



April 27, 2006

Via Facsimile and Electronic Mail

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.W.
Washington, DC 20549

Re: File Number 4-511; Internal Control Roundtable.

Dear Chairman Cox:

The U.S. Small Business Administration’s Office of Advocacy (“Advocacy”) is submitting this letter in response to the U.S. Securities and Exchange Commission’s (“SEC”) request for comments on compliance experience with section 404 of the Sarbanes Oxley Act of 2002.¹ Advocacy believes that new section 404 internal control reporting requirements are imposing large and disproportionate costs on smaller companies, and are likely to present major barriers for smaller public companies seeking capital, perhaps to such an extent that their application to small issuers would prevent small businesses entirely from accessing U.S. capital markets. Therefore, Advocacy supports the recommendations of the SEC’s Advisory Committee on Smaller Public Companies (“Advisory Committee”).

I. SEC Should Not Impose Disproportionate Burdens on Smaller Companies by Excluding them from Access to Capital Markets.

The Office of Advocacy was created, in part, to recommend specific measures for creating an environment in which businesses will have the opportunity to compete effectively and expand to their full potential.² In this case, specifically, the Office of Advocacy believes that American capital markets must remain open and accessible to smaller, entrepreneurial companies that seek to grow and compete with large companies on an even playing field.

The Regulatory Flexibility Act of 1980³ was passed for the express purpose of avoiding the one-size-fits-all approach that too often winds up imposing disproportionate regulatory burdens on

¹ *Sarbanes Oxley Act of 2002*, Pub. L. No. 107-204, 116 Stat. 745 (2002).

² 15 U.S.C. § 634b(9).

³ *Regulatory Flexibility Act of 1980*, Pub. L. No. 96-354, 94 Stat. 1164 (1980) (codified as amended at 5 U.S.C. § 601 et seq.). Advocacy is charged under the statute with overseeing agency compliance with the RFA. 5 U.S.C. § 612.

small business and erects barriers to market entry and fair competition.⁴ Recently, some commenters have stated a preference for ignoring such disproportionate impacts, even if they would have the effect of excluding small firms from capital markets entirely.⁵ Advocacy believes that restrictions on access to capital will have a potentially negative effect on small businesses and their ability to contribute new jobs and innovations to the economy.

II. The Evidence Solicited by the Advisory Committee Establishes that Application of Section 404 Reporting Requirements to Non-Accelerated Filers Will Impose Major Obstacles for Access to Capital by Small Business.

The evidence in the record for consideration of the Advisory Committee's recommendations establishes that the extension of section 404 reporting requirements to smaller and non-accelerated filers will impose major obstacles in access to capital. Surveys of actual Sarbanes Oxley section 404 costs indicate that annual small company compliance costs approach \$1,000,000. For example, Financial Executives International's most recent quarterly survey, completed in March of this year, shows that non-accelerated filers each spent approximately \$ 935,000 to comply with section 404.⁶

In addition, the Advisory Committee has collected ample evidence from actual companies that they would be faced with very high section 404 compliance costs. One firm, Across America Real Estate (NAS: "AARD"), reported that it earned net income of only \$77,666 in 2005.⁷ Another startup, a cutting-edge nanotechnology firm called Nanophase Products (NAS: "NANX"), informed the Advisory Committee that though it had not yet begun generating income for its shareholders, it had been required to spend 8% of its 2004 revenues and 4% of its 2005 revenues just to comply with the new section 404 rules.⁸ Another microcap company, Focus Enhancements, informed the Advisory Committee that it would be forced to expend 3% of

⁴ Specifically, when Congress passed the Regulatory Flexibility Act, it found that:
(3) uniform Federal regulatory and reporting requirements have in numerous instances imposed unnecessary and disproportionately burdensome demands including legal, accounting and consulting costs upon small businesses, small organizations, and small governmental jurisdictions with limited resources;
(4) the failure to recognize differences in the scale and resources of regulated entities has in numerous instances adversely affected competition in the marketplace, discouraged innovation and restricted improvements in productivity;
(5) unnecessary regulations create entry barriers in many industries and discourage potential entrepreneurs from introducing beneficial products and processes."
Regulatory Flexibility Act, at § 2 "Findings and Purposes," Pub. L. No. 96-354, 94 Stat. 1164.

⁵ One representative example is a comment by ex-SEC Chairman Richard Bredeen, who simply concluded, "No one forces anyone to be a public company and take money from investors...If a business feels the burdens of being public are too great, it should consider going private." Kathleen Day, *Small Firms Still Want SEC to Give Them a Pass*, WASHINGTON POST, at D-01 (April 13, 2006).

⁶ FEI, Survey on SOX Section 404 Implementation: Exhibit A: Costs by Filing Status (March 2006).

⁷ Letter from Alexander V. Lagerborg, Pres. & CEO, Across America Real Estate, to Jonathan G. Katz, Committee Management Officer, SEC Advisory Committee on Smaller Public Companies, at 2 (April 3, 2006) (available online at <http://www.sec.gov/rules/other/265-23.shtml>).

⁸ Letter from Jess Jankowski, CFO, Nanophase Technologies Corporation, to SEC Advisory Committee on Smaller Public Companies (April 3, 2006) (available online at <http://www.sec.gov/rules/other/265-23.shtml>).

its revenues on first-year compliance with section 404.⁹ Wilbur Corporation (AMEX: “GIW”), a company with approximately \$115 million in market capitalization and 530 registered shareholders, informed the Advisory Committee that it was forced to expend 4.5% of its net 2005 income solely on section 404 compliance, and that this effort had made it less competitive in the marketplace by forcing it to divert its limited resources to paperwork burdens, rather than customer service.¹⁰ Another company within the “smaller public company” size threshold, Candela Corporation (NAS: “CLZR”), reported that in 18 months, it was forced to expend \$1,650,000 on section 404 alone.¹¹ OPNET Technologies (NAS: “OPNT”) commented that it incurred its first ever quarterly loss due in part to the approximately \$2,400,000 it was forced to expend on section 404 compliance.¹² These comments are not unique; the Advisory Committee has received evidence from dozens of other companies that section 404 costs would represent a significant regulatory barrier to entry into U.S. capital markets.

III. The Office of Advocacy Supports the Adoption of the Small Business Advisory Committee’s Recommendations to Defer Implementation of Section 404 Reporting by Small Public Companies Until Such Time as the Reporting Can Be Done In a Cost-Effective Manner.

Pursuant to the RFA, the SEC should consider alternative regulatory approaches in implementing section 404 of the Sarbanes-Oxley Act of 2002 that could minimize small business burdens. Advocacy supports the Advisory Committee’s recommendation that the SEC exempt smaller public firms from additional burdensome outside audit requirements.¹³ Advocacy agrees with the assessment of Chairman Oxley, who has concluded that SEC possesses ample discretionary authority to provide deferrals for small business implementation of the Act that bears his name.¹⁴ Advocacy recommends that the SEC ensure the continuing availability of capital to smaller companies by deferring implementation of section 404 until such time as a showing can be made that internal control audits can be completed in a cost-effective manner, pursuant to the recommendations of the SEC’s own Advisory Committee.¹⁵

⁹ Letter from Gary Williams, CEO, Focus Enhancements, Inc., to SEC Advisory Committee on Smaller Public Companies (April 3, 2006).

¹⁰ Letter from Joseph E. Sutaris, CFO, The Wilbur Corporation, to SEC Advisory Committee on Smaller Public Companies (April 3, 2006) (available online at <http://www.sec.gov/rules/other/265-23.shtml>).

¹¹ Letter from Gerard E. Puorro, CEO, F. Paul Broyer, CFO, and Darrel W. Simino, Corporate Director, Internal Audit & Controls, Candela Corporation, to SEC Advisory Committee on Smaller Public Companies (April 11, 2006) (available online at <http://www.sec.gov/rules/other/265-23.shtml>).

¹² Letter from Ramsey Price, Director of Internal Audit, OPNET Technologies, Inc., to SEC Advisory on Smaller Public Companies (April 2, 2006).

¹³ The RFA requires Federal agencies like the SEC to complete small business regulatory flexibility analyses—including consideration of costs and regulatory alternatives to reduce small business costs—when an agency determines that a rule would have a significant economic impact to a substantial number of small entities. 5 U.S.C. § 605(b).

¹⁴ Letter from Chairman Michael Oxley, U.S. House of Representatives, Committee on Financial Services, and Chairman Richard Baker, U.S. House of Representatives, Committee on Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, to Chairman Christopher Cox, U.S. Securities and Exchange Commission (Mar. 2, 2006).

¹⁵ SEC Advisory Committee on Smaller Public Companies, *Final Report of the SEC Advisory Committee on Smaller Public Companies*, at 43-48, Recs. III.P.1, II.P.2 (April 23, 2006) (available online at <http://www.sec.gov/info/smallbus/acspc.shtml>).

If you have any questions on this letter or related issues, please feel free to contact Michael See at Michael.See@sba.gov or (202) 619-0312.

Sincerely,

/s

Thomas M. Sullivan
Chief Counsel for Advocacy

/s

Michael R. See
Assistant Chief Counsel

cc: Commissioner Paul S. Atkins, U.S. Securities and Exchange Commission
Commissioner Cynthia A. Glassman, U.S. Securities and Exchange Commission
Commissioner Roel C. Campos, U.S. Securities and Exchange Commission
Commissioner Annette L. Nazareth, U.S. Securities and Exchange Commission
Gerald LaPorte, Chief, Office of Small Business Policy, U.S. Securities and Exchange Commission