NVCA

National Venture Capital Association

April 3, 2006

VIA Email

Nancy M. Morris
Federal Advisory Committee Management Officer
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: File No. 265-23, Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies (Release No. 33-8666; 34-54385).

Dear Ms. Morris:

The National Venture Capital Association (NVCA) represents approximately 450 venture capital and private equity firms. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy and support entrepreneurial activity and innovation. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provide reliable industry data, sponsor professional development, and facilitate interaction among its members.[1]

NVCA supports the key recommendations in the Exposure Draft of the Final Report of the Advisory Committee ("Draft Report"). We also wish to commend the Committee for its considerable effort and significant contribution to the general understanding of the universe of thousands of smaller public companies that fall under the jurisdiction of the SEC.

[1] For more information about the NVCA, please visit www.nvca.org.

BACKGROUND

Venture capital occupies a unique and valuable role in the U.S. economy. From 1970 – 2003 venture capital funds invested $338.5 billion dollars into more than 21,600 U.S. companies.[2] Every year, the most successful venture-backed private companies access the public equity markets through the IPO market. As the Committee has noted, smaller public companies can grow into some of the most prominent of U.S. companies. Microsoft, Federal Express, AOL, Apple, Office Depot, Intel, Home Depot, Cisco, Compaq, Genentech, Amgen and Starbucks all received venture financing during their growth phases. More recent beneficiaries of venture funding include: e-Bay, JetBlue, Seagate, and Google. A regulatory environment that promotes capital formation for small, growing companies is essential to the unique vibrancy of the American economy.

Venture capital's stake in maintaining and enhancing the strength and integrity of the public equity markets drives NVCA's support for the Advisory Committee and other efforts to improve regulation of smaller public companies. Venture investors – public pension funds, private institutions, financial companies and qualified individual investors – rely on venture capital investment returns to meet their financial obligations and to contribute to the virtuous economic cycle of liquidity and re-investment into new ventures. It is important to remember that venture capital is investors' capital. The ultimate liquidity of venture investments is essential to investor protection and capital formation.

Although many view SEC activity as applicable only to companies already in the public sphere, SEC rules and the securities laws upon which they are based directly impact venture capital. The new requirements of the Sarbanes-Oxley Act (SOX) have highlighted this fact. Venture backed companies seeking to access the public equity markets through the IPO process

[2] "*Venture Impact 2004: Venture Capital Benefits to the U.S. Economy,*" a study commissioned by the NVCA and conducted by leading economic analysis and forecasting firm Global Insight (formerly known as DRI-WEFA), p. 2. The study found venture capital funded companies were directly responsible for 9.4% of total U.S. private sector employment and 9.6% of company sale. *Id.* at 3. Global Insight constructed a database of more than 20,000 U.S. companies that received venture capital investment at some point between 1970 and 2003. From this database, Global Insight was able to measure the number of jobs and revenues these companies contributed to the U.S. economy in the years 2000 and 2003. A copy of the study is available at http://www.nvca.org/pdf/VentureImpact2004.pdf.

have had to meet the new SOX regulatory requirements. That additional significant hurdle has increased the cost of an IPO and has slowed the process of venture-backed companies going public. NVCA does not view a longer pre-IPO period as a problem *per se*; however, unless regulatory requirements add investor value, their added cost should be a matter for concern to all policy makers.

Sarbanes-Oxley has had a more subtle impact as well. Perhaps the best illustration is in the comparative rate of venture-backed IPOs to venture-backed companies that are acquired. While the historic split between the IPO and acquisition routes has averaged about 50/50, in 2004 there were 333 merger-acquisition transactions of venture-backed companies and 83 venture-backed IPOs. While many factors affect the IPO market for the high-growth, innovative companies that venture funds typically back, the heightened cost, complexity and liability of SOX are certainly among the causes of this significant shift toward the acquisition route over the IPO.

The impact of SOX on acquisitions of private companies is not as well understood. SOX requirements have rippled through the world of private companies because of the importance for public companies of growth by acquisition. As noted, only a portion of successful venture-backed companies are candidates for an IPO. Many others achieve their maximum investor return by being acquired. Acquiring companies are quite often either public companies or are companies moving toward becoming public. Therefore, the certifiable SOX compliance of any potential acquisition is a key aspect – sometimes the crucial aspect – of such a transaction. Therefore, for many private companies with no immediate plan for offering stock to the public, SOX-compliance is still a necessity. New requirements, including the very costly requirements imposed by SOX Section 404, have added cost and delay to the private market for venture backed companies.

The overall landscape for capital formation through IPOs and acquisitions has been reshaped by Sarbanes-Oxley and the new rules, listing standards and practical norms that followed its enactment. As noted, SOX-related compliance concerns of public companies have added costly friction to the acquisition market -- and have actually prevented some transactions. In addition, the IPO market has changed at least in part because of new rules and a heightened sense of liability for IPO underwriters and restrictions on broker-sponsored analyst research. While many of these changes were necessary reforms to the IPO underwriting and distribution process, the cumulative effect of these many changes is certainly a factor in the overall liquidity of venture-backed companies.

NVCA's comments on the Draft Report are offered against this backdrop. These many new requirements on access to public capital -- however appropriate in isolation -- have had consequences of a magnitude beyond any anticipation and have affected important areas of the economy that were hardly considered. Therefore, we commend the Committee for its focus on capital formation as well as investor protection. We urge the Committee also to continue to focus critically on cost and benefits in formulating its final recommendations.

SCOPE OF NVCA COMMENTS

We support the Draft Report's key recommendations. In particular, we support the recommendation that the SEC scale its regulations in ways that differentiate among the three categories of companies in the Draft Report. We also support the Draft's recommendations that smallcap companies and microcap companies be relieved of some of the most costly requirements of SOX 404, provided they address their internal controls by other more cost effective means.

In addition, NVCA encourages the Committee to emphasize four other recommendations from the Draft Report in its final Report. One of these key recommendations is aimed at improving analyst coverage for smaller companies. We offer an additional item for the Committee's consideration in this area.

In addition, we support three particular recommendations that aim to mitigate some of the most counterproductive aspects of recent changes in accounting rules and the accounting profession.

Our comments are based on data, surveys and many discussions with venture capitalists whose daily focus is in helping the managers of growing companies add value for investors.

DETAILED COMMENTS REGARDING SECTION 404 AND SCALED REGULATION

The Draft Report's recommendations on SOX 404 compliance strike the appropriate balance regarding investor protection, shareholder value and national economic priorities.

NVCA supports the Draft Report's recommendations for significant relief from the requirements of SOX 404 for both categories of smaller public companies. The experience of venture capitalists is consistent with the Committee's observations and conclusions, set out in its excellent Draft Report. The majority of venture-backed companies will be affected by changes in the requirements on the category of companies designated "smallcap" companies. Therefore, our comments are focused on the Draft Report's recommendations regarding smallcap companies rather than "microcap" companies.

We nonetheless view the recommendation for exemption of microcap companies from both major aspects of SOX 404 as appropriate. The Committee's careful consideration of the special circumstances of microcap companies supports the draft recommendation for a conditional exemption from SOX 404. Moreover, the new requirements the Draft recommends regarding audit committees, certifications and codes of conduct are the types of internal controls that can be most effective in microcap companies.

We agree with the Draft Report's conclusions regarding the benefits and costs of Section 404 compliance for smallcap companies. The Draft correctly describes the very different control environment in smaller companies compared to the large corporations for which Section 404 was written. Internal controls in smaller companies differ from those in larger companies as much as their cultures.

The approach to internal controls compliance that companies have experienced to date has been excessively costly and wasteful. The Draft properly notes that the PCAOB's AS-2 has caused an audit approach based on detailed, fully-documented process controls which has created unnecessary cost while failing to add substantially to the effectiveness of internal controls in smaller companies.

We fully support the Draft's conclusion that smaller companies, of necessity, operate differently than large ones. They must adapt more readily, change more rapidly and compete more relentlessly in order to succeed. For these reasons, as noted in the Draft, smaller companies do not reach a "steady state" where repetition and familiarity mitigate costs. Moreover, while the costs of SOX 404 have been well-documented, its purported benefits have been mostly assumed rather than proven.

As noted earlier in this letter, Sarbanes-Oxley requirements have rippled through the economy in unanticipated ways. Private companies are spending inordinate amounts of time and money on compliance and controls that are not appropriate to the nature of these enterprises. From the venture capitalist perspective, there is another more insidious cost – management and board distraction.

Our culture of entrepreneurship is a national treasure. It creates jobs, builds communities and promotes growth of many kinds. The success of entrepreneurial companies depends on dedicated managers and board members who are focused on adding value to their companies. Venture capitalists have seen how this focus is blurred and this zeal blunted by time-consuming unproductive compliance exercises. For this reason alone, the Draft Report's recommendations are of critical importance. Absent relief from at least some of these unproductive compliance exercises, the pre-eminence of American entrepreneurship could fade.

The Draft Report's assessment of excessive overall costs in relation to benefits is accurate. The hard costs are well documented and the soft costs from management distraction are easily understood. Benefits from this massive effort to document and verify internal control procedures have not been demonstrated. The Committee's final Report should clearly state that the benefits of 404 compliance (and any new regulation, for that matter) should face the same scrutiny as have claims of excessive cost. Mere assertions of improved "investor confidence" should not suffice when so much is at stake.

For these reasons, NVCA supports the conclusion that exemption of smallcap companies from the auditor attestation part of SOX 404 strikes the appropriate balance between a company's obligation to create value for its shareholders and its duty to prevent mistakes and/or fraud in financial reporting. Knowing that the downside economic risk from requiring 404 compliance is greater and the cost disproportionately higher for the thousands of smaller companies, it is bad regulatory policy to require them to go through the expense and management distraction of the 404 attestation process. Similarly we support the conclusion that microcap companies should be exempt from Section 404 provided they have adopted appropriate governance and control-enhancing practices such as those outlined in the Draft Report.

<u>The SEC should designate separate smallcap and microcap categories of public companies that should be treated separately for SOX 404.</u>

The Draft Report recommendation on scaled regulation reflects some of the Committee's most important work. Through its focus on smaller public companies, the Committee has brought new rigor to the questions of numbers, size and characteristics of the thousands of public companies that make up the smallcap and microcap segments of SEC registrants. The Draft Report's recommendations are fully supported by its analysis. Moreover, as noted above, important economic – and investor -- goals will be promoted by adopting a tailored regulatory approach that reflects the actual benefits and actual costs of new SEC requirements.

We are aware that the Committee was very thoughtful in its consideration of the right measures and right metrics for categorizing smallcap and microcap companies. The Draft Report reflects this careful analysis. We also recognize the value of the "market capitalization" metric in the SEC regulatory context. However, from a venture capital perspective, revenue is the single most tangible indicator of a company's size and operational complexity. Therefore, we support the additional use of revenue criteria in the Draft Report for differentiating companies by size for Section 404 purposes. Indeed, should the Committee decide that the final Report should recommend a metric other than market capitalization for scaled regulation generally, we recommend revenue as that metric.

<u>Many of the assumptions underlying arguments against the Draft Report's recommendations are incorrect.</u>

The Draft Report includes separate statements from three committee members. NVCA appreciates the contributions of all committee members but respectfully disagrees with both the conclusions and assumptions that underlay the opposition of Messrs. Jensen, Schacht and Veihmeyer to the Draft Report's recommendations for smallcap and midcap exemptions from some of the requirements of Section 404.

These separate statements do not reflect idiosyncratic views. Many others have made similar arguments in their public opposition to these key Committee recommendations since they were initially considered. Therefore, we will focus on the erroneous premises which are most often cited as reasons why the Committee should back away from the recommendations in the Draft Report.

The first erroneous premise is that Section 404 is the "cornerstone" of the Sarbanes-Oxley Act. While it has long been recognized that internal controls reporting and attestation would represent an enormous proportion of the issuers' cost of SOX, the Act had profound and far-reaching consequences even before Section 404 became effective. To suggest that an exemption from any of the requirements of 404 eviscerates Sarbanes-Oxley is to ignore the vast proportion of this multi-faceted law. To name a few provisions that affect issuing companies only, CEO and CFO certification, Audit Committee independence rules, new listings standards and new criminal liability provisions made Sarbanes-Oxley a boon to the legal profession in advising managers and boards on compliance. Moreover, SOX created the PCAOB (federalizing regulation of the accounting profession), restricted links between investment banking and research (changing the securities underwriting business), changed the reporting obligations of lawyers who advise corporations, nearly doubled the size of the SEC and greatly expanded the Commission's authority (Fair Funds authority, for example). Therefore, it is a gross exaggeration to suggest that the 404 exemptions in the Draft Report would undermine the impact of Sarbanes-Oxley on public companies.

The second faulty premise in most criticism of the Draft Report is that a disproportionate number of fraud cases arise in the very companies that would receive 404 relief. One of the separate statements cites (with alarm) the fact that 75% of accounting fraud cases brought during the period 1998 – 2003 were in "small firms." This type of assertion has been made in support of regulation of smaller issuers for many years. However, thanks to the work of the Advisory Committee, we now know that smaller public companies (comprising only 6% of the total market capitalization) make up 80% of public companies. Thus the number of accounting frauds cited and the number of companies are roughly proportional. While definitions no doubt differ and numbers may vary, it is hard to see how these statistics support an assertion that smaller companies present special fraud risks.

In the internal controls context, it is useful to examine the COSO report of 1987-97[3], which is often cited as supporting the need for SOX 404 mandates in smaller companies. This study noted that the vast majority of small company frauds involved senior managers. As the Draft Report notes, the types of process level controls required by SOX 404 and AS-2 can be over-ridden by CEOs and CFOs in the small company environment. Therefore, even if smaller public companies presented a special – albeit unproven -- fraud risk, application of SOX 404 would not address it.

The third faulty – or at least unproven – premise of arguments against the Committee's 404 recommendations is relates to investor confidence. It is argued that Sarbanes-Oxley restored investor confidence to the benefit of all issuers; therefore, it is argued, this issuer benefit would be jeopardized by the relatively narrow relief proposed in the Draft Report. As noted already, the benefits of SOX and 404 in particular are more presumed than proven. Clearly those who criticized early claims of extraordinary 404 costs as "anecdotal" should be required to provide more than opinions and narrow examples of its benefits.

From the perspective of venture capital, we certainly cannot find any indication that SOX has lowered the cost of capital or returned investors to the IPO market. As noted already, the

[3] Committee of Sponsoring Organizations, "Fraudulent Financial Reporting: 1987-1997 - An Analysis of U.S. Public Companies." Available at www.coso.org.

IPO market did not recover dramatically with the implementation of various SOX provisions. To the contrary, the new regulatory friction and risk that resulted from SOX has increased the compliance cost of going public without any demonstrable increase in investor appetite. Similarly, the merger and acquisition market for venture-backed private companies has suffered because of cost and compliance risk. On the other hand, investor reaction shows little affect of any increased confidence arising from SOX.

On the larger question of the Act's total impact on investor confidence, at least one respected observer believes it was negative. Peter Wallison, Resident Fellow at the American Enterprise Institute, documented the case in a 2004 Paper[4] that the passage of the sweeping Sarbanes-Oxley legislation actually had a negative effect on the stock markets while the scandals that prompted legislative action were readily absorbed by the markets. Therefore, while such contrarian views may still be unconventional, there is, on the other hand, no real evidence that a smallcap exemption from the Section 404 auditor attestation risks the loss of an amorphous SOX-based investor confidence. Nor will the Draft's recommendation for a conditional full exemption for companies that comprise only 1% of total market capitalization.

The fourth faulty premise -- which is really a hopeful argument – is that "better implementation" will correct the gross imbalance of cost to benefit in 404 implementation. NVCA has been hopeful that experience and the passage of time would help correct the imbalance. However, at this stage, we must view such assertions as the triumph of hope over experience.

To date, additional SEC and PCAOB guidance seem to have brought little improvement. The COSO's attempt to adjust its guidance for smaller companies was a failure. As noted already, the structure of Section 404 and the PCAOB's AS-2 are simply not appropriate for smallcap and microcap companies.

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[4] Peter J. Wallison, *Sarbanes-Oxley as an Inside-the- Beltway Phenomenon*, (AEI, June 2004). Available at http://www.aei.org/publications/filter.all,pubID.20582/pub_detail.asp. *See generally*, Materials related to AEI program, "Sarbanes-Oxley: What Have We Learned?" (March 13, 2006). Available at http://www.aei.org/events/eventID.1273,filter.all/event_detail.asp.

Moreover, our members believe that neither changes in guidance nor changes in the rules will fundamentally alter the 404 compliance requirements. The reason for this pessimistic assessment is that ultimately the accounting profession, and the Big Four accounting firms in particular, will determine what companies are required to do before the audit firm can attest to the quality of a company's internal controls. Unfortunately, all the incentives for an audit firm line up in favor of extensive and detailed documentation and testing of process level controls.

Whether an auditor considers his or her professional reputation, risk of PCAOB sanctions, private civil liability risk or financial incentives, they all point to requiring more, not less documentation and verification. These are, of course, the types of activities that undermine the cost-effectiveness of internal controls oversight in smaller companies. Therefore, we strongly urge the Committee to decline the tempting appeal of "better implementation" in favor of its forthright and well-supported recommendation for new internal controls rules that will be cost-beneficial for smaller public companies and entrepreneurial private companies.

DETAILED COMMENTS ON OTHER IMPORTANT COMMITTEE RECOMMENDATIONS

The Draft Report contains many sound recommendations that deal with areas of great importance to smaller publicly-traded companies. NVCA comments will focus on four of these recommendations that we see as most crucial for entrepreneurial companies and venture capital in particular. We see these recommendations dealing with analyst coverage and accounting as among the most critical for the SEC to address in the current market and regulatory environment.

<u>NVCA especially supports Recommendation IV. P.4. The SEC and other regulatory agencies should undertake a special review of the importance of analyst coverage for companies and investors.</u>

The steady decline in analyst research for smaller public companies has been a matter of concern for many years. Changes in the economics of the equities markets as well as changes in the rules on broker-sponsored analyst research have steadily eroded the amount of third-party analytical information about smaller public companies available to investors. This is of serious concern for venture capital because of the importance of analyst coverage to newly public companies. We therefore, strongly urge the Committee to emphasize this recommendation in the final Report.

We support the two specific recommendations in the Draft Report. There is a clear need for credible third-party research coverage for smaller companies that cannot attract the attention of "buy-side" analysts. The SEC should continue to permit fully-disclosed company-sponsored analyst reporting. Furthermore, we support the recommendation for continuation of brokers' use of "soft dollars" to support true research by their clients.

We also believe the Committee could do more in the analyst research area. We recommend that the Committee review and consider supporting the recent recommendation by the NASD to eliminate the quiet periods before and after expiration, termination or waiver of a lock-up agreement. The recent imposition of these quiet periods has affected the coverage available to newly-public companies. The NASD believes that SEC Regulation AC certification addresses the "booster shot" problem (underwriter providing overly-rosy analysis to investment banking clients). Aside from "booster shots" these quiet periods are unnecessary as far as we can see. Moreover, allowing continued research coverage during this critical time in the life of new public companies would help protect all IPO investors who hold beyond the initial period but need liquidity for a portion of their holdings in the first year. Finally, more continuous research coverage would almost certainly promote the capital formation role of the IPO market for smaller growth-oriented companies.

The overall lack of analyst coverage for smaller companies is shown clearly in the excellent data provided in the Draft Report by the SEC's Office of Economic Analysis. See Draft Report, Table 14. The absence of meaningful coverage for so many companies should prompt the SEC to take the lead in encouraging other knowledgeable organizations to consider ways to broaden it. This initiative should also involve a careful look at other ways to remove regulatory disincentives to analyst coverage of newly public companies. The Committee should recommend that this effort be evaluated to see whether it can work synergistically with SEC Chairman Cox's broad initiative on use of interactive data.

<u>NVCA especially supports Recommendation V.P.1. The SEC should develop a protocol for accounting that would protect the good faith preparer from regulatory action or legal liability.</u>

Like many others in business, venture capitalists and entrepreneurs have witnessed the steady erosion in the use of judgment and common sense in accounting and auditing decisions over the past few years. Many regulatory changes and other events have affected the accounting profession over this time period. Nearly all of them have promoted the tendency of accounting firms to respond hesitantly and conservatively to any ambiguous accounting situation. The fact that this tendency has added cost and complexity for issuers is no surprise. Moreover, this added cost and complexity has been accompanied by confusion as to the proper treatment of various transactions. This situation makes a mockery of well-publicized effort to move to more principle-based accounting standards and more understandable financial reports.

The Draft Report makes the appropriate points as to the nature of the problem. Its proposal for a safe harbor for thoughtful, good faith accounting judgments could provide part of the solution to the often dysfunctional situation that exists between issuers and their accounting firms. The safe harbor for forward looking statements in the securities laws is a good model as the Draft Report suggests.

We hope that the safe harbor approach can help cut through the various layers of liability concern that have eroded the use of judgment and common sense in accounting. Some of our members believe that, aside from genuine liability concerns – both real and perceived - some accountants have used liability risk as a catch-all rationale for costly, complex and overly conservative approaches to ambiguous accounting situations. Whether accountants' liability concerns are real, perceived or wholly unreasonable, the impact on the issuer-client is the same.

Were a true safe harbor in effect for the types of well-documented judgments described in the Draft Report, the result should be a more reasonable approach to accounting interpretations. Such a result would be a substantial help to smaller companies, both public and private. Therefore, we urge the Committee to emphasize this recommendation in its final Report.

<u>NVCA especially supports Recommendation V.P.4. The PCAOB should establish a *de minimus* exception to the SEC's auditor independence rules.</u>

A materiality standard is appropriate to ensure that the consequences <u>to the client</u> of an independence violation are proportional to the nature of the violation. The shortage of audit firms with scope, reputation and capabilities heightens the potential impact of independence rules on smaller private companies and venture-backed companies in particular.

The consequences of a finding of non-independence by an auditor of a company are profound. This is especially true for a company in the pre-IPO process. Venture-backed companies have a very real exposure to over-broad interpretations of auditor independence rules. Since a single venture fund invests in many companies, there is a risk that "affiliate" relationships could be found which would undermine the independence of an auditor based on the most highly attenuated connection. This is just one example where a common sense approach to independence rule violations would help. In general, an approach that distinguishes violations that are material to an issuer's financial statements from those that are merely technical would be a significant benefit for capital formation without compromising investor protection. Therefore, we urge the committee to highlight this recommendation in its final Report.

<u>NVCA urges the Committee to include Secondary Recommendation V.S.1 regarding increasing competition in the accounting field in the Committee's primary recommendations in the final Report.</u>

Any discussion of the practical consequences of the Sarbanes-Oxley Act and the events of the past years inevitably comes to the need for more competition in the accounting profession. Cost and service concerns have arisen and continue to arise in obtaining audit or accounting services since SOX. We believe these problems are most acute for smaller companies and for the newer, private companies in which venture funds invest.

We are aware of the suggestion that an exception from Section 404 attestation requirements could exacerbate concentration in the accounting profession. On the other hand, if fewer auditors are tied up with the type of detailed process-level internal controls evaluation that has characterized 404 attestation work to date, perhaps the supply of accountants available to smaller companies would increase. In any case, concentration of the accounting profession has a clear impact on smaller companies, as noted in the Draft Report.

Efforts to enhance competition should include close monitoring of the impact of all regulatory decision on the situation as well as implementing the recommendations in the Draft Report.

CONCLUSION

NVCA again commends the Committee and its many members and staff for an outstanding contribution to the understanding of the regulatory situation of smaller public companies. We also urge the Committee to include recommendations in its final report – those we have highlighted in particular -- that will improve the capital formation climate for pre-public companies. The excellent Draft Report can also be improved by noting the impact that public company regulations have on private companies as well.

Sincerely yours,

Mark G. Heesen
President