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Sent via e-mail to rule-comments@sec.gov

Advisory Committee on Smaller Public Companies
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-3628
Attn: James C. Thyen, Co-Chair
Herbert S. Wander, Co-Chair

Re: File No. 265-23
Recommendations for Reducing Unnecessary Regulatory Burdens on Smaller Public Companies

Ladies and Gentlemen:

This letter is submitted by the undersigned attorneys, all of whom represent smaller public companies and are active members of the Committee on Federal Regulation of Securities and/or the Small Business Committee of the American Bar Association's Section of Business Law. We are writing in response to the Advisory Committee's request for input on ways to improve the current regulatory system for smaller companies under the securities laws of the United States, including the Sarbanes-Oxley Act of 2002 ("SOX").

The comments expressed in this letter represent the views of the individuals listed below and have not been approved by the House of Delegates or Board of Governors of the American Bar Association ("ABA") and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Section of Business Law or any of its Committees. This letter also does not represent the views of any other ABA Section.

We are providing a separate letter expressing our endorsement of the Report of the ABA Small Business Committee's Task Force on Private Placement Broker-Dealers and offering suggestions for implementation of the Task Force's recommendations.

Summary of Recommendations

We urge the Advisory Committee to recommend to the Securities and Exchange Commission (the "Commission") the following specific actions to relieve the disproportionate regulatory burdens placed on smaller public companies that, we believe, are unduly costly and are not necessary for investor protection:

1. Continue the reformation of the securities offering process, specifically:

- Adopt a definition of "qualified purchaser."

- Provide relief from registration under the Securities Exchange Act of 1934 where a private company has more than 500 option holders.

- Increase the revenue/public float tests to qualify as a small business issuer under Regulation S-B and address the delays in processing registration statements in the Office of Emerging Growth Companies.

- Expand the availability of the Form S-3 registration statement to include resales of securities by companies listed on the OTC Bulletin Board.

- Eliminate restrictions on offers and general solicitations in private placements of securities.

- Review administrative and interpretive positions regarding the offering process and relax restrictions on smaller public companies.

2. Provide relief from burdensome SOX requirements where compliance costs outweigh the benefits to shareholders:

- Modify the director independence rules to allow smaller public companies to access a larger pool of potential directors who are otherwise currently barred from serving under current self-regulatory organization ("SRO") listing standards.

- Eliminate the auditor attestation requirement.

3. Make it easier for smaller public companies to withdraw from the public reporting regime of the Exchange Act and provide an "amnesty" period for smaller public companies that went public pre-SOX to exit the reporting system.

4. Work with the self-regulatory organizations to ease unnecessary regulatory burdens, specifically:

- Improve SRO-listed company dialogue regarding compliance issues.

- Take steps to make the OTC Bulletin Board a more viable market.

5. Expand the blue sky exemption under the National Securities Market Improvement Act of 1996 ("NSMIA") to include companies listed on the Nasdaq Small-Cap Market.

6. Work with the Public Company Accounting Oversight Board ("PCAOB") and the accounting profession to ease the increasingly confrontational relationships between smaller public companies and auditors.

Capital Formation

On June 29, 2005 the Commission unanimously adopted final rules dealing with securities offering reform (Securities Act Release No. 33-8591). The new rules, which become effective on December 1, 2005, serve to update a number of regulations dealing with registered public offerings under the Securities Act of 1933. In particular, the new regulations recognize the impact of nearly instantaneous communications and the greatly expanded ability to promptly access comprehensive information on public companies. These important improvements will help assure that U.S. capital markets remain vigorous and readily available to both companies and investors.

Although the new regulations represent a significant improvement, the principal beneficiaries are large public companies identified as well-known seasoned issuers or "WKSIs" and "seasoned issuers" who meet the Form S-3 primary offering tests. The remaining public companies (or "unseasoned issuers") and non-reporting issuers do not get the full benefit of the new rules. Consequently, a substantial majority of all public companies remain subject to many of the traditional procedural restrictions and disclosure obligations.[1]

As the Advisory Committee has undoubtedly discovered, one of the anomalies of the current securities offering system is that a smaller public company is often exposed to a more rigorous regulatory review and expanded filing requirements than a larger public company. These burdens, in turn, when considered in the context of a smaller public company with lower revenues and a much smaller number of employees, result in disproportionately higher regulatory and compliance costs. The new securities offering regulations, which substantially ease the registration process for WKSIs and seasoned issuers, further underscore the cost disparity between unseasoned issuers and their WKSI and seasoned issuer counterparts.

Before presenting our specific proposals, we wish to emphasize that the efficiency of the registered offering process can be as much affected by staff administrative and interpretive positions as by formal rules. We believe it would be worthwhile for the staff to review its administrative and interpretive positions that affect the offering process for smaller public companies, including disclosure, accounting and Section 5 matters, and the method by which these positions are developed, maintained and reviewed. The level of scrutiny and disclosure standards applied by the staff should be scaled back for smaller public companies and smaller transactions in recognition of the fact that (i) the resources available to smaller public companies to respond to staff comments are significantly less than larger public companies; and (ii) the costs of meeting such standards dissipates a disproportionate amount of valuable capital. In addition, the needs of smaller public companies in obtaining capital when not outweighed by the protection of investors should be recognized.

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[1] The Advisory Committee's August 18, 2005 letter to Chairman Cox included a proposed definition of Smaller Public Company which noted that approximately 80% of all U.S. public companies had a market capitalization of less than $700 million.

We believe that the following proposals introduce more flexibility into the capital formation process and can serve to ease the regulatory burden and related costs, without compromising the quality of disclosure or the integrity of the public markets.

1. Adopt a definition of Qualified Purchaser. The Commission should adopt a definition of qualified purchaser as provided for under NSMIA. Under NSMIA, securities offered and sold to "qualified purchasers" are covered securities and the states may not require registration of offerings of such securities. Such offerings would be solely regulated under federal law. Release 33-8041 dated December 19, 2001, proposed such a definition as mirroring the definition of accredited investor. The Release states that the definition "strikes the appropriate balance between the necessity for investor protection and meaningful relief for issuers offering securities, especially small businesses" and we concur. A uniform definition would override diverse state exemptions for financially sophisticated investors, thereby simplifying the offering process and promoting capital formation.

2. Provide relief from registration under Exchange Act Section 12(g) when a company has more than 500 option holders. Registration under Section 12(g) of the Exchange Act is required once a company has over $10 million in assets and more than 500 holders of a class of equity securities. Therefore, when there are sufficient exercises of options so that, coupled with holders of previously outstanding shares, there are more than 500 holders of common stock, Exchange Act registration is required, even in the absence of an IPO. Unfortunately, the Commission considers employee options to be a separate class of equity securities. Accordingly, if there are more than 500 option holders, registration under the Exchange Act is required even if none of such options has been exercised. While the Commission has provided some limited relief in these circumstances, it has been conditioned on the provision of financial information to option holders. Once such information has been distributed to employees (and ex-employees who still hold options), it is nearly impossible to keep such financial and proprietary information confidential. Disclosure of this information may often put the issuer at a serious competitive disadvantage.

It bears emphasis that stock options are issued to employees and others in the compensation context and not as part of capital-raising transactions. We believe that elimination of the information requirement would solve the problem without sacrificing investor protection. Therefore, we recommend that the Commission revisit the conditions for relief from required Exchange Act registration solely by reason of having more than 500 option holders. We recommend consideration of (i) elimination of the information requirements altogether as long as the options are non-transferable (except for gifts to family members), or (ii) elimination of such requirements if the options could only be exercised on a net exercise basis without new consideration paid by the optionee.

3. Increase the revenue/public float tests to qualify as a Small Business Issuer under Regulation S-B and address delays in processing registration statements by the Office of Emerging Growth Companies. As previously noted, one of the most significant challenges

facing smaller public companies is that they are subjected to a filing and review process at the state and federal level that is often more comprehensive than what larger public companies undergo. Although small business issuers[2] conducting financings under Regulation S-B are only required to provide two years of audited financial statements and are subject to reduced disclosure requirements, the final prospectus is often every bit as detailed as a registration statement filed on Form S-1. Indeed, often only an experienced professional can identify a financing by a company filing on Form SB-1 or SB-2 from a Form S-1 filing.

A company using Forms SB-1 or SB-2 files its registration statements with the Office of Emerging Growth Companies of the Commission's Division of Corporation Finance. It has been the experience of several of the persons who prepared this letter that filings in this office are subjected to a review process that is not only much more comprehensive but is substantially slower than the review process conducted by other branches of the Division of Corporation Finance when processing the supposedly more-detailed Form S-1 filings. Under a long-standing internal operating practice, the Division of Corporation Finance has endeavored to provide comment letters on new filings on Form S-1 within 30 days with staff comments on subsequent pre-effective amendments being made within several days of filing. Our experience with Form SB-1 and SB-2 filings in the Office of Emerging Growth Companies, however, has been that the first comment letter can often take 35 or more days and that comments on subsequent pre-effective filings can take more than 30 days. Furthermore, filings on Forms SB-1 and SB-2 can often require four or five amendments before they are declared effective. As a consequence, the filing and processing of a Form SB-1 or SB-2 Registration Statement can often take twice as much time as a filing on Form S-1. When inquiries have been made of the staff as to the reason for such a delay, two answers have been given: (1) the operating practice of the Office of Emerging Growth Companies is to reread each amendment in its entirety; and (2) the Office has a substantial backlog of filings.

We believe that Regulation S-B has merit and has the potential to be a cost-effective way for small companies to raise capital. To better realize this potential we recommend that the Advisory Committee consider recommending the following operational and qualification changes:

(i) The Office of Emerging Growth Companies should either revise its practice of rereading each amendment in its entirety or hire more staff to better address the substantial delays currently being experienced when processing Forms SB-1 and SB-2.

(ii) The definition of "small business issuer" should be modified to increase the revenue and public float tests to at least $100 million. This change would reflect the effect of

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[2] A "small business issuer" is defined in Rule 405 of Regulation C under the Securities Act as "...an entity...that has revenues of less than $25,000,000...[and] a public float (the aggregate market value of the outstanding voting and non-voting common equity held by non-affiliates) of [less than] $25,000,000..." Forms SB-1 and SB-2 are registration statement forms that may be used by small business issuers. Form SB-1 may be used to raise up to $10,000,000, while Form SB-2 may be used to raise up to $25,000,000.

inflation and allow more smaller companies to gain the benefits of reduced audited financial information and other disclosure requirements.

4. Expand the availability of the Form S-3 Registration Statement to include resales of securities by companies listed on the OTC Bulletin Board. During the past decade, a new financing vehicle has emerged as an important source of capital for public companies.[3] PIPEs (or private investment in public equity) allows a company to privately sell its securities (usually convertible preferred stock) to a select group of investors followed by the filing of a registration statement with the Commission, which registers securities (typically shares of common stock to be issued upon conversion of the preferred stock) for resale. This financing practice allows a company to promptly access capital in a cost-effective manner (particularly if the company is eligible to use Form S-3) for the resale.

Form S-3 is an abbreviated registration statement that allows an issuer to incorporate by reference a substantial amount of information the issuer has or will file under the Exchange Act. The consequence of using the Form S-3 to register the shares for resale, as opposed to Form S-1 (or Form SB-1 and SB-2) for small business issuers is significant. Although Form S-1 will allow *backwards* incorporation by reference as of December 1, 2005, under the recently adopted Securities Offering Reform release, only Form S-3 will allow *forward* incorporation by reference. Without the ability to use Form S-3's forward incorporation by reference, smaller public companies will not share in the benefits provided to larger companies after December 1.

The Form S-3 is available for resales of privately placed securities if the securities being registered are of the same class as the issuer's securities that are listed and registered on a national securities exchange (*e.g.* NYSE or AMEX) or are quoted on the automated quotation system of a national securities association (Nasdaq National Market or Small-Cap System). This test has required companies whose shares are traded on the OTC Bulletin Board to have to file a substantially more comprehensive registration statement that takes far more time to prepare and will be more costly and will require the filing of amendments in the future to reflect changes rather than being able to rely on incorporation of Exchange Act requirements..

The unavailability of Form S-3 to the very companies that most frequently use PIPE financing results in a substantially greater disclosure and administrative burden and the use of a larger portion of the funds being raised in such financing to pay for the costs of preparing and processing a registration statement. Under the circumstances, we believe that smaller companies' shareholders would be better served if such companies were allowed to use the abbreviated Form S-3 to register such resales. We also believe that the use of Form S-1 delivers

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[3] The April 15, 2005 edition of The PIPEs Report, an industry newsletter, estimated that $5.3 billion was raised in equity investments by over four hundred public companies during the first quarter of 2005, a 6% increase over the $4.9 billion raised during the final three months of 2004. The same report estimated that 235 of the 404 issuers had a market capitalization of less than $50 million.

no proven benefit to investors since they can receive the information provided by accessing the issuers' Exchange Act reports on EDGAR.

5. Remove restrictions on "Offers" and "General Solicitation" in private placements of securities. In view of the telecommunications and media revolution, the Commission should recognize that it is both unrealistic and unnecessary to restrict communications in connection with private placements and other exempt offerings and, therefore, should eliminate all restrictions on "offers" and "general solicitation" with respect to securities being sold other than pursuant to registration under the Securities Act. Eligibility for exemption from registration should turn on the status of the actual purchasers and not the number or status of offerees or the method of reaching eligible purchasers. Persons who do not end up parting with money to purchase securities are not harmed by publicity and unfulfilled offers to sell to them.

The private offering process is best served by employing straight-forward objective tests that focus on the purchaser's status, rather than subjective standards that attempt to determine when and how offerees were found. We believe that the focus should be on documenting the qualifications of the investors who actually purchase securities and confirming they are making an informed investment decision.

Sarbanes-Oxley Reforms

Using its rulemaking and SRO oversight authority, we believe the Commission should review those SOX requirements that most burden smaller public companies and provide relief where the compliance costs outweigh the benefits to investors. Specifically, we believe that the definition of independent director should be made less stringent and that the SOX Section 404 auditor attestation requirement should be eliminated for smaller public companies.

1. Director Independence. The benefits of independent directors both for the internal management of a business corporation and for the protection of investors cannot be underestimated. However, in light of the time demands placed on directors of public companies, as well as the litigation risk and potential liability associated with service as a director, it is difficult for smaller companies to attract qualified directors who have no affiliation whatsoever with the company. In addition, for strategic reasons, the use of directors who are not "independent" under the current rules, including advisors, consultants, vendors, distributors, customers and other persons with intimate knowledge of the company and its industry, often is highly desirable. Excluding such persons from the definition of "independent" unnecessarily eliminates many persons with the knowledge, experience and interest to guide the company's business.

We recommend that the Commission encourage the self-regulatory organizations to modify their listing standards to permit the following persons to be considered independent as directors of smaller public companies:

- vendors, distributors, customers and other persons who do business with the company, provided that such persons would not be considered independent for purposes of service on the compensation committee; and

- attorneys, accountants (other than auditors) and other professionals who provide, individually or through their firms, professional services to the company.

Another problem of the independence requirements is that a large shareholder that owns less than a majority of the company's outstanding shares is effectively eliminated from all significant deliberation and decision-making regarding the company. So long as a majority of the members of the board of directors and a majority of each board committee are comprised of independent directors, we do not believe that major shareholders of smaller public companies should be excluded from participation in board committees, including the audit, compensation and nominating committees.

2. SOX Section 404 Auditor Attestation. We believe that the SOX Section 404 auditor attestation requirement should be eliminated for smaller public companies. As the Commission has recognized by its decisions to postpone effectiveness of Section 404 for non-accelerated filers, the process of implementation of the attestation regime is time-consuming and expensive. Further, despite the encouragement of the Commission and the PCAOB to avoid a "one size fits all" approach to internal controls, this has not been the case. Outside auditors are routinely applying the detailed requirements that are necessary for large enterprises to much smaller companies. This adds a huge amount of cost (in auditor fees) and requires company personnel to sacrifice time that should be devoted to their normal business activities in order to complete tasks required by the auditors. For many if not most smaller public companies, the size, scope and complexity of operations, number of locations and employees simply do not require the rigorous and costly overlay of an independent review of internal controls beyond what already is required for auditors to pass on the company's financial statements. We do not advocate elimination of the company's own review and quarterly report on its own internal controls. To the contrary, we believe that management's review and the certifications required of the chief executive officer and the chief financial officer should be retained and strong emphasis placed on compliance in this regard.

Exiting the Public Reporting System

Few will dispute the proposition that SOX significantly increased the expense of being a public company and the potential exposure to liability for the company and its officers and directors. Many small companies that, after doing a cost-benefit analysis of being public, chose to do so prior to the adoption of SOX but would most certainly *not* choose to go public in the post-SOX world. The problem is that, since they already are public companies, the only way to get out from under SOX (and other costly aspects of being a public company) is either to be acquired or to go private.

Many smaller public companies would like to go private so that they can stop paying the costly price of being public and better utilize their cash and their employee talent to run their businesses instead of for SOX compliance activities (including significantly higher accountants' fees). Unfortunately, the process of going private itself carries a big one-time price tag: there are significant legal, accounting and investment banking costs, the diversion of management from running the business and the delay inherent in going through a comprehensive review by the Division of Corporation Finance's staff.

It should not be so difficult for a smaller public company to go private. We propose that the Commission create a one-year "amnesty" going private program for any smaller public company that went public prior to July 30, 2002. For these companies, the Commission's going private rules (Rule 13e-3) and the concomitant scrutiny provided by the staff would be suspended in favor of a much kinder, gentler and simpler process. This would permit those public companies that simply cannot afford to go private under the current regime but cannot afford to stay public the opportunity for a second chance. Without the costly burdens of being a public company, these companies will be able to focus more on their core businesses, and may one day grow and prosper to a point where it *does* make sense for them to go public.

SRO Relationships

Using its oversight authority, the Commission should work with the self-regulatory organizations, particularly Nasdaq, to ease unnecessary regulatory burdens. Over the course of the past several years, Nasdaq disclosure and listing requirements have been significantly expanded. The level of review and scrutiny applied by the Nasdaq staff has similarly increased. Today, smaller public companies, particularly those listed on the Nasdaq SmallCap Market, often find themselves subject to rigorous monitoring that can be both burdensome and expensive.

The Nasdaq staff oversees a series of listing, disclosure and voting requirements applicable to both Nasdaq National Market and SmallCap companies. The regulations dealing with the issuances of securities and shareholder voting can be particularly troublesome. Many of these regulations are written in broad terms and often are interpreted by the Nasdaq staff in an expansive manner. The end result is often costly filing and disclosure obligations and/or inadvertent violations that can lead to possible delisting.

We also recommend that the Commission and Nasdaq or a similar SRO take steps to make the OTC Bulletin Board a more viable market for smaller public companies that cannot meet the listing standards of the Nasdaq Stock Market. At the present time, there are thousands of public reporting companies the securities of which are traded on the OTC Bulletin Board. Unfortunately, the OTC Bulletin Board seems to be suffering from benign neglect. Anything that could serve to enhance the visibility and liquidity of this market would benefit the thousands of public companies whose securities trade in this "market."

Expand NSMIA to Include Nasdaq SmallCap Companies

We recommend that companies listed on the Nasdaq SmallCap Market be exempted from blue sky filings when conducting a public financing. The substantial costs and delays associated with a blue sky filing and attendant review place an additional layer of regulation on smaller companies that already are meeting all of the comprehensive disclosure requirements under the Exchange Act and Nasdaq regulations.

Accounting

In an environment of increased liability exposure for auditors and the client "upgrading" of major accounting firms following the demise of Arthur Andersen, relationships between smaller public companies and auditors have become increasingly confrontational. The procedural hurdles imposed by auditors and the "checklist" mentality have created unnecessary barriers between auditors and their clients. Many of our public company clients have seen their accounting costs substantially increase because of expanded testing and disclosure requirements. This increase has occurred even though auditors are increasingly reluctant to help resolve sticky accounting issues.

We understand that the Advisory Committee has already received and considered testimony concerning the deterioration of client/auditor relationships. Therefore, we have limited our comments on this issue. We wish to go on record, however, as calling attention to what we perceive to be a significant issue for many smaller public companies.

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We hope these comments are helpful to the Advisory Committee, and we would be happy to engage in further dialogue and bring additional market participants to any discussion of these issues.

Respectfully submitted,

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