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Business Law Section
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April 3, 2006

Nancy M. Morris, Federal Advisory Committee Management Officer
Securities and Exchange Commission
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Washington, D.C. 20549-9303
E-mail address: rule-comments@sec.gov

Re: File No. 265-23
Exposure Draft of the Final Report of the Advisory Committee on Smaller Public Companies
Release Nos. 33-8666 and 34-53385

Dear Ms. Morris:

The Committee on Securities Regulation (the "Committee") of the Business Law Section of the New York State Bar Association appreciates the invitation in the above Release to comment on the Exposure Draft (the “Exposure Draft”) of the Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission (the “Commission”).

The Committee is composed of members of the New York Bar, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and in corporation law departments. A draft of this letter was reviewed by certain members of the Committee, and the views expressed in this letter are generally consistent with those of the majority of members who reviewed and commented on the letter in draft form. The views set forth in this letter, however, are those of the Committee and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

We strongly support the initiative undertaken by the Commission to charter the Advisory Committee on Smaller Public Companies, and applaud the extraordinary efforts of the Advisory Committee in seeking public comment regarding a broad range of issues of critical importance to smaller public companies, reviewing these comments in a conscientious manner, and composing a thoughtful and practical series of recommendations to the Commission, as set forth in the Exposure Draft. As recognized by the Advisory Committee, the serious problems smaller public companies encounter in meeting their obligations under our securities laws implicate our capital markets

profoundly, affecting the ability of such companies to allocate resources in a manner serving the best interests of shareholders, to attract qualified directors and managers, and to remain competitive and entrepreneurial in the commercial marketplace. To the extent that the perceived burdens of public company status have deterred companies from listing on national securities exchanges or on Nasdaq, or seeking access to our public capital markets, we believe that those companies, as well as public investors, have been deprived of the significant benefits that can arise when smaller companies embarking on a growth trajectory have access to the resources of a robust capital market.

We understand that the issues smaller public companies currently face derive, in substantial part, from the earnest efforts by Congress and the Commission to increase the integrity of public company disclosure. We do not fault these efforts to increase investor protection, especially in light of the abuses that have occurred over the past few years, and we appreciate the consistent efforts of the Commission to be sensitive to the needs of smaller public companies. As the Commission is no doubt aware, even the most enlightened systems need to be tested in the crucible of practical experience, and the measure of a system's quality derives in large part from the ability of the system to marry the practical with the aspirational. The efforts of the Advisory Committee, and the recommendations set forth in the Exposure Draft, form an important part of this process.

We believe that it would be outside the scope of this letter to suggest additional substantive recommendations not included in the Exposure Draft. Our view is based on our respect for the process undertaken by the Advisory Committee in soliciting comments and setting forth recommendations based on those comments and the extensive expertise of the members of the Advisory Committee. We believe that the Final Report should reflect the culmination of the process, rather than any new ideas presented at this late stage by persons or groups that have not played a direct role in the process. The Advisory Committee has properly identified in the Exposure Draft a broad range of problems confronting smaller public companies, and in our view the Commission should accord the recommendations to be set forth in the Final Report a high priority for Commission consideration and rulemaking. Our expression of support for these recommendations should not be construed to suggest that we have concluded that each specific element of such recommendations meets with our approval, but only that we believe that the Commission should proceed promptly to take the next step by translating such recommendations to more complete proposals. We encourage the Commission not to delay in addressing these matters. Any such delay could result in the loss of the momentum generated by the Advisory Committee's efforts, as well as the opportunity to provide promptly much needed relief to smaller public companies.

We have not undertaken in this letter to comment substantively on each of the recommendations set forth in the Exposure Draft. We understand that the recommendations are invitations for the Commission to propose rulemaking, and that ample opportunity will exist following the publication of any proposed rules for interested persons to provide detailed comments on those proposals. Instead, we have set

forth below a limited number of comments that reflect suggestions, not included in the recommendations set forth in the Exposure Draft, that the Advisory Committee may want to consider reflecting in the Final Report. In order to avoid presenting these comments out of context, we have first set forth the proposed recommendations of the Advisory Committee with respect to which we have comments, followed by our comments thereon.

Recommendation II.P.1:
Establish a new system of scaled or proportional securities regulation for smaller public companies using the following six determinants to define a "smaller public company":
the total market capitalization of the company;
a measurement metric that facilitates scaling of regulation;
a measurement metric that is self-calibrating;
a standardized measurement and methodology for computing market capitalization;
a date for determining total market capitalization; and
clear and firm transition rules, i.e., small to large and large to small.
Develop specific scaled or proportional regulation for companies under the system if they qualify as "microcap companies" because their equity market capitalization places them in the lowest 1% of total U.S. equity market capitalization or as "smallcap companies" because their equity market capitalization places them in the next lowest 1% to 5% of total U.S. equity market capitalization, with the result that all companies comprising the lowest 6% would be considered for scaled or proportional regulation.

Comment:

1. We support the concept of scaled or proportional securities regulation for smaller public companies. Without necessarily agreeing that market capitalization represents the most appropriate measure of a company's size for this purpose, we note the Advisory Committee's view that holdings by affiliates should not be excluded from the market capitalization test because affiliates often require information regarding public companies to the same extent as other investors. We question this conclusion for a number of reasons:

(a) In situations where an affiliate or affiliate group beneficially owns over 50% of the voting power of the public company, we do not believe that such affiliate or affiliates would likely be dependent upon the public company disclosures for information regarding the public company. In many cases, the parent entity may actively manage the business and affairs of the subsidiary. The New York Stock Exchange and Nasdaq have

acknowledged the special status of controlled companies in exempting such issuers from certain of the governance requirements otherwise applicable to listed companies.[1]

(b) Under the securities laws, an affiliate is a person or entity that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, the person specified.[2] In view of this definition, it would not seem that an entity that controls a public company, even if it beneficially owns 50% or less of the issuer's securities, would necessarily be dependent upon the issuer's public disclosures. We therefore do not believe that any affiliate holdings should be included in the market capitalization calculation.

(c) The Advisory Committee indicates that the exclusion of affiliates from the market capitalization calculation could prove difficult. In our view, this exclusion would not be as difficult to achieve as the Advisory Committee suggests.We note that under the current reporting requirements Forms 10-K and 10-KSB require an issuer to set forth, on the cover page, the aggregate market value of the voting and non-voting common equity held by non-affiliates. In addition, this information is made available to issuers pursuant to the requirements under Section 13(d) and Section 16 of the Securities Exchange Act of 1934 (the "Exchange Act"). Should the Advisory Committee deem it appropriate to suggest a bright-line test, it could, for example, propose that at the determination date, an issuer exclude any holdings of 10% or greater beneficial holders.[3]

2. We also believe that any scaling methodology should apply to foreign private issuers. The Advisory Committee notes the effect that real or perceived over-regulation of foreign private issuers has had on the willingness of such issuers to remain in, or enter, the U.S. markets.[4] None of the Advisory Committee's recommendations clearly indicates that the recommendations are intended to be applicable to foreign private issuers, and the proposed reference to a scaling standard based on U.S. equity market capitalization leaves unresolved how the Advisory Committee would propose to deal with companies that maintain domestic securities listings as well as listings in securities markets outside the United States. It would be incongruous if smaller domestic companies were subject to less stringent standards than were to apply to foreign companies of comparable size.[5] Any recommendations the Advisory Committee can provide in this context may prove helpful to the Commission. For example, we suggest that the Advisory Committee recommend that certain sections of Form 20-F, the annual report form used by foreign private issuers,

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[1] See, for example, the provisions of Section 314A.00 of the New York Stock Exchange Listed Company Manual and Nasdaq Marketplace Rule 4350(c)(5) relating to controlled companies.
[2] See, for example, the definition in Rule 405 under the Securities Act of 1933.
[3] Because beneficial ownership includes securities that may be acquired pursuant to the exercise, exchange or conversion of certain securities, the rulemaking would need to address how the calculation is to be performed for this purpose (e.g., whether it should exclude such derivative securities).
[4] See footnotes 88 through 90 of the Exposure Draft and the accompanying text.
[5] Footnote 29 of the Exposure Draft indicates that the U.S. equity market capitalization was based on study by the Commission's Office of Economic Analysis, derived from information for New York Stock Exchange, American Stock Exchange, NASDAQ Stock Market and OTC Bulletin Board companies.

should be modified to reflect the changes proposed by the Advisory Committee for domestic issuers.[6]

3. As proposed, the recommendation would apply to companies whose outstanding common stock (or equivalent) in the aggregate comprises the lowest 6% of total U.S. equity market capitalization. It is not clear to us whether the term "(or equivalent)" is intended to bring into the calculation options, warrants, convertible securities and other securities that are exercisable or convertible into, or exchangeable for, the issuer's securities, and how these other securities are to be valued for this purpose.

4. The Advisory Committee report does not address the treatment of two significant classes of issuers: those that have a reporting obligation relating only to debt securities and those that are voluntary filers. Issuers with a reporting obligation relating only to debt (in most cases arising pursuant to Section 15(d)) would have no U.S. equity market capitalization. If it is the intention of the Advisory Committee that the equity market capitalization of such companies be treated as zero (and thus equivalent to microcap companies), we believe it would be appropriate for the Final Report to reflect this view. If this is not the Advisory Committee's intention, we believe it would be helpful to the Commission to understand the extent to which the Advisory Committee believes that such issuers should be entitled to relief from the obligations under the Exchange Act. Similarly, many companies that do not have reporting obligations under Sections 13 or 15(d) nonetheless file reports with the Commission either as a result of indenture or other contractual provisions or a desire to provide market visibility for their securities. While we assume that it is the Advisory Committee's view that such voluntary filers should be treated as microcap companies for the purposes of the Report, an express statement to such effect would, we believe, be appropriate.

Recommendation III.P.1:
Unless and until a framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs, provide exemptive relief from Section 404 requirements to microcap companies with less than $125 million in annual revenue and to smallcap companies with less than $10 million in annual product revenue that have or expand their corporate governance controls that include:

adherence to standards relating to audit committees in conformity with Rule 10A-3 under the Exchange Act;

adoption of a code of ethics within the meaning of Item 406 of Regulation SK applicable to all directors, officers and employees and compliance with the further obligations under Item 406(c) relating to the disclosure of the code of

[6] Among the items in Form 20-F that, we believe, should be amended in accordance with the Advisory Committee's recommendations would be Items 15(b) and (c), which deal with management's annual report on internal controls over financial reporting and the registered accounting firm's attestation, and Instruction 1 to Item 8, which refers to Rules 3-05 and 3-09 of Regulation S-X.

ethics; and
design and maintence of effective internal controls over financial reporting.
In addition, as part of this recommendation, we recommend that the Commission confirm, and if necessary clarify, the application to all microcap companies, and indeed to all smallcap companies also, of the existing general legal requirements regarding internal controls, including the requirement that companies maintain a system of effective internal control over financial reporting, disclose modifications to internal control over financial reporting and their material consequences and apply CEO and CFO certifications to such disclosures.

Recommendation III.P.2:
Unless and until a framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs, provide exemptive relief from external auditor involvement in the Section 404 process to the following companies, subject to their compliance with the same corporate governance standards as detailed in the recommendation above:
• Smallcap companies with less than $250 million in annual revenues but greater than $10 million in annual product revenue; and
• Microcap companies with between $125 and $250 million in annual revenue.

Comment:

Although we agree with the need for interim exemptive relief from the current internal control requirements for smaller public companies, we acknowledge the significant dialogue this recommendation has ignited. We strongly support the Commission's efforts to continue to review the requirements and effects of internal control reporting[7], and believe that the public interest will best be served by the prompt translation of Recommendations II.P.2 and II.P.3 into a rulemaking proposal, on which all relevant constituencies, including this Committee, will have the opportunity to submit comments.

Recommendation IV.P.2:
Incorporate the primary scaled financial statement accommodations currently available to small business issuers under Regulation S-B into Regulation S-K or Regulation S-X and make them available to all microcap and smallcap companies.

[7] The Commission's efforts include, among other things, the Roundtable on Second Year Experiences with Internal Control Reporting and Auditing Provisions scheduled for May 2006.

Comment:

1. We support this recommendation as it applies to the primary financial statement accommodations currently afforded to small business issuers under Regulation S-B.[8] In addition to the relief for microcap and smallcap companies suggested in the Exposure Draft relating to Rule 3-09 of Regulation S-X, we believe the Advisory Committee should also consider recommending relief from Rule 3-05 and Article 11 of Regulation S-X. These provisions require an issuer to provide financial information regarding businesses acquired or to be acquired, as well as pro-forma information.

2. As indicated elsewhere in this letter, we suggest that the Advisory Committee make clear in its Final Report that its recommendations are intended to apply to foreign as well as domestic microcap and smallcap companies.

Recommendation IV.P.5:
Adopt a new private offering exemption from the registration requirements of the Securities Act that does not prohibit general solicitation and advertising for transactions with purchasers who do not need all the protections of the Securities Act's registration requirements. Additionally, relax prohibitions against general solicitation and advertising found in Rule 502(c) under the Securities Act to parallel the "test the waters" model of Rule 254 under that Act.

Comment:

1. We support this recommendation and believe that the proposed exemption should be self-executing. Were the Commission to adopt a definition of "qualified purchaser" pursuant to the authorization in Section 18(b)(3) of the Securities Act of 1933 (the "Securities Act") (as discussed in connection with Recommendation IV.S.11 below), such definition could perhaps be applicable to this new private offering exemption. Whether or not this is the case, we agree that the current limitations on general solicitation and advertising are unnecessarily restrictive in view of the ease by which information is disseminated in this age of electronic communications (including information regarding filings of Form D).

2. We also support the relaxation of the prohibitions against general solicitation and advertising to permit "testing the waters" in the context of Rule 506. While the ability to test the waters under Rule 506 may be subject to different criteria than apply to offerings under Regulation A, such a relaxation would permit issuers to determine if sufficient interest exists in an offering prior to incurring the full costs of proceeding with the offering.

[8] We are not commenting on Recommendation IV.P.1 or Recommendation IV.P.2 as they apply to the incorporation into Regulation S-K or Regulation S-X of scaled disclosure accommodations and financial statement accommodations currently available to small business issuers under Regulation S-B.

Recommendation IV.S.1:
Amend SEC Rule 12g5-1 to interpret "held of record" in Exchange Act Sections 12(g) and 15(d) to mean held by actual beneficial holders.

Comment:

1. Although we support, in general, a reconsideration of the "held of record" definition, we believe that the application of a beneficial ownership test to determine whether an issuer is initially subject to registration under Section 12(g) would be unnecessarily complex. In our view, private companies should be entitled to use a simplified mechanism for determining their Section 12(g) obligations, and an annual assessment of their beneficial holdings would impose on them unnecessary burdens. In view of the fact that claimed abuses of the current "held of record" definition arose in the deregistration context, perhaps it would be preferable to limit the change in the definition to deregistration.

2. As the Commission is aware from the foreign private issuer context (where a review of beneficial ownership is required in connection with a determination of holders of record[9]), determination of the number of beneficial holders may not always be easy.[10] We would suggest that the Advisory Committee propose that any modification to the definition include rules or assumptions that would permit an issuer to readily determine its eligibility to deregister.

3. We concur that, prior to the adoption by the Commission of a beneficial ownership test for Section 12(g) registration or deregistration, the Commission should undertake a study to determine the effects of such a change, and possibly to change the number of shareholders that would trigger Exchange Act reporting or eligibility for deregistration. We believe that the applicable number would be integrally dependent upon the scaling concepts the Commission determines to adopt.

Recommendation IV.S.7:
Increase the disclosure threshold of Securities Act Rule 701(e) from $5 million to $20 million.

Comment:

[9] See Rule 12g3-2(a).
[10] A number of the comment letters addressed to the Commission in connection with its foreign private issuer deregistration proposal (*Release No. 34-53020; International Series Release No. 1295; File No. S7-12-05; December 23, 2005)* make this point. See, for example, the comment letter of this Committee (http://www.sec.gov/rules/proposed/s71205/mjholliday2517.pdf).

We support this recommendation, especially in view of the continued application of the general antifraud provisions to such offerings and the prohibition on the use of such offerings for capital raising purposes. As discussed in our comment to Recommendation IV.S.11 below, we suggest that the Advisory Committee consider recommending that all offerings and sales under Rule 701 be brought within the scope of "covered securities" under the National Securities Markets Improvement Act of 1996 ("NSMIA").

Recommendation IV.S.11:
Increase uniformity and cooperation between federal and state regulatory systems by defining the term "qualified investor" in the Securities Act and making the NASDAQ Capital Market and OTCBB stocks "covered securities" under NSMIA.

Comment:

1. We support the recommendation that NASDAQ Capital Market and OTCBB stocks be included within the definition of "covered securities" under NSMIA.[11]

2. We suggest that the Advisory Committee consider recommending that options or warrants to acquire covered securities, and other securities that are exercisable for, convertible into or exchangeable for, covered securities, be themselves included within the scope of the covered securities definition. In addition, if a security consists of or includes a guarantee of another security, we suggest that the Advisory Committee consider recommending that both the underlying security and the guaranty be deemed covered securities, if either alone is a covered security. We understand that the Commission's ability to propose this change will depend on the Commission's assessment of its statutory authority regarding the expansion of the definition of covered security.

3. We agree with the recommendation that the Commission define the term "qualified purchaser" in order to provide greater uniformity and certainty in the application of the provisions of NSMIA.

4. We suggest that the Advisory Committee consider recommending that securities offered or issued pursuant to compensatory benefit plans and compensatory contracts in accordance with Rule 701 be included within the definition of "covered securities." While a number of states exempt limited offers and offers to employees, the lack of federal pre-emption requires issuers to review various state law obligations in connection with each of their employee share programs, and may require an issuer to register or qualify its employee share programs, or to restructure or restrict such programs, as a result of state law considerations.

[11] We note that The Nasdaq Stock Market, Inc., in a petition to the Commission dated February 28, 2006, has requested that securities listed on the Nasdaq Capital Market be designated as covered securities (http://www.sec.gov/rules/petitions/petn4-513.pdf).

The Advisory Committee's recommendation in the Exposure Draft is not sufficiently broad to cover all securities that may be issued in Rule 701 transactions. While some of these transactions would be captured by the recommendation in the Exposure Draft that the definition of covered securities be broadened to include Nasdaq Capital Market and OTCBB securities, a number of nonreporting issuers with securities quoted in the Pink Sheets would not fall within the scope of the recommendation. In addition, if the Commission determines not to recommend a blanket inclusion of all Nasdaq Capital Market and OTCBB securities within the definition of covered securities, it could still determine that securities issued subject to the conditions of Rule 701 should be entitled to inclusion. We therefore suggest that the Advisory Committee consider expanding the scope of its recommendation to securities offered or issued in transactions exempted by Rule 701. We understand that the Commission's ability to propose this change will depend on the Commission's assessment of its statutory authority regarding the expansion of the definition of covered security.

We hope the Advisory Committee finds these comments helpful. We would be happy to discuss these comments further with representatives of the Advisory Committee.

Respectfully submitted,

COMMITTEE ON SECURITIES REGULATION

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