Statement of Edward S. Knight,
Executive Vice President and General Counsel, The Nasdaq Stock Market, Inc.,
at the Meeting of the SEC Advisory Committee on Smaller Public Companies
June 17, 2005
Columbia Law School, New York, New York

Thank you for allowing Nasdaq to participate in the proceedings of this committee. We applaud the SEC for focusing attention on the securities-law related issues facing small public companies.

Nasdaq is committed to maintaining the highest standards in listing rules and regulation. Beginning in 2002, we reviewed all our listing rules to deal with the crisis in confidence in corporate governance. In doing so, we followed five principles established by the Nasdaq Listing and Hearing Review Council, a standing advisory committee to our Board.

Specifically, our goals were to:

- Adopt mandatory listing standards, not just recommended "best practices"
- Adopt standards that are clear and objective
  - Unambiguous rules are better for both investors and issuers rather than vague, subjective standards. This is especially true for smaller companies that don't have large internal staffs or large budgets for advisers. In addition, we sought to avoid secret law, which can place smaller companies at a disadvantage to larger companies that often have multiple advisers.
- Recognize that one size does not fit all
  - NASDAQ companies and the NASDAQ market have unique characteristics that listing standards should reflect, especially the diversity in size and age of our companies.
  - We recognized the need to provide smaller companies the flexibility to structure board oversight of management in a manner that makes sense to the company, while preserving board accountability for key decisions.
- Ensure timely and complete reporting so that investors are well informed
- Do no harm – avoid "the law of unintended consequences"

In applying these principles and with the Commission's support, we adopted rules that gave smaller companies, in particular, alternatives to rushing out and quickly recruiting new directors to populate the independent compensation and nominating committees. We gave companies a choice: they could either have separate independent compensation and nominations committees, or allow their independent directors as a group to serve in these capacities. With the average Nasdaq-listed company having only seven directors, this helped many of our companies manage the cost of recruiting and retaining additional directors.

Since then, we have worked diligently to streamline our processes and make them more transparent. In particular, we have proposed to clarify the procedures applicable to companies that fall below one of our listing standards and reinforced our commitment to public disclosure by clarifying the strict time limits that apply to companies with late Form 10-K and 10-Q filings.

We now believe that there is universal agreement that we need to pause in new rulemaking and assimilate all the rulemaking that has occurred over the past three years. This is not the time to put more burdens on boards.

If anything, we will be trying to clarify and even simplify our rules, especially for smaller companies. One example of such a change is a proposal we hope to submit in the near term to clarify the definition of independent director. We will make clear that a director does not lose his or her independence merely by serving as an interim CEO or CFO, as the company searches for a permanent replacement for that employee. This rule change will prove particularly helpful to small companies that may find it more difficult to quickly recruit new independent directors.

There are a number of emerging issues that especially affect smaller public companies that we hope will be addressed in the near term.
Let me mention four top issues from our perspective:

- Section 404 requirements lead the list of securities law-related issues cited by smaller Nasdaq–listed companies. The burdens of 404 are not always commensurate to its benefits, especially with regard to smaller public companies.
  - A recent survey we did of our companies revealed that the Sarbanes-Oxley statute (SOX) is not the issue: 74% of our companies believe SOX is necessary.
  - But it does appear that, practically speaking, an inflexible framework for 404 implementation has been imposed on all companies regardless of complexity and size. This has put excessive compliance and control requirements on smaller companies.
  - Based upon a survey of our companies, as a percent of revenue, smaller issuers (i.e. issuers with less than $ 100 million in revenue) appear to have spent approximately 11 times more than larger companies (i.e. issuers with revenues greater than $2 billion) on 404 compliance.

  - The average cost per company was $1 million, with some companies reporting costs to us as high at $15 million.
  - The total cost of 404 implementation (both internal and external costs) extrapolated to all Nasdaq issuers is conservatively estimated at $3.5 billion. On average, these numbers were 2.5 times their fully-loaded audit fees.
  - Regrettably, the additional PCAOB and SEC guidance urging improved approaches to 404, such as a risk based approach to prioritizing 404 financial controls, though well intentioned, does not appear to be changing behavior at the major accounting firms.

- Smaller companies are increasingly finding it difficult to make timely annual and quarterly filings because the Big 4 auditors are dropping them as clients, generally because these companies fall below the Big 4's risk profile due to size. Since auditor resources are stretched thin, the set of smaller companies that do retain national auditors often receive less attention and are put on a lower priority track than larger companies. This makes it more difficult for smaller companies to get back on track within a reasonable time period after they have had a late filing. So far this year Nasdaq issued 60 delisting letters to issuers that failed to file their Forms 10-K. Last year only 14 companies were late on their Forms 10-K at this point. What are the contributing factors to this trend?
  - Auditors are risk averse and seem to be particularly unwilling to take risk on behalf of many smaller companies. Less well established audit firms are often retained, as a result. Many of these firms do not have a national office structure with strong ties to the SEC.
  - Underwriters may be reluctant to participate in transactions with these firms, thereby impacting smaller companies' ability to raise capital.

- Smaller public companies are increasingly finding it difficult to recruit and retain qualified CFO's, finance staff, and internal auditors.
  - In a highly competitive market for talent, small companies are finding it difficult to match large company compensation.
  - Also, qualified individuals are reluctant to take on reputational risk in serving in sensitive positions at smaller companies, especially at a lower salary level.

- Although effective public disclosure is critical, today's rules are particularly burdensome on smaller companies. For example, consideration should be given to affording smaller companies some relief from the increasingly burdensome Form 8-K filing requirements.

What changes to 404 should be considered? Let me suggest five:

- **Incenting the CPA firms away from over-auditing**. Understandably, major CPA firms are extremely sensitive that they will be judged as too lenient by the PCAOB during their QC audits. They feel they are being squeezed in both directions and are still erring on the side of being overly conservative. As a result, they and their clients may be performing too much testing of discrete processes that feed the financial statements. This continues to be the case even after the most recent PCAOB guidance.

- **Raising the level of materiality used for planning the scope of the 404 audit and what must be reported as material**. Perhaps the PCAOB should provide several different thresholds for materiality from which smaller companies can choose. Several measures to consider would be a percent of gross revenues, market cap or assets.

- **Permitting different forms of evidence that an effective control has been executed and alternating the frequency of control testing**. Small companies by their nature do not have the documentation and formality of larger companies. We should consider accepting existing control documentation and affidavits. And why not rotate tests for controls that are found to be effective to every other year?

- **Staggering internal control assessments to midyear to alleviate the year-end rush to evaluate internal control deficiencies and allow more flexibility for issuers to successfully implement remediation plans.**

- **Embracing the recommendations of the COSO task force that is developing a framework tailored for small businesses.** The task force is doing good work in developing detailed, clear guidance for what is acceptable for small companies within the COSO model.

That said, based on Nasdaq's own experience as a public company with 404 compliance, we are advising all our listed companies to consider 404 and SOX as an opportunity to continue to improve their financial reporting, governance and enterprise risk management. We are urging them to embrace it as part of their culture and use it as a way to minimize compliance risk in general.

For some companies these issues and others add up to a conclusion that being a public company is not for them. In the first quarter of this year, 22 Nasdaq issuers voluntarily delisted compared to only 7 in the same period in 2004. This includes domestic issuers that elected to deregister and cease filing financial reports with the Commission, as well as foreign issues that elected to terminate ADR programs. In each of these cases, the companies explained their decisions by citing the increasing regulatory costs associated with being public.

In the same vein, we have heard from venture capitalists and others that smaller issuers are increasingly reluctant to consider going public. In some cases, we are told that companies are filing registration statements for IPO's but doing so more in the hope that another firm will read their materials and make an offer to acquire them. If small businesses forgo the lower cost capital-raising opportunities afforded by the public markets, it will, in the long term, have adverse effects on the economy.

In closing, I want to mention an issue affecting smaller public companies that does not require any regulatory action. We know that a lack of research coverage impacts company valuation, liquidity and ultimately the welfare and growth of public companies. It has long been a concern of ours that approximately 1,200 of NASDAQ's 3,200 listed companies and 35% of all public companies have no research coverage. These are primarily smaller companies.

Last week, Nasdaq and Reuters announced the formation of a new company to help public companies obtain independent analyst coverage. The Independent Research Network (IRN) will aggregate multiple, independent research providers to procure and distribute equity research on behalf of under-covered companies to increase the market's understanding of a company's fundamental prospects. The service will be targeted to all companies listed in the U.S., as well as private companies looking for research coverage. Neither NASDAQ, Reuters nor IRN will play a role in preparing the research or issuing recommendations.

The Independent Research Network's model addresses the issues of independence, credibility and distribution that have held the research category back. We believe IRN can begin to reverse the trend away from less information for investors to more and provide a better window into public companies.

………………………………..

On behalf of Nasdaq, I want to thank the SEC again for establishing this committee and thank the members for their willingness to serve.