compliance will thus encourage additional internal controls because it confers two benefits to companies for increasing
internal controls. First, each incremental additional control benefits the company by reducing errors and fraud. Second, once the incremental controls cross the threshold of certification, the company gains a one-time boost that comes from a signal to the market that their controls meet a minimum threshold. Because of this one-time jump in marginal benefit, some companies will produce internal controls that exceed their natural equilibrium in the absence of regulations and auditor certification. Whether a company will cross this threshold depends on the difference between the additional benefit of the jump and the additional costs of creating internal controls to reach the threshold of compliance. If the jump in benefit is greater than the additional costs, then the company will choose compliance and create internal controls exceeding those that it might otherwise adopt in an unregulated state.

Finally, note that certification only creates signaling value for companies that comply with Section 404. For companies that choose not to comply, investors will still face information deficiencies and will need to expend resources to obtain and analyze this information. Thus, even though Section 404 compliance should be optional because it is more economically efficient, perhaps the SEC should consider a lesser level of mandatory internal controls disclosure, which may be a beneficial alternative for companies that opt out.

D. Opting Out

On balance, an opt-out regime is preferable to an opt-in regime for Section 404 compliance. Opt-out rules can create a certain "stickiness" that aligns corporate norms with policy objectives. This stickiness can be made more adhesive by requiring the board to

50. A unique aspect of auditor certification is that it is not a graduated benefit, but a one-time gain. Certification is a binary signal to the market—it offers no benefit before the company certifies, but it offers its full benefit after the company certifies. A company gradually accrues the benefits of additional internal controls that prevent internal fraud and receives an additional benefit when internal controls reach the point that satisfies auditor certification. However, a market will not be perfectly efficient when marginal costs and marginal benefits are not able to align. In other words, opportunities for inefficiency exist where the shareholders would be willing to pay a higher share price for some improvement in internal controls, so long as that improvement could be certified. A shareholder would want this incremental certification even if it fell short of full Section 404 compliance. Thus, a true welfare-maximizing system would offer graduated benefits for graduated levels of certified compliance; a small improvement in internal controls would be accompanied by a proportional recognition by the SEC, and thereby a small benefit to the company in the market for its shares would follow. While this graduated approach works in this simple analysis, the transaction costs of actually implementing it would be high.
solicit shareholder approval before the company can opt out. This stickiness may counteract some residual agency costs when management assumes the hassle and risk of compliance. Thus if the objective is to maximize the number of companies complying, than an opt-out system is preferable.

There are also several arguments in favor of an opt-in system. An opt-in system is also less paternalistic, allowing the individual company and its shareholders to determine the appropriate time to participate. At least initially, a large number of smaller public companies may choose not to set up internal controls. If so, then an opt-in system might better align the presumptions of the law with the realities of compliance, and thereby reduce transaction costs. Thus, reasonable arguments exist for either an opt-in or an opt-out system of compliance. Given the balance of these interests and the current political realities, this Note argues for an opt-out system. Nothing in this argument, however, is inconsistent with establishing an opt-in system instead.

E. Smaller Companies

Optional compliance should be available only to smaller public companies. We should pause to ask whether to extend optional compliance to all companies—large and small—or whether it should be available only to smaller companies. At first glance it seems that the full force of the economic argument above supports optional compliance for all companies. Also, there is evidence that if only smaller companies are exempted, it will encourage them to stay ineffectively small, thus suggesting that perhaps large companies should be exempted as well. These are forceful observations, but there are important distinctions here between large and small public companies. First, Congress passed Sarbanes-Oxley in the wake of some of the largest corporate scandals in recent history, with the purpose and intent of reigning in abuses at the country's largest public companies. Second, the public is likely to expect regulators to be particularly vigilant about control of the largest companies. Third, an opt-out system makes sense when the market segment

51. Roberta Romano favors opt-ins over opt-outs for Sarbanes-Oxley generally, as she doubts that most companies would adopt many of Sarbanes-Oxley's provisions at all. Romano, supra note 2, at 1596.
53. See infra Part III.B.
being regulated is highly variable in its reaction to the rule. Optional compliance has the most appeal when individual companies have widely varying compliance costs and benefits, and are able to make individual decisions that maximize the value of their particular situation. Smaller public companies are more highly variable in their reaction to Section 404 than are their larger brethren. As such, optional compliance is most appropriate for smaller companies.

III. Statutory Considerations

Not only is optional compliance for smaller companies good policy, but also the SEC has the legal authority to create it. Part III argues that this exemptive authority stems from the text and legislative intent of Sarbanes-Oxley. As explained in Part III.A, the text of Sarbanes-Oxley, read in combination with the Securities Exchange Act of 1934 (Exchange Act), gives the SEC exemptive authority for Section 404. Part III.B looks at the intent of Congress in enacting Sarbanes-Oxley, and explains that Congress was concerned not with smaller companies, but with large ones. Furthermore, contrary to current realities, Congress did not intend for Section 404 to increase companies' auditing costs.

A. Interpreting the Statutory Text

The text and statutory structure of Section 404 authorize the SEC to enact optional compliance. Representative Michael Oxley and SEC Chairman Christopher Cox both suggest that the SEC has the authority to enact a solution through its rulemaking process. Representative Oxley told the SEC they have the authority to mitigate the impact of Sarbanes-Oxley on smaller public companies, rebutting the argument put forth by the dissenters in the Final Report. Oxley believes such authority comes from both Section 36(a) of the Exchange Act and Section 3(a) of Sarbanes-Oxley,

and he suggests that because Congress is not slated to revise the legislation, the SEC should "proceed as it deems appropriate." Similarly, Chairman Cox suggests that the SEC has "ample authority" to fix the problems of Section 404 without Congress enacting any new laws.

A small number of detractors disagree and argue that the SEC lacks the legal authority to enact the Final Report's exemptive recommendations. In a letter written to the Advisory Committee, Professor James Cox argued that the SEC does not have exemptive authority under Section 404. He insisted that Section 404 was not an amendment to the Exchange Act, but rather a statutory section that stands alone. He argued that Section 36(a) of the Exchange Act did not give the SEC exemptive authority for Section 404 in the way it does for provisions under the Exchange Act. He pointed to the language of Section 36(a) of the Exchange Act, which limits its grant of exemptive authority only to "provisions of this title," and suggested that this provision refers only to Title I of the Exchange Act. Had Congress intended Section 404 to be subject to the Exchange Act's qualifications and exemptions, he writes, Congress should have written it as an amendment to Section 13(b)(2). His argument concludes that Congress intended no exemption to Section 404 because it used language that the SEC "prescribe rules

60. E.g., Final Report, supra note 10, at 11129 (dissenting statement of Kurt Schacht) ("It is unclear to many whether the broad exemptive recommendations of the [Advisory Committee] are even within the commission's legal authority. Comprehensive, sweeping exemptions from Section 404 may not be possible under the current legislation, which specifically excluded Section 404 of the Securities and Exchange Act of 1934."); Letter from Brainerd Currie Professor of Law James D. Cox et al. to Christopher Cox, Chairman of the SEC (Mar. 21, 2006) (on file with the University of Michigan Journal of Law Reform) [hereinafter Letter from Prof. James Cox to Chairman Christopher Cox], available at http://www.sec.gov/rules/other/265-23/26523-309.pdf ("It is our opinion that section 36(a) of the Securities Exchange Act, or for that matter section 5(a) of Sarbanes-Oxley, does not empower the SEC to exempt issuers from section 404 of Sarbanes-Oxley.").
61. Letter from Prof. James Cox to Chairman Christopher Cox, supra note 60.
62. Id.
63. Id.
64. Id.
65. Id.
requiring each annual report” to contain assessments of internal controls.66

Professor Cox’s argument fails because it misinterprets the structure of the statute. Section 404 of Sarbanes-Oxley is textually incorporated into the Exchange Act, and is thereby afforded the same exemptive possibilities as other provisions in that Act. Section 404 is necessarily intertwined with the internal reporting prescribed by the Exchange Act. Before Section 404 existed, Section 13(b)(2)(B) of the Exchange Act required issuers to maintain internal controls.67 In other words, Section 13(b)(2)(B) mandated the internal controls requirement in the first place—Section 404 merely adds the management report and auditor attestation requirements. Despite Professor Cox’s assertion to the contrary, Section 404 does not stand alone.

The in pari materia canon of construction clarifies this statutory scheme. It applies when two statutes that were enacted at different times pertain to the same subject.68 Statutes in pari materia must be interpreted in light of each other since they have a common purpose. When a provision is included in one Act but omitted in another, we incorporate the former into the latter if the purposes of the two Acts are consistent.69 Since Section 404 and Section 13(b)(2)(B) govern the same subject matter and contain similar language, the canon states that they must be interpreted in light of one another.70

This concept is familiar to securities law. In Axelrod & Co. v. Kordich, Victor & Neufeld, for example, the Second Circuit held that the Securities Act71 and the Exchange Act “are in pari materia and should be construed together as one body of law.”72 In doing so, the court relied on the similar wording of the relevant provisions in the two Acts. It affirmed precedent, finding that the relevant provision of the Exchange Act was “supplementary” to the similarly worded section of the Securities Act, and that the “same logic” ap-

66. Id.
68. 2B SUTHERLAND STATUTORY CONSTRUCTION § 51.02 (6th ed. 2000).
69. Id.
70. Id. § 51.03.
plied to both statutes. The court concluded that reading the two acts as one body of law "is reasonable, logical and in accord with the intent of Congress." In another case, the Supreme Court relied on the same principle to hold that "security" as defined under the Exchange Act is interpreted in light of the Securities Act.

The Supreme Court has also applied the in pari materia construction to similar statutory terms in other Acts that govern securities. In Schreiber v. Burlington Northern, Inc., the Court incorporated parts of the Williams Act into the Exchange Act. This general view of the securities law has led the Court to explain that "the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen."

This approach applies to the two related provisions at hand. Section 404 and Section 13(b)(2)(B) contain very similar language. This is no coincidence, as they are meant to jointly govern management's oversight of internal controls. Section 13(b)(2)(B) requires each issuer to "maintain a system of internal accounting controls" to ensure that "transactions are executed in accordance with management's ... authorization." Adding to this, Section 404 requires an "internal control report" that states "the responsibility of

73. Id. (quoting Moran v. Paine, Webber, Jackson & Curtis, 389 F.2d 242, 245 (3d Cir. 1968)).
74. Id.
75. Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967) (footnotes and citation omitted) ("This case presents the Court with its first opportunity to construe [the definition of 'security' in Section 3(a)(10) of the 1934 Act]. But we do not start with a blank slate. The Securities Act of 1933 ... contains a definition of security virtually identical to that contained in the 1934 Act. Consequently, we are aided in our task by our prior decisions which have considered the meaning of security under the 1933 Act.").
77. Schreiber v. Burlington N., Inc., 472 U.S. 1 (1985). The Court's analysis noted the language "fraudulent, deceptive or manipulative acts or practices" in Section 14(e) of the Williams Act, and explained that since Section 10(b) of the Exchange Act contained the similar phrase "manipulative or deceptive device or contrivance," Sections 10(b) and 14(e) were to be construed together. Id. at 5-8.
management for establishing and maintaining an adequate internal control structure.\textsuperscript{80}

Representative Oxley stated the argument even more broadly, suggesting not only that we must interpret Section 404 in light of the Exchange Act, but also that we must interpret all of Sarbanes-Oxley this way.\textsuperscript{81} Whether Representative Oxley is correct in his broader analysis of Sarbanes-Oxley, Section 404 clearly governs the same matter of internal controls as Section 13(b)(2)(B). The Exchange Act plainly grants the SEC broad authority to exempt internal controls under the general authority of Section 36(a),\textsuperscript{82} as well as the narrower authority of Section 13(6).\textsuperscript{83} Thus, just as the SEC has exemptive authority under Section 13(b)(2)(B), so too does it under the derivative rule of Section 404.

This construction makes sense. If the SEC has authority to exempt companies from internal controls under the Exchange Act, to lack the corresponding authority under Section 404 would be inconsistent. If the SEC can excuse internal controls compliance, then it must be able to excuse management’s assessment and the auditor’s attestation of those same controls. To reason otherwise would render meaningless the SEC’s ability to exempt companies under Section 13(b)(2)(B). It would imply that whenever the SEC grants a company an exemption under Section 13(b)(2)(B), the company would enjoy a legal exemption while simultaneously vio-


\textsuperscript{81} Oxley-Baker Letter, supra note 54 (“[T]he Exchange Act and the Sarbanes-Oxley Act must be constructed together as they relate to the same subject matter under the legal cannon of construction in pari materia.”).

\textsuperscript{82} Section 36(a), which grants the SEC authority to exempt companies under the Exchange Act, generally reads:

\begin{quote}
[Except as related to Section 15(c) of the Exchange Act,] the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.
\end{quote}


\textsuperscript{83} Section 13(6), which grants the SEC authority to exempt companies from Section 13, reads:

\begin{quote}
The Commission, by rule, regulation, or order, consistent with the purposes of this title, may exempt any person or class of persons or any transaction or class of transactions, either conditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection, and the rules and regulations thereunder.
\end{quote}

lating Section 404. Congress did not intend this odd and internally inconsistent result.

Lastly, the SEC's exemptive authority is buttressed by Sarbanes-Oxley's broad grant to that agency. Section 3(a) of Sarbanes-Oxley grants the SEC the authority to "promulgate such rules and regulations . . . as may be necessary or appropriate in the public interest or for the protection of investors." Congress likely made such a broad grant because it recognized that the SEC is better able to govern this technical area and that the agency might encounter difficult and unforeseen problems in Sarbanes-Oxley's implementation. As such, the relief of optional compliance—which best serves the interests of investors and the public generally—is exactly the sort of rulemaking power Congress meant the SEC to have.

B. Congressional Record

Congressional records display intent to regulate large companies, not small ones. Congress enacted Sarbanes-Oxley in response to accounting scandals at Enron and WorldCom—two of the largest companies in America. The national public concern with these mega-scandals, and their effect in getting this "emergency legislation" rushed to cloture, is well known. Accounting at smaller companies was of little concern to Congress. As an illustration, consider the Senators' statements after Congress introduced the bill. In explaining why Congress should enact these reforms, the Senators mentioned Enron forty-six times, WorldCom thirty-two times, Global Crossing nine times, General Motors six times, Arthur Andersen six times, Xerox four times, and Tyco three times. In comparison, the Senators mentioned "small company," "small companies," and "smallest companies," only five times, collectively, and even then only to point out that rules created for large companies are burdensome and should apply differently to small companies.

The legislative history of Sarbanes-Oxley also shows that Congress did not intend Section 404 to significantly raise the costs of doing business as a public company. Language from the Senate

85. See Romano, supra note 2.
87. Id. at S6335 (statement of Sen. Gramm) ("[G]iving the board the ability to set a principle and apply it in one way to General Motors and in another way to a small company in a small town makes eminently good sense in practice.").
Committee Report accompanying the floor debate makes this clear:

In requiring the registered public accounting firm preparing the audit report to attest to and report on management's assessment of internal controls, the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees.\(^8\)

In fact, auditor attestation of Section 404 has greatly increased auditing fees—a direct contradiction of Congress's intent and belief that the costs of compliance would be negligible. It seems then that the implementation of Section 404 is contrary to the expressed desire of Congress. Responsibility lies with the SEC to set Section 404 back on the path that Congress intended.

Thus, the SEC has the legal authority to create Section 404 exemptions. Not only does the SEC have the requisite legal authority, but also there are compelling reasons for the SEC to exempt smaller public companies. The current costly implementation of Section 404 is contrary to expressed legislative intent not to increase the costs of auditing fees. Additionally, Congress passed Sarbanes-Oxley out of concern for accounting at larger companies, not smaller ones. For these reasons, it is both legal and appropriate for the SEC to adopt a system of optional Section 404 compliance for smaller public companies.

Finally, although this Note argues for optional compliance for smaller public companies, optional compliance does not mean smaller public companies get off scot-free. Allowing smaller companies to opt out of Section 404 does not mean they will be allowed to opt out of all internal controls regulations. A company opting out of Section 404 will still be bound by the lesser internal controls requirements of the Exchange Act,\(^9\) as well as state internal controls laws such as Caremark in Delaware.\(^9\)

**Conclusion**

The SEC should adopt optional Section 404 compliance for smaller public companies. Optional compliance eliminates the

\(^8\) S. Rep. No. 107-205, at 31 (2002) (emphases added); see also 15 U.S.C. § 7262(b) (2002) (stating that a Section 404 audit "shall not be the subject of a separate engagement").

deadweight loss created by the current mandatory rule. Because the market rewards compliance when the benefits outweigh the cost, optional compliance promotes compliance in precisely the companies for which it is most valuable. While Section 404 does not need to be mandatory to be effective, its very existence nonetheless creates value by prescribing a uniform set of good accounting practices by which investors can evaluate internal controls. This uniform set of rules, combined with auditor attestation of compliance, is economically valuable because it reduces the information problem in the market for internal controls. Finally, the SEC has the legal authority to create an exemptive rule for smaller companies, and should do so to carry out Congress' original intentions.