FINAL REPORT

OF THE

ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES

TO THE

U.S. SECURITIES AND EXCHANGE COMMISSION

[April 23], 2006

Final Report
of the
Advisory Committee on Smaller Public Companies
to the
U.S. Securities and Exchange Commission

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TRANSMITTAL LETTER

SEC ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES

Washington, DC 20549-3628

April 23, 2006

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1070

Dear Chairman Cox:

On behalf of the Commission's Advisory Committee on Smaller Public Companies, we are pleased to submit our Final Report.

[Contents of letter to be included in Final Report.]

Respectfully submitted on behalf of the Committee,

______________________	______________________
Herbert S. Wander Committee Co-Chair	James C. Thyen Committee Co-Chair

Enclosure

cc: Commissioner Cynthia A. Glassman
Commissioner Paul S. Atkins
Commissioner Roel Campos
Commissioner Annette L. Nazareth
Ms. Nancy M. Morris

MEMBERS, OFFICIAL OBSERVERS AND STAFF OF ADVISORY COMMITTEE

Members:

Herbert S. Wander, Co-Chair
Partner, Katten Muchin Zavis Rosenman
(Ex Officio Member of All Subcommittees and Size Task Force)

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[1] Alan Beller resigned as Director of the Division of Corporation Finance in February 2006.

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Associate Chief Accountant
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EXECUTIVE SUMMARY[2]

Background [3]

The U.S. Securities and Exchange Commission (the "Commission" or "SEC") chartered the Advisory Committee on Smaller Public Companies on March 23, 2005. The Charter provided that our objective was to assess the current regulatory system for smaller companies under the securities laws of the United States, and make recommendations for changes. The Charter also directed that we specifically consider the following areas of inquiry, including the impact in each area of the Sarbanes-Oxley Act of 2002: [4]

- frameworks for internal control over financial reporting applicable to smaller public companies, methods for management's assessment of such internal control, and standards for auditing such internal control;
- corporate disclosure and reporting requirements and federally imposed corporate governance requirements for smaller public companies, including differing regulatory requirements based on market capitalization, other measurements of size or market characteristics;
- accounting standards and financial reporting requirements applicable to smaller public companies; and

[2] This report has been prepared by the Committee and reflects its members' views. It does not reflect any position or regulatory agenda of the Commission.
[3] **Note on Terminology**: To aid understanding and improve readability, we have tried to avoid using defined terms with initial capital letters in this report. We generally use the terms "**public company**" and "**reporting company**" interchangeably to refer to any company that is required to file annual and quarterly reports with the SEC in accordance with either Section 13 or 15(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78m or 78o(d). When we refer to "**microcap companies**," we are referring to public companies with equity capitalizations of approximately $128 million or less. When we discuss "**smallcap companies**," we are talking about public companies with equity capitalizations of approximately $128 million to $787 million. We believe these labels generally are consistent with securities industry custom and usage. When we refer to "**smaller public companies**," we are referring to public companies with equity capitalizations of approximately $787 million and less, which includes both microcap and smallcap companies. We recognize that formal legal definitions of these terms may be necessary to implement some of our recommendations that use them, and we discuss our recommendations as to how some of them should be defined in Part II.
[4] Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

- the process, requirements and exemptions relating to offerings of securities by smaller companies, particularly public offerings.

The Charter further directed us to conduct our work with a view to furthering the Commission's investor protection mandate, and to consider whether the costs imposed by the current regulatory system for smaller companies are proportionate to the benefits, identify methods of minimizing costs and maximizing benefits and facilitate capital formation by smaller companies. The language of our Charter provided that we should consider providing recommendations as to where and how the Commission should draw lines to scale regulatory treatment for companies based on size.[5]

Our chartering documents[6] purposely did not define the phrase "smaller public company." Rather, it was intended that we recommend how the term should be defined. In addition, we were advised that we were charged with assessing the securities regulatory system for all smaller companies, both public and private, and were not limited to considering regulations applicable to public companies. The Commissioners and the SEC staff did advise us, however, that they hoped we would focus primarily on public companies, because of the apparent need for prompt attention to that area of concern, especially in view of problems in implementing the Sarbanes-Oxley Act of 2002.

Our 21 members voted unanimously on April 20, 2006 to adopt this Final Report and transmit it to the Commission. The recommendations set forth in this report were for the most part adopted unanimously. Where one or more members dissented or, while present, abstained from voting with respect to a specific recommendation, that fact has been noted in the text. Additionally, Part VII of this report contains separate statement(s) submitted by _____________ that describes briefly their reasons for disagreeing with specific recommendations of the majority of our voting members.

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[5] For a discussion of the need to tailor regulation to the specific attributes of smaller public companies, see Letter from BDO Siedman, LLP to SEC, 2 (Oct. 31, 2005) (on file in SEC Public Reference Room File No.S7-06-03).
[6] The official notice of establishment of the Committee and its Charter, included in this report as Appendices A and B, respectively, constitute our chartering documents.

Recommendations

Our final recommendations are discussed in the remainder of this report. Before summarizing our highest priority recommendations below, we would like to explain why we have presented them in the order that we have. As detailed under the caption "Part I—Committee History—Committee Activities," we conducted most of our preliminary deliberations in four subcommittees and a "size task force" comprised of a representative of each subcommittee and Committee Co-Chair James C. Thyen, who chaired the size task force. The subcommittees and the size task force generated preliminary recommendations that were discussed and approved by the full Committee. We agreed at our meeting on April 20, 2006 to submit to the Commission the 32 final recommendations contained in this report.[7]

We recognize that it is unlikely that the Commission and its staff will be able to consider, much less act upon, all 32 of these recommendations at once. Furthermore, submitting such a large number of recommendations, without any indication of the importance or priority we ascribe to them, might make the Commission less likely to act upon recommendations in areas where we believe the need for action is most urgent. Accordingly, we have adopted a two-tiered approach towards the prioritization of our recommendations.

The first tier—the recommendations to which we assign the highest priority—we refer to as our "primary recommendations." Our primary recommendations are set forth under the specific topic to which they relate: our recommendation concerning establishment of a scaled securities regulation system is discussed under the caption "Part II. "Scaling Securities Regulation for Smaller Companies"; recommendations related to internal control over financial reporting are discussed under the caption "Part III. Internal Control Over Financial Reporting"; corporate governance, disclosure and capital formation recommendations are discussed under the caption "Part IV. Corporate Governance, Disclosure and

Capital Formation"; and accounting standards recommendations are discussed under the caption "Part V. Accounting Standards."

Our first primary recommendation concerns establishment of a new system of scaled or proportional securities regulation for smaller public companies based on a stratification of smaller public companies into two groups, microcap companies and smallcap companies. Under this recommendation, microcap companies would consist of companies whose common stock (or equivalent) in the aggregate comprises the lowest 1% of total U.S. equity market capitalization, and smallcap companies would consist of companies whose common stock (or equivalent) in the aggregate comprises the next lowest 5% of total U.S. equity market capitalization. Smaller public companies, consisting of microcap and smallcap companies, would thus in the aggregate comprise the lowest 6% of total U.S. equity market capitalization. While they account for only a small percentage of total U.S. equity market capitalization, these companies represent a substantial percentage of all U.S. public companies, as show in the table below:[8]

	Market Capitalization Cutoff	**Percentage of Total U.S. Equity Market Capitalization**	**Percentage of all U.S. Public Companies**
Microcap Companies	<$128 million	1%	50%
Smallcap Companies	$128-$787 million	5%	30%
Smaller Public Companies*	<$787 million	6%	80%
Larger Public Companies	>$787 million	94%	20%

* Includes both microcap and smallcap companies.

We believe that the Commission should establish such a system before or in connection with proceeding to examine individual securities regulations to determine whether they are candidates for integration of scaling treatment under the new system. Because of its significance, we felt that this recommendation merited discussion under a separate caption. Accordingly, we discuss this

[7] This does not include two recommendations, detailed in Appendix L of this report, which the Committee adopted on August 10, 2005 and submitted to the Commission in a separate report dated August 18, 2005. The Commission acted favorably upon these two recommendations on December 21, 2005.

recommendation and our thoughts about implementing in "Part II. Scaling Securities Regulation for Smaller Companies."

Below is a list of our remaining primary recommendations, and the location in this report where they are described in greater detail:[9]

- 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 (Recommendation II.P.1).

- Unless and until a framework for assessing internal control over financial reporting for microcap companies is developed that recognizes the characteristics and needs of those companies, provide exemptive relief from the requirements of Section 404 of the Sarbanes-Oxley Act[10] to microcap companies with less than $125 million in annual revenue and to smallcap companies with less than $10 million in annual 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 Securities Exchange Act of 1934[11]; and
    - adoption of a code of ethics within the meaning of Item 406 of Regulation S-K[12] 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 ethics.

  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

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[8] Source: SEC Office of Economic Analysis, Background Statistics: Market Capitalization and Revenue of Public Companies (Aug. 2, 2005) (included as Appendix I).
[9] We have labeled our recommendations by section in which their full description appears, status (either primary (P) or secondary (S)), and rank within a given section. Hence the first primary recommendation in Part III is Recommendation III.P.1; the third secondary recommendation in Part IV is Recommendation IV.S.3, etc.
[10] 15 U.S.C. 7262.
[11] 15 U.S.C. 78a et seq.
[12] 17 C.F.R. 229.

smallcap companies also, 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.

Moreover, management should be required to report on any known material weaknesses. In this regard, the Proposed Statement on Auditing Standards of the AICPA, "Communications of Internal Control Related Matters Noted in an Audit," if adopted by the AICPA and the Public Company Accounting Oversight Board (PCAOB), would strengthen this disclosure requirement and provide some external auditor involvement in the internal control over financial reporting process. (Recommendation III.P.1).

- Unless and until a framework for assessing internal control over financial reporting for smallcap companies is developed that recognizes the characteristics and needs of those companies, provide exemptive relief from external auditor involvement in the Section 404 process to smallcap companies with less than $250 million but greater than $10 million in annual revenues, subject to their compliance with the same corporate governance standards detailed in the recommendation above (Recommendation III.P.2).

- While we believe that the costs of the requirement for an external audit of the effectiveness of internal control over financial reporting are disproportionate to the benefits, and have therefore adopted the second Section 404 recommendation above, we also believe that if the Commission reaches a public policy conclusion that an audit requirement is required, we recommend that changes should be made to the requirements for implementing Section 404's external auditor requirement to a cost-effective standard, which we call "ASX," providing for an external audit of the design and implementation of internal controls (Recommendation III.P.3).

- Incorporate the scaled disclosure accommodations currently available to small business issuers under Regulation S-B into Regulation S-K, make them available to all microcap companies, and cease prescribing separate specialized disclosure forms for smaller companies (Recommendation IV.P.1).

- 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 smaller public companies, including both microcap companies and smallcap companies (Recommendation IV.P.2).

- Allow all reporting companies to be eligible to use Form S-3, if they have been reporting under the Exchange Act for at least one year and are current in their reporting at the time of filing (Recommendation IV.P.3).

- Adopt policies that encourage and promote the dissemination of research on smaller public companies (Recommendation IV.P.4).

- Adopt a new private offering exemption to the registration requirements of the Securities Act of 1933 (the "Securities Act")[13] 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 (Recommendation IV.P.5).

- Spearhead a multi-agency effort to create a streamlined NASD registration process for finders, M&A advisors and institutional private placement practitioners (Recommendation IV.P.6).

- Develop a "safe-harbor" protocol for accounting for transactions that would protect well-intentioned preparers from regulatory or legal action when the process is appropriately followed (Recommendation V.P.1).

- In implementing new accounting standards, the FASB should permit microcap companies to apply the same extended effective dates that it provides for private companies (Recommendation V.P.2).

- Consider additional guidance for all public companies with respect to materiality related to previously issued financial statements (Recommendation V.P.3).

- Implement a de minimis provision in the application of the SEC's auditor independence rules (Recommendation V.P.4).

Our second tier consists of all of remaining recommendations, which we refer to in this report as "secondary recommendations." Although we have assigned these a lower priority than the recommendations set forth above, we do not in any way intend to diminish their importance. In this regard, we note that importance is at times not only a function of the perceived need for change but also the perceived ease with which the Commission could enact such change; as noted throughout the report, many problems simply defy easy solution. Moreover, several of these recommendations are aspirational in nature, and do not involve specific Commission action. As with the primary recommendations, these secondary recommendations are set forth under the specific topics to which they relate, and within each such section, recommendations are presented in descending order of

[13] 15 U.S.C. 77a et seq.

importance (i.e., the secondary recommendation that we would most like to see adopted is listed first, etc.).

PART I. COMMITTEE HISTORY

On December 16, 2004, then SEC Chairman William H. Donaldson announced the Commission's intent to establish the SEC Advisory Committee on Smaller Public Companies.[14] At the same time, Chairman Donaldson announced his intention to name Herbert S. Wander and James C. Thyen as Co-Chairs of the Committee. The official notice of our establishment was published in the Federal Register five days later.[15] The Committee's membership was completed on March 7, 2005, representing a wide range of professions, backgrounds and experiences.[16] The Committee's Charter was filed with the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services on March 23, 2005, initiating our 13-month existence.[17]

Committee Activities

We held our organizational meeting on April 12, 2005 in Washington, D.C., where Chairman Donaldson swore in and addressed our members. Also at that meeting, we adopted our by-laws, proposed a Committee Agenda to be published for public comment[18] and reviewed a subcommittee structure and Master Schedule prepared by our Co-Chairs. This and all of our subsequent meetings were open to the

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[14] SEC Establishes Advisory Committee to Examine Impact of Sarbanes-Oxley Act on Smaller Public Companies, SEC Press Release No. 2004-174 (Dec. 16, 2004) (included as Appendix D).
[15] Advisory Committee on Smaller Public Companies, SEC Release No. 33-8514 (Dec. 21, 2004) [69 Fed. Reg. 76498] (included as Appendix B).
[16] SEC Chairman Donaldson Announces Members of Advisory Committee on Smaller Public Companies, SEC Press Release No. 2005-30 (Mar. 7, 2005) (included as Appendix E). This press release describes the diverse backgrounds of the Committee members.
[17] See Committee Charter (included as Appendix B).
[18] The Record of Proceedings of this and subsequent meetings of the Committee are available on our web site at http://www.sec.gov/info/smallbus/ascpc.shtml.. See Record of Proceedings, Meeting of the Securities and Exchange Commission Advisory Committee on Smaller Public Companies (Apr. 12, June 16, June 17, Aug. 9, Aug. 10, Sept. 19, Sept. 20, Oct. 24, Oct. 25 & Dec. 14, 2005 & Feb. 21, Apr. 11 & Apr. 20, 2006) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/info/smallbus/ascpc.shtml (hereinafter Record of Proceedings (with appropriate date)).

public and conducted in accordance with the requirements of the Federal Advisory Committee Act.[19] All meetings of the full Committee also were Web cast over the Internet.

Shortly following our formation, we adopted several overarching principles to guide our efforts:

- Further Commission's investor protection mandate.
- Seek cost choice/benefit inputs.
- Keep it simple.
- Maintain culture of entrepreneurship.
- Capital formation should be encouraged.
- Recommendations should be prioritized.

We held subsequent meetings in 2005 on June 16 and 17 in New York City, August 9 and 10 in Chicago, September 19 and 20 in San Francisco, and October 14 again in New York City. A total of 42 witnesses testified at these meetings.[20] We adopted our Committee Agenda at the June 16 meeting in New York.[21] We adopted two recommendations to the Commission at our Chicago meeting, where we also adopted an internal working definition of the term "smaller public company."[22] We held additional meetings in Washington on October 24 and 25 and December 14, 2005 and February 21, 2006 to consider and vote on recommendations and the draft of our final report to the Commission. SEC Chairman Christopher Cox, who had succeeded Chairman Donaldson on August 3, 2005, addressed us at the October 24 meeting in Washington. No witnesses testified at the additional meetings in Washington.

The Committee, through the Commission, published three releases in the Federal Register

[19] 5 U.S.C.–App. 1 et seq.

[20] Appendix K contains a list of witnesses who testified before the Committee.

[21] The Committee Agenda is included as Appendix C.

[22] The Chicago recommendations were submitted to the Commission by letter dated August 18, 2005 to SEC Chairman Christopher Cox, who had succeeded Chairman Donaldson. The text of the letter is included as Appendix K. The letter included copies of documents entitled "Six Determinants of a Smaller Public Company" and "Definition of Smaller Public Company," which had been made available to the Committee before it adopted its definition of the term "smaller public company."

formally seeking public comment on issues it was considering. On April 29, 2005, we published a release seeking comments on our proposed Committee Agenda,[23] in response to which we received ___ written submissions. On August 2, 2005, we published 29 questions on which we sought public input, to which we received 266 responses.[24] Finally, on February 27, 2006, we published an exposure draft of our final report,[25] which generated ___ written submissions. In addition, each meeting of the Committee was announced by formal notice in a Federal Register release, and each such notice included an invitation to submit written statements to be considered in connection with the meeting. In total, we received ___ written statements in response to Federal Register releases, all of which are available in the SEC's Public Reference Room and posted on our Web page at http://www.sec.gov/info/smallbus/acspc.shtml.

In addition to work carried out by the full Committee, fact finding and deliberations also took place within four subcommittees appointed by our Co-Chairs. The subcommittees were organized according to their principal areas of focus: Accounting Standards, Capital Formation, Corporate Governance and Disclosure, and Internal Control Over Financial Reporting. Each of the subcommittees prepared recommendations for consideration by the full Committee. We approved preliminary versions of most recommendations at our December 14, 2005 meeting. A fifth subgroup, sometimes referred to as the "size task force" in our deliberations, consisted of one volunteer from each subcommittee and our Co-Chair James C. Thyen. The size task force met to consider common issues faced by the subcommittees relating to establishment of parameters for eventual recommendations on scalability of regulations based on a company's size. The task force developed internal working guidelines for the subcommittees to use for this purpose and reported them to the full Committee at our August 10, 2005 meeting.[26] We voted to

[23] Summary of Proposed Committee Agenda of Advisory Committee on Smaller Public Companies, SEC Release No. 33-8571, (Apr. 29, 2005) [70 Fed. Reg. 22378] .
[24] See Request for Public Input by Advisory Committee on Smaller Public Companies, SEC Release No. 33-8599 (Aug. 5, 2005) [70 Fed. Reg. 45446] (included as Appendix H).
[25] ________________________________, SEC Release No. 33-____ (2006) [71 FR].
[26] See Record of Proceedings 62-103 (Aug. 10, 2005).

approve the guidelines, which are discussed in the next part of this report.

PART II. SCALING SECURITIES REGULATION FOR SMALLER COMPANIES

We developed a number of recommendations concerning the Commission's overall policies relating to the scaling of securities regulation for smaller public companies. As discussed below, we believe that these recommendations are fully consistent with the original intent and purpose of our Nation's securities laws.[27] We believe that, over the years, some of the original principles underlying our securities laws, including proportionality, have been lost sight of, and that the Commission should seek to restore balance in these areas where appropriate.

Our primary recommendation concerning scaling, and one that underlies several other recommendations that follow in this report, is as follows:

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.**

This new system would replace the SEC's current scaling system for "small business issuers" eligible to use Regulation S-B[28] as well as the current scaling system based on "non-accelerated filer"

[27] For background on the history of scaling federal securities regulation for smaller companies, see the discussion under the caption "—Commission Has a Long History of Scaling Regulation" below.
[28] Regulation S-B can be found at 17 CFR 228.

status,[29] but would provide eligibility for scaled regulation for companies based on their size relative to larger companies.[30]

Under our recommended system, companies would be eligible for special scaled or proportional regulation if they fall into one of two categories of smaller public companies based on size. We call one category "microcap companies" and the other "smallcap companies." Both categories of companies would be included in the category of "smaller public companies" that qualify for the new scaled regulatory system. Companies whose common stock (or equivalent) in the aggregate comprises the lowest 1% of total U.S. equity market capitalization (companies with equity capitalizations below approximately $128 million[31]) would qualify as microcap companies. Microcap companies would be entitled to the regulatory scaling benefits that both small business issuers and non-accelerated filers now receive. Companies whose common stock (or equivalent) in the aggregate comprises the next lowest 5% of total U.S. equity market capitalization (companies with equity capitalizations between approximately $128 million and $787 million) generally would qualify as smallcap companies.[32] Smallcap companies would be entitled to the regulatory scaling provided by SEC regulations for companies of that size after study of their characteristics and special needs.

Under the system we are recommending, microcap companies generally would be entitled to the accommodations afforded to small business issuers and non-accelerated filers under the SEC's current rules. Smallcap companies would be entitled to whatever accommodations the SEC decides to provide

[29] "Non-accelerated filers" are public companies that do not qualify as "accelerated filers" under the SEC's definition of the latter term in 17 C.F.R. 240.12b-2, generally because they have a public float of less than $75 million. Companies that do not qualify as accelerated filers have more time to file their annual and quarterly reports with the SEC and have not yet been required to comply with the internal control over financial reporting in Section 404 of the Sarbanes-Oxley Act.

[30] We believe our recommended system complements the SEC's recently promulgated securities offering reforms, which are principally available to a category of public companies with over $700 million in public float known as "well-known seasoned issuers." We recognize, however, that the Commission will need to assure that our recommendations, if adopted, are integrated well with the categories of companies established in the securities offering reform initiatives.

[31] SEC Office of Economic Analysis, Background Statistics: Market Capitalization and Revenue of Public Companies (Aug. 2, 2005) (included as Appendix I). Data was derived from Center for Research in Security Prices (CRSP) for 9,428 New York

them in the future. As discussed below, we are recommending that the SEC provide certain relief under Section 404 of the Sarbanes-Oxley Act to certain smaller public companies.[33] We also are recommending that the SEC permit smaller public companies to follow the financial statement rules now followed by small business issuers under Item 310 of Regulation S-B rather than the financial statement rules in Regulation S-X currently followed by all companies that are not small business issuers.[34]

Our primary reason for recommending special scaled regulation for companies falling in the aggregate in the lowest 6% of total U.S. equity market capitalization is that this cutoff assures the full benefits and protection of federal securities regulation for companies and investors in 94% of the total public U.S. equity capital markets. This limits risk and exposure to investors and protects investors from serious losses (e.g., 100 bankruptcies companies with $10 million total market capitalization would be required to equal the potential loss of the bankruptcy of a company with $1 billion of market capitalization). Our recommended standard acknowledges the relative risk to investors and the capital markets as it is currently used by professional investors.

In addition, the Committee considered the SEC's recent adoption of rules reforming the securities offering process.[35] Reporting companies with a public float of $700 million or more, called "well-known seasoned issuers," generally will be permitted to benefit to the greatest degree from securities offering reform. We are hopeful that the Commission will see fit to adopt a disclosure system applicable to "smaller public companies" that integrates well with the disclosure and other rules applicable to "well-known seasoned issuers." We believe that companies that qualify as "smaller public companies" on the basis of equity market capitalization should not also qualify as "well-known seasoned issuers."

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and American Stock Exchange companies as of Mar. 31, 2005 and from NASDAQ for NASDAQ Stock Market and OTC Bulletin Board firms as of June 10, 2005.

[32] Id.

[33] See the discussion in Part III below.

[34] See the discussion in Part IV below.

[35] See Securities Offering Reform, SEC Release No. 33-8591 (July 19, 2005) [70 FR 44722].

We recommend that the SEC implement this recommendation by promulgating regulations under which all U.S. companies with equity securities registered under the Exchange Act would be ranked from largest to smallest equity market capitalization at each recalculation date.[36] The ranges of market capitalizations entitling public companies to qualify as a "microcap company" and "smallcap company" would be published soon after the recalculation. These ranges would remain valid until the next recalculation date. Companies would be able to determine whether they qualify for microcap and smallcap company treatment by comparing their market capitalization on their determination date, presumably the last day of their fiscal year, with the ranges published by the SEC for the most recent recalculation date.[37] This is what we mean when we say that the measurement metric for determining "small public company" status should be "self-calibrating."

In promulgating these rules, the SEC will need to establish clear transition rules providing how companies would graduate from the microcap category to the smallcap category to the realm where they would not be entitled to smaller public company scaling. The transition rules would also need to specify how companies would move from one category to another in the reverse order, from no scaling entitlement to smallcap company treatment to microcap entitlement. The SEC has experience and precedents to follow in its transition rules governing movement to and from Regulation S-B and Regulation S-K, non-accelerated filer status and accelerated filer status, and well know seasoned issuer eligibility and non-eligibility.

We believe that our plan for providing scaled regulatory treatment for smaller public companies contains features that recommend it over some other SEC regulatory formats. For example, it provides

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[36] We leave to the Commission's discretion the frequency with which this recalculation should occur, but note that frequent recalculation, even on an annual basis, could introduce an undesirable level of uncertainty into the process for companies trying to determine where they fall within the three categories.

[37] In formulating this recommendation, we looked for guidance at the method used to calculate the Russell U.S. Equity Indexes. For more information on Russell's method, see Russell U.S. Equity Indexes, Construction and Methodology (July 2005)), available at www.russell.com.

for a flexible measurement that can move up and down, depending on stock price and other market levels. It avoids the problem of setting a dollar amount standard that needs to be revisited and rewritten from time to time, and consequently provides a long-term solution to the problem of re-scaling securities regulation for smaller public companies every few years. Finally, assuming the plan is implemented as we intend, the system would provide full transparency and allow each company and its investors to determine the company's status in advance or at any time based on publicly available information. This would allow companies to plan for transitions suitably in advance of compliance with new regulations.

We recommend that the SEC use equity market capitalization, rather than public float, to determine eligibility for smaller public company treatment for several reasons.[38] We are aware that the SEC historically has used public float as a measurement in analogous regulatory contexts.[39] We believe, however, that equity market capitalization better measures total risk to investors (including affiliates) and the U.S. capital markets than public float, and consequently that it is the most relevant measure in determining which companies initially should qualify for scaled securities regulatory treatment based on size. We also believe that using market capitalization has the additional advantage of simplicity, as it avoids what can be the difficult problem of deciding for legal purposes which holdings are public float and which are not.[40] This can be a subjective determination; not all companies reach the same conclusions on this issue based on similar facts, which can lead to problems of comparability.

In formulating our scaling recommendation, we considered a number of alternatives to market capitalization as the primary metric for determining eligibility for scaling, including revenues. Ultimately, however, we felt that any benefits to be derived from adding additional metrics to the

[38] The Commission would, of course, need to prescribe a standardized methodology for computing market capitalization.
[39] For example, a public float test is used to determine a company's eligibility to use Forms SB-2, F-2, F-3 and S-3 and non-accelerated filer status.
[40] Because public float by definition excludes shares held by affiliates, calculation of public float relies upon an accurate assessment of affiliate status of officers, directors and shareholders. As the Commission acknowledged in the Rule 144 context, this requires a subjective, facts and circumstances determination that entails a great deal of uncertainty. See Revision of Rule 144, Rule 145 and Form 144, SEC Release No. 33-7391 (Feb. 20, 1997) [62 FR 9246].

primary formula were outweighed by the additional complexity that introduction of those additional size parameters would entail. We wish to make it clear, however, that we believe that additional determinants based on other metrics of size may be appropriate in the context of individual securities regulations. For example, our own recommendations on internal control over financial reporting contain metrics conditioning the availability of scaling treatment on company annual revenues.

Commission Has a Long History of Scaling Regulation

Since federal securities regulation began in the 1930's, it has been recognized that some companies and transactions are of insufficient magnitude to warrant full federal regulation, or any federal regulation at all. Smaller public companies primarily have been subject to two securities statutes, the Securities Act and the Exchange Act. The Securities Act, originally enacted to cover distributions of securities, has from the beginning contained a "small issue" exemption in Section 3(b)[41] that gives the SEC rulemaking authority to exempt any securities issue up to a specified maximum amount. This amount has grown in stages, from $100,000 in 1933 to $5 million since late 1980.[42] The Exchange Act originally was enacted to regulate post-distribution trading in securities. It did so by requiring registration by companies of classes of their securities. At first, the Exchange Act required companies to register only if their securities were traded on a national securities exchange. This assured that smaller companies of insufficient size to warrant exchange listing would not be subject to overly burdensome federal securities regulation.

In 1964, Congress extended the reach of most of the Exchange Act's public company provisions to cover companies whose securities trade over-the-counter.[43] Since all securities other than exchange-

[41] 15 U.S.C. 77c(b).
[42] Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 387 (2004). The Commission has adopted a number of exemptive measures for small issuers pursuant to its authority under Section 3(b), including Rules 504 and 505, Regulation A and the original version of Rule 701.
[43] Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (adding Section 12(g), among other provisions, to the Exchange Act).

listed securities technically trade "over-the-counter," this expansion required limiting the companies covered to avoid creating a burden on issuers and the Commission that was "unwarranted by the number of investors protected, the size of companies affected, and other factors bearing on the public interest."[44] Congress wanted to ensure that "the flow of reports and proxy statements [would] be manageable from the regulatory standpoint and not disproportionately burdensome on issuers in relation to the national public interest to be served."[45] Accordingly, Congress chose to limit coverage to companies with a class of equity security held of record by at least 500 persons and net assets above $1 million.[46] Over time, the standard set by Congress at 500 equity holders of record and $1 million in net assets required adjustment to assure that the burdens placed on issuers and the Commission were justified by the number of investors protected, the size of companies affected, and other factors bearing on the public interest, as originally intended by Congress. The Commission has raised the minimum net asset level several times; it now stands at $10 million.[47]

In 1992, the Commission adopted Regulation S-B,[48] a major initiative that allows companies qualifying as "small business issuers" (currently, companies with revenues and a public float of less than $25 million[49]) to use a set of abbreviated disclosure rules scaled for smaller companies. In 2002, the Commission divided public companies into two categories, "accelerated filers" and "non-accelerated filers," and in 2005 added a third category of "large accelerated filers," providing scaled securities regulation for these three tiers of reporting companies.[50] Non-accelerated filers are fundamentally public

[44] S. Rep. No. 88-379, at 19 (1963).
[45] Id.
[46] 15 U.S.C. § 78l(g).
[47] 17 C.F.R. 240.12g5-1.
[48] 17 C.F.R. 228.10 et seq.
[49] 17 C.F.R. 228.10(a)(1). "Small business issuers" must also be U.S. or Canadian companies, not investment companies and not majority owned subsidiaries of companies that are not small business issuers.
[50] See "Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Report," SEC Release No. 33-8128, 34-46464 (Sep. 16, 2002) [67 FR 58480].

companies with a public float below $75 million, and large accelerated filers are public companies with a public float of $700 million or more.[51]

Notwithstanding the benefits to which smaller business issuers and non-accelerated filers are entitled under the Commission's current rules, we believe significant changes to the federal securities regulatory system for smaller public companies, such as those recommended in this report, are required to assure that it is properly scaled for smaller public companies. Our experience with smaller public companies, as well as the testimony and written statements we received, support this view. We believe that the problem of improper scaling for smaller public companies has existed for many years, and that the additional burdens imposed by the Sarbanes-Oxley Act only exacerbated the problem and caused it to become more visible.

PART III. INTERNAL CONTROL OVER FINANCIAL REPORTING

Introduction

From the earliest stages of its implementation, Sarbanes-Oxley Act Section 404 has posed special challenges for smaller public companies. To some extent, the problems smaller companies have in complying with Section 404 are the problems of companies generally: lack of clear guidance; an unfamiliar regulatory environment that leads to overly conservative judgments and a focus on detailed control activities by auditors; and the lack of sufficient resources and competencies in an area in which companies and auditors have previously not placed great emphasis.

But because of their different operating structures, smaller public companies have felt the effects of Section 404 in a manner different from their larger counterparts. With more limited resources, fewer internal personnel and less revenue with which to offset both implementation costs and the more or less fixed costs of Section 404 compliance, these companies have been disproportionately subject to the

[51] 17 C.F.R. 240.12b-2. Both accelerated filers and large accelerated filers must also have been reporting for at least 12

burdens associated with Section 404 compliance. Moreover, the benefits of documenting,[52] testing and certifying the adequacy of internal controls, while of obvious importance for large multinational corporations, are of less certain value for smaller public companies, who rely to a greater degree on "tone at the top" and high-level monitoring controls, which may be undocumented and untested,[53] to influence accurate financial reporting. The result is a cost/benefit equation that, many believe, diminishes shareholder value, makes smaller public companies less attractive as investment opportunities and impedes the ability of smaller public companies to compete. This last factor is particularly problematic in light of the crucial role smaller public companies play in job creation and economic growth.

We acknowledge that in the course of our deliberations we heard certain respected persons question whether the Section 404 problem for smaller public companies is, in fact, overstated.[54] In the view of some, the benefits of Section 404 for small companies outweigh the costs, authoritative guidance for smaller public companies will provide issuers with sufficient guidance in areas where clarity is currently lacking, and at any rate Section 404 expenditures will decrease substantially as issuers and their auditors become more familiar with the law's requirements. However, our collective experience, and the outpouring of testimony, comment letters and input we received, suggests otherwise.

After thorough consideration of the evidence presented, we believe that Section 404 represents a clear problem for smaller public companies and their investors, one for which relief is urgently needed. Our recommendations as to how to improve the existing structure, consistent with investor protections, are discussed below. Although these recommendations are based upon 13 months of intensive study and

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months, have filed at least one annual report and not be eligible to use Forms 10-KSB and 10-QSB.

[52] SEC rules require that a company maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the company's internal control over financial reporting. See Section II.B. of Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release No. 33-8238 (June 5, 2003) [68 FR 36636]

[53] The COSO framework recognizes that formal documentation is not always necessary, and that informal and undocumented controls, even when communicated orally, can be highly effective. See COSO framework at pp. 30, 73.

[54] See, e.g., Record of Proceedings 64 (Sept. 19, 2005) (testimony of Lynn E. Turner), available at http://www.sec.gov/info/smallbus/acspc/acspctranscript091905.pdf.

debate, they essentially derive from a few fundamental ideas: the primary objective of internal control requirements should be the prevention of materially inaccurate financial statements; companies operate differently, depending on size, and internal control rules should reflect this fact; and the benefits of any regulatory burden—Section 404-related or otherwise—should outweigh the costs.

Because an appreciation of the existing Section 404 problem requires an understanding of the problem's origin, we have included below a brief background section, followed by an overview of our recommendations and the recommendations themselves.

Background of Section 404

Sarbanes-Oxley Act Section 404 directed the SEC to adopt rules requiring all reporting companies, other than registered investment companies, to include in their annual reports a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting, together with an assessment of the effectiveness of those internal controls. Section 404 further required that the company's independent auditors attest to, and report on, this management assessment.

In accordance with Congress' directive, on June 5, 2003 the Commission adopted the basic rules implementing Section 404 with regard to management's obligations to report on internal control over financial reporting.[55] In addition, on June 17, 2004 the Commission issued an order approving Auditing Standard No. 2 of the PCAOB, entitled <u>An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements</u> ("AS2"), which established the requirements that apply to the independent auditor when performing an audit of a company's internal control over financial reporting.[56] The rules adopted by the Commission and the PCAOB implementing Section 404 require management to base its evaluation of internal control over financial reporting on a suitable, recognized control framework that is established by a body or group that has followed due-process

[55] SEC Release No. 33-8238 (June 5, 2003) [68 FR 36636].
[56] SEC Release No. 34-49884 (June 17, 2004) [69 FR 35083].

procedures, including the broad distribution of the framework for public comment.[57] Commission rules implementing both Section 404 and AS2 specifically identify the internal control framework published by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") as suitable for such purposes, and indeed, the COSO framework has emerged as the internal control framework used by virtually all U.S. companies.[58]

During the early stages of implementation of Section 404, it became clear that smaller public companies, due to their size and structure, were experiencing significant challenges, both in implementing that provision's requirements and in applying the SEC and PCAOB-endorsed COSO framework. Many expressed serious concerns about the ability to apply Section 404 to smaller public companies in a cost-effective manner, and also about the need for additional guidance for smaller businesses in applying the COSO framework. Against this backdrop, and at the encouragement of the SEC staff, COSO in October 2005 issued for public comment an exposure draft entitled "Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting."[59] While intended to provide much needed clarity, the guidance has to date received mixed reviews, with many questioning whether it will significantly change the disproportionate cost and other burdens or the cost/benefit equation associated with Section 404 compliance for smaller public companies.[60]

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[57] See Exchange Act Rules 13a-15(c) and 15d-15(c) [17 C.F.R. 240.13a-15(c) and 240.15d-15(c)].

[58] COSO is a voluntary private sector organization sponsored by the American Institute of Certified Public Accountants (AICPA), the American Accounting Association, Financial Executives International, the Institute of Internal Auditors, and the Institute of Management Accountants. The COSO framework presents a common definition of internal control and provides a framework against which internal controls within a company can be assessed and improved. Under the COSO framework, internal control over financial reporting is defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the reliability of financial reporting. Internal control over financial reporting includes five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring. For a summary discussion of the framework, see Committee of Sponsoring Organizations Treadway Commission, Internal Control–Integrated Framework (1992), available at http://www.coso.org/publications/executive_summary_integrated_framework.htm.

[59] Available at http://www.ic.coso.org.

[60] Several comment letters submitted to COSO in respect of the guidance are illustrative, including the following: Letter of PCAOB to COSO (Jan. 18, 2006) ("[S]ome of the approaches and examples in the draft may be inappropriate or impractical for the smallest public companies. We recommend that COSO reconsider whether there is additional, more practical advice that COSO could give to such companies."); Letter of Institute of Management Accountants to COSO (Oct. 24, 2005) ("The

Reporting companies initially were to be required to comply with the internal control reporting provisions for the first time in connection with their fiscal years ending on or after June 15, 2004 (accelerated filers)[61] or April 15, 2005 (non-accelerated filers and foreign private issuers). Recognizing the importance of these provisions and the time necessary to implement them properly, on February 24, 2004 the Commission extended these compliance dates to fiscal years ending after November 15, 2004 for accelerated filers and July 15, 2005 for non-accelerated filers and foreign private issuers.[62]

On March 2, 2005, the Commission further extended the compliance dates for non-accelerated filers and foreign private issuers to fiscal years ending after July 15, 2006.[63] Additionally, due to the continuing evaluation of the impact of the Section 404 requirements on smaller public companies by this Committee, on September 21, 2005, the Commission provided an additional one-year extension of the compliance deadline for non-accelerated (but not larger foreign) filers to fiscal years ending after July 15, 2007.[64]

Unintended Consequences of Attempts to Address Internal Controls

The legislative history of Section 404 makes clear that regulators and members of Congress never anticipated many of the challenges that Section 404 compliance has presented. Section 404 itself states

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IMA is unclear as to how this guidance, built on the existing COSO framework, tangibly reduces SOX compliance costs for small businesses or businesses of any size."); Letter of Deloitte & Touche LLP to COSO (Dec. 30, 20050 ("We believe that many of the examples in the exposure draft are too high-level and generic and do not address the issues faced by smaller public companies."); Letter of Crowe Chizek and Company LLC to COSO (Dec. 29, 2005) ("While the document will help smaller companies, we do not believe that it will result in substantial reduction in the cost of evaluating and documenting the internal control process by management, and on the cost to audit internal controls by companies' auditing firms."); Letter of Ernst & Young LLP to COSO (Jan. 15, 2006) ("[A]lthough we believe the Guidance will be an excellent implementation aid, we are less convinced that it will significantly reduce the cost of 404 implementation for smaller companies, at least to the degree expected by some.") All such comment letters are available at http://www.ic.coso.org/coso/cosospc.nsf/COSO%20Public%20Comments%20Document.pdf. The Chairman of COSO made a presentation at our San Francisco meeting and met informally with members of our Internal Control Over Financial Reporting Subcommittee.

[61] The term "accelerated filer" is defined in Rule 12b-2 [17 C.F.R. 240.12b-2] under the Exchange Act [15 U.S.C. 78a et seq.].

[62] SEC Release No. 33-8392 (Feb. 24, 2004) [69 FR 9722].

[63] SEC Release No. 33-8545 (Mar. 2, 2005) [70 FR 11528].

[64] SEC Release No. 33-8545 (Sep. 22, 2005) [70 FR 11528].

that the auditor's attestation "shall not be the subject of a separate engagement." Moreover, the Senate Committee Report that accompanied Section 404 to the Senate floor included the following language:

> In requiring the registered public accounting firm preparing the audit report to attest to and report on management's assessment of internal controls, the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees. High quality audits typically incorporate extensive internal control testing. The Committee intends that the auditor's assessment of the issuer's system of internal controls should be considered to be a core responsibility of the auditor and an integral part of the audit report.[65]

Additionally, the Commission's June 2003 release adopting internal control rules, which predated adoption and approval of AS2, estimated that the average annual internal cost of compliance with Section 404 over the first three years would be $91,000, and that cost would be proportional relative to the size of the company.[66] The reality has, of course, been much different.

The anxieties that Section 404 has produced, and the heavy expenses that have been incurred in an attempt to comply with its requirements, parallel those experienced as a result of Congress' last major initiative to address internal accounting controls, the Foreign Corrupt Practices Act of 1977, or FCPA.[67] That statute added two accounting requirements applicable to public companies under the Exchange Act, including Section 13(b)(2)(B), the provision that requires public companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that specified objectives are attained.[68] Then, as now, Congress acted to address public concerns following several high profile cases of corporate malfeasance. And then, as now, arguably uncertain standards of compliance, combined with the threat of significant liability for non-compliance, worked to create an atmosphere in which

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[65].S. Rep. No. 107-205, at 31 (2002) (emphasis added).

[66] See Sections IV and V of Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release No. 33-8238 (June 5, 2003) [68 FR 36636] ("[W]e assumed that there is a direct correlation between the extent of the burden and the size of the reporting company, with the burden increasing commensurate with the size of the company."). The Commission did, however, anticipate that for many companies the first-year internal cost of compliance would be well in excess of the average.

[67] Pub. Law No. 95-213, tit. I (1977).

[68] 15 U.S.C. 78m(b)(2)(B).

companies and their advisors strayed far from the statute's original intent. In both instances, what began with an idea with which few would disagree—that companies should have in place effective controls over their transactions and dispositions of assets—unexpectedly became a source of significant anxiety, activity and expense.

With respect to the FCPA, the fears of public companies and their advisors were put to rest by a speech that then SEC Chairman Harold Williams gave in 1981, in which he outlined a Commission approach to FCPA compliance based upon reasonableness and minimal intrusion in internal corporate decision making.[69] The speech was adopted by the SEC Commissioners as an official agency interpretation and policy statement, and retains that status to this day.[70] Chairman Williams' approach served to calm much of the anxiety that had arisen, and his address and the Commission's adoption of it as official agency policy are not only instructive,-but also are relevant to today's Section 404 environment. The directives in the address should be considered as the standard for management's establishment of internal controls**.**

Origin of the Current Problem

The expectation on the part of lawmakers and regulators in enacting and implementing Section 404 was that if internal process controls are operating effectively, then confidence in the financial statements ipso facto will be higher. In theory, this idea appears sound, particularly for larger companies, where financial statement preparation relies heavily on the effective operation of business process controls. The requirements that management assess, and that the external auditor attest to the adequacy of, internal controls likewise appear to be sensible objectives.

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[69] See Foreign Corrupt Practices Act of 1977: Statement of Policy, SEC Release No. 34-17500 (Jan. 29, 1981) [46 FR 11544] (presenting address by SEC Chairman Harold Williams to AICPA Annual Conference as Commission statement of policy) (included as Appendix M).
[70] 17 C.F.R. 241 (citing id.) .

In practice, however, several factors have led to an unexpected explosion of activity in connection with implementing Section 404. First, although AS2 was developed as a guide for external auditors in determining whether internal control over financial reporting is effective, no similar guide has been developed for management. SEC rules require management to base its assessment of internal control over financial reporting on a suitable, recognized control framework. Although the COSO framework provides criteria against which to assess internal control, it does not provide management with guidance on how to document and test internal control or how to evaluate deficiencies identified. Consequently AS2 has become the de facto guide for management, even though it was only intended to be used as an auditing standard; management has tried to meet the same requirements as auditors in performing their assessments, when in fact management and auditors likely perform their assessments of internal controls differently. Adding to the problem was the absence of any clear definition or guide as to what constitutes adequate internal controls for smaller companies. This problem was compounded by the different requirements in Section 404 for management and for their external auditors.[71] Management must assess the effectiveness of the internal controls over financial reporting, while the external auditor must report on whether management's assessment of the effectiveness of internal control is fairly stated and provide a separate opinion on whether the company's internal control is effective.

Second, as both accelerated filers and non-accelerated filers busily prepared for the first audit of internal control and Section 404 implementation efforts were taking place, there had been little attempt to tailor, or "scale" regulation to address the specific manner in which smaller companies operate. Although many feel that smaller companies are operationally different from larger companies in ways relevant to

[71] The distinction between the Section 404 requirements for management versus those for the external auditors is misunderstood, and often overlooked. This distinction is important because our recommendation is that as companies grow in size and complexity, they should take on more expansive Section 404 requirements. For smaller companies, we think there should be a management assertion as to the adequacy of the internal control over financial reporting, but that the need for the external auditor involvement does not arise until a company reaches a certain size and complexity. Therefore, there is a need for a definition and guide for management on what are adequate internal controls for smaller companies.

internal controls, and hence that small companies' internal controls and methods of evaluating them should be scaled accordingly, neither AS2 nor any other source provides a clear definition or guide for management as to what constitutes adequate internal controls for smaller companies.[72] As noted above, COSO is developing guidance intended to facilitate the application of the COSO framework in the small business environment; however, the draft guidance recently exposed for public comment by COSO does not fully offer a solution for small businesses and may not reduce costs of implementing Section 404 in a small business environment.

Moreover, even though auditors maintain that they are already taking a risk-based approach to the AS2 audit, we heard significant testimony from companies suggesting that implementation of AS2 has resulted in very rigid, prescriptive audits as a result of onerous AS2 requirements. Most issuer comments we received indicated that auditors applied a one-size-fits-all standard, even as auditors maintained that each audit stands on its own; as the Commission's May 2005 guidance suggests, and the input we received confirms, auditors in many instances utilize an approach that is "bottom-up" rather than "top-down."[73] This results in audits that are not risk-based and, in particular, involve extensive testing of information technology (IT) controls. The result is extensive focus by auditors on detailed processes, many of which create little or no risk to the integrity of the financial statements.

Finally, the Sarbanes-Oxley Act resulted created the PCAOB to monitor the performance of the external auditors. The creation of this regulatory watchdog, the introduction of PCAOB inspectors and

[72] AS2, in practice, has proven not to be scalable in a manner that would make it applicable in a cost-effective way to smaller companies. Although the PCAOB proposed for comment a draft AS2 that included an appendix for smaller companies, the appendix was not included in the version of AS2 that the PCAOB and, later, the Commission approved. Additionally, the COSO framework includes some guidance regarding smaller companies but it is minimal. A number of Committee members feel that although many observers acknowledge the need to scale for smaller public companies but because of the challenges involved in scaling have avoided attempting to scale despite the need.

[73] Despite the May 2005 guidance's call for a more top-down, risk-based approach, testimony we heard indicated that such guidance has not substantially altered the approach of auditors.

the subsequent issuance of AS2 have altered auditor behavior and led to excessive auditor conservatism.[74]

Disproportionate Impact: The Smaller You Are, The Larger the Hit

Studies into the consequences of Section 404 indicate that actual average costs of Section 404 compliance have in fact been far in excess of what was originally anticipated. In addition, although costs generally decline following the first year of implementation, a recent study commissioned by the Big Four accounting firms acknowledges that second year total costs for public companies with a market capitalization between $75 million and $700 million will still equal, on average, approximately $900,000.[75]

But beyond the aggregate costs involved with Section 404 compliance, costs have been disproportionately borne by smaller public companies. The lack of proportionality of the cost and amount of resources devoted to Section 404 compliance for smaller public companies is evidenced by data which shows that the cost of Section 404 implementation, as a percentage of revenue, is dramatically higher for smaller public companies than it is for larger public companies. The following chart illustrates this disparity:[76]

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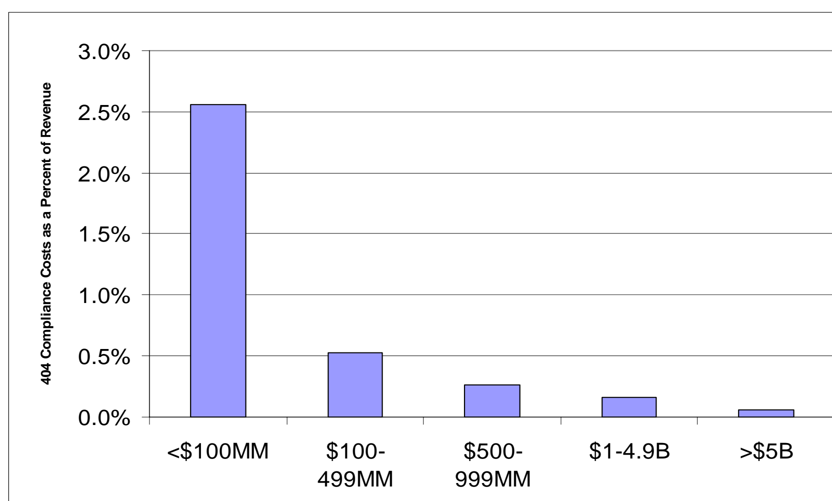
[74] See After Sarbanes-Oxley, National Law Journal Online (Dec. 12, 2005) (remarks of former SEC Commissioner Joseph Grundfest).

[75] See CRA International Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update at 1. For further information concerning the impact of Section 404, see American Electronics Association, Sarbanes-Oxley Section 404: The "Section" of Unintended Consequences and Its Impact on Small Business (Feb. 2005) and Financial Executives International, FEI Special Survey on Sarbanes-Oxley Section 404 Implementation (Mar. 2005). Although these studies are subject to further critical analysis, they indicate considerably higher Section 404 compliance costs than the Senate, the SEC and others estimated.

[76] We note that companies with a market capitalization of less than $75 million generally did not have to comply with Section 404 in 2004. We expect that compliance costs for the smallest companies in the chart will consequently be much higher when such companies are required to comply.



Source: American Electronics Association (AeA) Report on Sarbanes-0xley Section 404, *The 'Section' of Unintended Consequences and its Impact on Small Business;* February 2005

We also note that external auditor fees have overall been increasing at a rapid rate, both before and after implementation of the Sarbanes-Oxley Act. The graph below illustrates the change in external audit fees and audit related fees as a percentage of revenue that has occurred for companies of varying market capitalizations, between 2000 and 2004.[77] This shows that external fees for smaller public companies have roughly tripled as a percentage of revenue between 2000 and 2004, and that the fees for these smaller public companies as a percentage of revenue have remained many times higher than for larger public companies over this period.[78]

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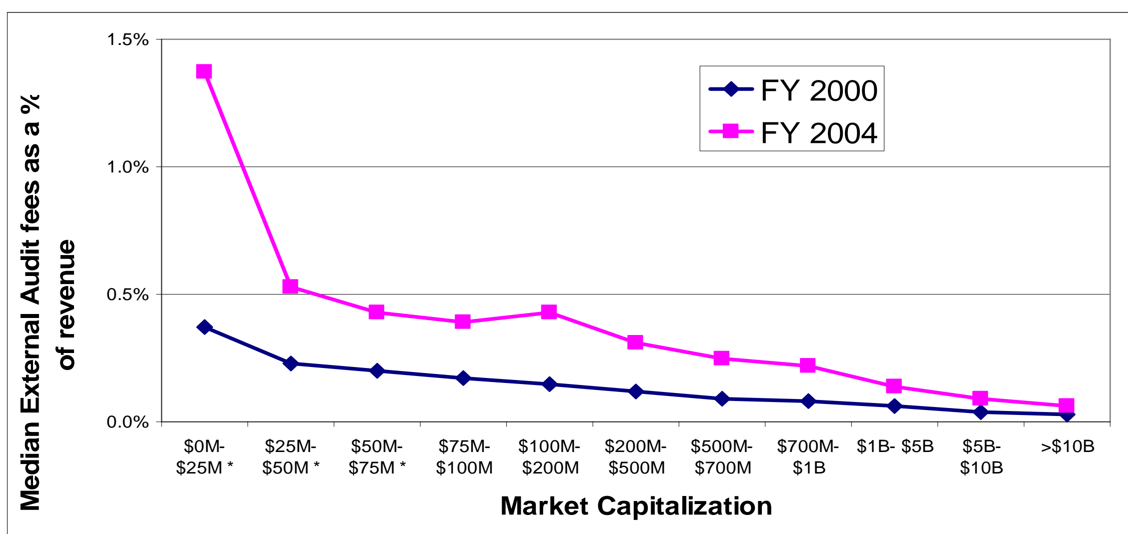
[77] Source: SEC Office of Economic Analysis, Background Statistics: Market Capitalization and Revenue of Public Companies (Aug. 2, 2005) (included as Appendix I). We note that this graph shows changes in fees for companies affected by Section 404 and non-accelerated filers that have not been required to comply with that provision's requirements.

[78] Percentage growth varies depending on the size of the company and measurement method. See Tables 8, 10 and 23 in Appendix I.



Many commentators, including the Commission, the Big Four audit firms, NASDAQ and the American Electronics Association, have estimated that the external audit fees represent between one quarter and one third of the total cost of implementing Section 404. When one factors in this multiplier on the cost borne by smaller public companies, it is clear that this results in a significant disproportionate cost for their shareholders.

Management Override and the Resulting Increase in Cost Structure for Smaller Public Companies

We believe that the risk of management override in any company is a key risk, and effective internal controls, particularly at the entity level, need to be in place to prevent such overrides from occurring.[79] In a smaller public company, this risk is increased due to top management's wider span of control and more direct channels of communication. The concentration of decision-making authority at the top of a typical smaller company results in both an increased chance of fraud due to management override, and also, conversely and more importantly, a significant increase in the probability that errors or fraud in financial reporting will be discovered through an honest senior management process that directly

[79] See AICPA, Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention (2005), available at http://www.aicpa.org/audcommctr/download/achilles_heel.pdf.

oversees financial reporting.[80] This dichotomy creates much of the tension in the debate over Section 404. Some members of this Committee believe that this fundamental difference in how large and small companies are managed deserves more focus and, as a result, are of the view that strengthening internal controls over top management in the smaller company will reduce the risk of management override and will provide investors better protection from a material fraud. Some also believe that, in a smaller company, it is difficult if not impossible for a widespread fraud to occur that does not involve senior management.

In smaller companies, people wear multiple hats. It simply is not feasible to have a person who focuses on a single area. It also means that personnel need to be cross trained in multiple jobs in order to fill in as needed or when someone is absent. The result is that segregation of duties, a key element of effective internal control, may not be achievable to the extent desired. This lack of segregation of duties requires senior management to not rely on the internal control environment for financial reporting purposes and therefore requires that they be involved in all material transactions and directly involved in financial reporting.[81] Smaller companies, by their nature, need to flexible and the environment they operate in requires them to make changes quickly in order to compete effectively with much larger and more entrenched competitors. In fact, it is this versatility and the ability to change quickly that is their single most effective competitive strength. By their nature, smaller companies are more dynamic and are constantly evolving, changing and growing more rapidly than larger companies. This dynamic nature

[80] Page 56 of the COSO framework described management control activities for small and mid-size companies as follows: "Further, smaller entities may find that certain types of control activities are not always relevant because of highly effective controls applied by management of the small or mid-size entity. For example, direct involvement by the CEO and other key managers in a new marketing plan, and retention of authority for credit sales, significant purchases and draw downs on lines of credit, can provide strong control over those activities, lessening or obviating the need for more detailed control activities. Direct hands-on knowledge of sales to key customers and careful review of key ratios and other performance indicators often can serve the purpose of lower level control activities typically found in large companies."

[81] The COSO framework states: "An appropriate segregation of duties often appears to present difficulties in smaller organizations, at least on the surface. Even companies that have only a few employees, however, can usually parcel out their responsibilities to achieve the necessary checks and balances. But if that is not possible – as may occasionally be the case – direct oversight of the incompatible activities by the owner-manager can provide the necessary control." Id.

requires frequent changes in process and more frequent job changes inside the company, which limits their ability to have static processes that are well documented. It also creates the need for top management involvement and review over financial reporting. Larger companies have more rigidly defined roles and processes that enable them to segregate duties to the extent that the internal control environment can be relied on for financial reporting. In fact, it is essential that larger companies have well-defined processes that enable them to create "boundaries" in order to be efficient and effective in competing with other companies, both large and small. This is the basic difference between large and small companies and is at the heart of the Committee's recommendations. Simply put, well established boundaries and flexibility are incompatible and not totally possible in a smaller company. Section 404 and AS2 can be effective in larger companies because of the boundaries inherent in those companies. In a smaller company their requirements cause the company to lose its flexibility, and as a result put these companies at a competitive disadvantage without significantly improving investor protection.

In our deliberations we focused on three financial reporting concerns as they relate to Section 404 applicability to smaller public companies. First, the lack of segregation of duties in these companies creates an internal control environment that is not primarily relied upon for financial reporting purposes by either management or auditors.[82] It is important to note that we believe these companies should be concerned with internal control, and we note that ample law is on the books today that requires all public companies to have an effective internal control system in place.[83] The point is that in the smaller public company, these controls are not primarily relied upon for financial reporting and are at times ineffective at preventing fraud at the executive level.

Second, the significant risk of management override in all companies creates an increased need for entity level controls and board oversight. At the process level, controls are not effective at controlling this

[82] Id.

risk; we believe there are more effective controls that can be put in place to reduce the risk of management override, especially at smaller companies. These include an increased oversight role for the board and audit committee, a more robust communication system between the board and the executive levels of the company, and increased scrutiny from external auditors in key areas where override can occur.[84]

Third, the requirements of AS2 and the requirements of auditors to document controls and the redundancy of control testing creates an environment in smaller companies that limit their ability to be flexible, and thereby hinders their competitiveness. We believe strongly that the formation of new companies and their ability to access the U.S. capital markets in a responsible manner should be encouraged by all market participants. Therefore we believe investor risk protection should be encouraged. We also strongly believe that a company must focus on value creation for its investors, and that our recommendations strike a more appropriate balance between the costs and benefits of Section 404.

We also note that the AICPA's Proposed Statement on Auditing Standards, Communication of Internal Control Related Matters Noted in an Audit, could be adopted by the PCAOB to improve communication on internal control matters between the auditor and audit committee in the case of companies whose internal controls are not audited pursuant to our recommendation.

Moreover and very importantly, the application of not only Section 404 but the other regulations adopted under Sarbanes-Oxley have serious cost and profitability ramifications for smaller public companies in addition to the financial reporting and management override aspects.

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[83] See Foreign Corrupt Practices Act of 1977, §102 (codified at Title I of Pub. Law No. 95-213 (1977) and Exchange Act §13(b)(2)(B).

[84] The COSO framework states: "Because of the critical importance of a board of directors or comparable body, even small entities generally need the benefit of such a body for effective internal controls." p. 31. See also the Exposure Draft of the AICPA, Communication of Internal Control Related Matters Noted in an Audit (Sept. 1, 2005).

First, the flexibility and requirement to change quickly is imposed on the smaller company by the customer; i.e. it is not management's choice. It is what the customer expects—indeed demands—for the smaller company's price, which often times is slightly higher than that charged by a larger company. Flexibility and quick change often means that processes and controls change, and consequently that the documentation of those controls change, resulting in a cost of keeping documentation that remains more or less constant each year. Given this dynamic, for smaller companies the cost of documentation, preparation and testing under AS2 will not likely be reduced as much as anticipated, and not to the extent it will in larger companies with more stable, rigid processes.

Second, larger companies frequently have lower material costs and can leverage their buying power. It is not unusual to see a whole percentage point difference in material costs between a large company and a small company. The small company must offset that large company advantage with their package of value (service, superior product, flexibility, adaptability). Because the price is often set by the customer, a smaller company must squeeze profitability out of overhead. That aspect of the cost structure must be smaller when compared to the large company. It must both offset the higher material costs and also support profitability, which is the ultimate determination of shareholder value. Increasing the burden for a small company directly and quickly erodes shareholder value. Because the estimate of the costs for Section 404 implementation was underestimated so dramatically, (millions of dollars per year, versus $91,000), the pain and the destruction of value has been significantly greater for a small company.

Third, the Sarbanes-Oxley Act not only added Section 404 costs and other burdens that fell disproportionately on smaller companies, it introduced burdens that, because of the nature of smaller companies, will be ongoing rather than one time. The incremental cost of operating a board of directors, for example, has increased because of higher director and officer insurance costs, the increased activity

and oversight responsibilities of the compensation, audit and nominating committee activities, more costly legal and audit fees, and increased fees for independent advisors to the committees, a new and somewhat uncontrollable expense. The pass-through cost from the supply chain (for Sarbanes-Oxley) is starting to find its way into the overall cost structure. These are compounding the increased burden cost and they are repetitive—not one time—costs.

In summary, these characteristics, result in frequent documentation change and sustained review and testing for certification under Section 404, the cost of which is more of a sustained annual cost. This forced cost choice, combined with increased board operation costs and other costs incurred as a result of Sarbanes-Oxley dramatically and adversely affect the cost structure of a small company.

Overview of Recommendations

As noted above, we believe that the crux of the existing problem, and the cornerstone of our recommended solution, is that smaller and larger public companies operate in a very different manner. As companies grow in size and complexity, they rely more on formal, prescriptive and transactional internal controls to maintain the operations of the company. This sentiment was confirmed by the significant input we received indicating that small and typically less complex companies are very different from larger companies and therefore, the reforms made by the Commission and the stock exchanges should be applied differently, depending on the size of the company. A number of witnesses challenged the application of AS2 to smaller, less complex businesses, regardless of structure, size or strategy. Faced with this reality, and in order to properly scale Section 404 treatment to ensure that the benefits of implementation outweigh burdens, we propose differing 404 compliance requirements based upon company size. By way of introduction to the recommendations below, we believe that two items bear mentioning at the outset: (1) the opt-in approach of our recommendations and (2) the use of revenue

filters as a means of capturing company complexity and consequently the cost-effectiveness of applying Section 404 requirements.

Opt-In Approach

An essential component of the exemptive relief we are proposing for smaller public companies is that an issuer, through its board of directors, and in consultation with its audit committee and external auditor, could very well decide not to take advantage of the exemptive relief available and instead comply with the Section 404 rules applicable to larger public companies.[85]

Some argue that internal control over financial reporting should be beneficial to smaller public companies because it will make it easier for them to attract capital. At this point in the development of the internal control requirements, we think the evidence is quite mixed on this question and, if anything, is tending in the opposite direction. A number of data points lead us in this direction, but we recognize that the evidence has not been fully analyzed and it may be premature to make any conclusions. Nevertheless, we observe the following:

- Some companies are either going dark or going private or considering doing so;[86]
- The London Exchange's Alternative Investment Market (AIM) for smaller public companies is gaining momentum;[87]

[85] For a discussion of the benefits of such an optional approach, as well as the circumstances that led to the formation of our Committee, see Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 Yale L.J. 1521, 1595-1597 (2005).

[86] We received several answers to this effect in response to Question 1 of Request for Public Input by Advisory Committee on Smaller Public Companies, SEC Release No. 33-8599 (Aug. 5, 2005) available at http://www.sec.gov/rules/other/265-23survey.shtml. The Ziegler Companies, Inc. is an example of a public company that decided to delist from the American Stock Exchange and deregister under the Exchange Act. As reasons for the delisting and deregistration, Ziegler said, among other things: "the costs associated with being a reporting company under the '34 Act are significant and are expected to continue to rise, thereby diminishing the Company's future profitability; the benefits of remaining a listed company with continued '34 Act reporting obligations are not sufficient to justify the current and expected future costs and no analysts cover the Company's shares." Ziegler's shares are now traded in the Pink Sheets and the Company provides its shareholders with, among other items, annual reports including audited financial statements, news of important events and a proxy statement. It also has a web page including financial and governance information.

[87] The AIM Market is actively and successfully prospecting for listing companies in the United States. See G. Karmin and A. Luchetti, New York Loses Edge in Snagging Foreign Listings, Wall St. J., Jan. 26, 2006, at C1. See also Letter of John P. O'Shea to Committee (June 16, 2005) (on file in SEC Public Reference Room File No. 265-23), available at

- Foreign new listings in the United States during 2005 dropped considerably from the previous year;
- Foreign issuers are departing from the U.S. market (and their institutional investors are voting for their going offshore); and
- U.S. investors continue to invest in foreign securities even though the issuers are not subject to internal control requirements like those promulgated under Section 404.[88]

Without deciding whether Section 404 is beneficial for investors in smaller public companies, we believe that in light of our reasons for recommending exemptive relief for these companies, permitting them to comply or take advantage of the relief is the appropriate course of action to recommend.

Use of Revenue Filters

We would add a revenue filter or criterion as a condition to providing Section 404 exemptive relief for smaller public companies, because we think that when evaluating the costs and benefits of applying the Section 404 requirements to smaller public companies, revenues are a very important factor. We believe that companies with revenues in excess of $250 million are generally complex, and hence rely more on process controls to generate their financial statements. Because auditors of such companies, as part of the financial audit, are likely to have relied on and thus tested these internal controls as part of the financial audit in the past, it is likely to be relatively less expensive, when compared to smaller, less complex companies with respect to which controls weren't previously tested for purposes of the financial audit, to comply with Section 404 . Conversely, we believe that companies with large market capitalizations and minimal revenues, such as development stage companies that trade on very large multiples because of potential, are generally simple in terms of operations and pose a lesser risk of

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http://www.sec.gov/rules/other/265-23/jposhea061605.pdf. See also Record of Proceedings 189 (Aug. 9, 2005) (testimony of James P. Hickey, Principal, Co-Head of Technology Group, William Blair & Co. indicating that strong IPO candidate elected to go public on the AIM exchange expressly to avoid costs and burdens of Sarbanes-Oxley Act compliance).

[88] Record of Proceedings 100 (Oct. 14, 2005) (testimony of Gerald I. White).

material financial fraud. Therefore, our recommendations provide that a smallcap company whose annual revenue in the last fiscal year did not exceed $10 million would, solely for purposes of our Section 404 recommendations, be treated the same as a microcap company.

We acknowledge that there exists no clear, obvious line for distinguishing between companies based on revenues. Our collective experience indicates, however, that companies with revenues of $250 million or more a year are getting large enough and complex enough that auditors rely more on the internal controls to conduct the financial statement audit than they do for companies with less revenues. Specifically, auditors of smaller companies and internal financial teams of smaller companies confirm that the smaller the company, the less valuable the internal control audit is to the financial statement audit. For smaller companies, the financial audits tend to become more substantive in nature, with particular attention on key, high risk areas (inventory, revenue recognition, etc.). Indeed, financial experts testified that the larger the company the more the auditor relies on the operation of internal controls to perform the financial statement audit. This is because, the larger the company, the more far flung and complex the operations become and the less practical it is to test significant numbers of transactions.

Internal Control Over Financial Reporting—Primary Recommendations

We recommend that the Commission and other bodies, as applicable, effectuate the following:

Recommendation III.P.1:

Unless and until a framework for assessing internal control over financial reporting for microcap companies is developed that recognizes the characteristics and needs of those companies, 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 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; and**

- **adoption of a code of ethics within the meaning of Item 406 of Regulation S-K 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 ethics.**

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.[89]

Moreover, management should be required to report on any known material weaknesses. In this regard, the Proposed Statement on Auditing Standards of the AICPA, "Communications of Internal Control Related Matters Noted in an Audit," if adopted by the AICPA and the PCAOB, would strengthen this disclosure requirement and provide some external auditor involvement in the internal control over financial reporting process.

Our first recommendation primarily concerns microcap companies, which represent the lowest 1% of total U.S. equity market capitalization. In our view, these companies should be entitled to full Section 404 exemptive relief, preconditioned upon their compliance with the enhanced corporate governance provisions described above.[90] The following federal securities law requirements would remain applicable to all companies that would qualify for full Section 404 relief in accordance with this recommendation:

- maintain a system of internal controls that provides reasonable assurances as to accuracy, as required by Exchange Act Section 13(b)(2)(B) enacted under the FCPA;
- provide chief executive officer and chief financial officer certifications under Sarbanes-Oxley Act Section 302;[91]
- receive external financial audits;

[89] Mr. Schact dissented from the majority vote on this recommendation. [A summary of the reasons for his dissent is contained in Part VII of this report.]
[90] The approach adopted by the Committee has been raised as a possibility by various parties. See, e.g., Letter of Ernst & Young LLP to SEC, page 16 (Apr. 4, 2005) (on file in SEC Public Reference Room File No. 4-497).
[91] We expect that the Section 302 certifications of companies receiving exemptive relief from Section 404 would still be required to include the introductory language in paragraph 4 of that provision (which refers to the certifying officers' responsibility for establishing and maintaining internal control over financial reporting) and paragraph 4(b) (which refers to the

- comply with the requirements of Item 9A of Form 10-K and Item 4 of Part I of Form 10-Q; and
- disclose, consistent with current Section 404 rules, all material weaknesses known to management, including those uncovered by the external auditor and reported to the audit committee.[92]

For microcap companies that comply with these requirements, we envision that full Section 404 relief would be effective immediately.

While we are convinced that the costs associated with Section 404 compliance are disproportionate and unduly burdensome to smaller public companies, we are also mindful of the Commission's investor protection mandate. We believe that our recommendation provides a more cost-effective method of enhancing investor protection. We believe that enhanced audit committee standards and practices and the adoption and enforcement of ethics and compliance programs are effective, as well as cost-effective, means of maintaining investor protections.

Rule 10A-3 under the Exchange Act requires national securities exchanges and associations to prohibit the initial or continued listing of a security of an issuer that is not in compliance with specified listing standards relating to audit committees. These standards relate to: audit committee member independence; responsibility for the appointment, compensation, retention and oversight of an issuer's registered public accounting firm; the establishment of procedures for the receipt of accounting-related complaints, including anonymous submissions by employees; the authority to engage advisors; and funding. The New York and American Stock Exchanges and the NASDAQ Stock Market have now

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internal control over financial reporting having been designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements).

[92] We considered other possible corporate governance and disclosure standards that might be imposed as a condition to any Section 404 relief for smaller public companies. In the final analysis, however, we felt that imposing conditions beyond those described above could result in hardship for smaller public companies that would not be commensurate with the benefits received from an investor protection standpoint.

incorporated the requirements of Rule 10A-3 into their respective listing standards. The audit committee standards mandated by Rule 10A-3 currently do not apply to any smaller public companies that are not subject to those listing standards. We believe that if Section 404 relief is granted to the microcap and smallcap companies that we recommend for relief, those companies should, as a condition to such relief, be required to adhere to the audit committee standards embodied in Rule 10A-3.

Item 406 of Regulation S-K requires a reporting company to disclose whether it has adopted a code of ethics that applies to its principal executive officer, chief financial officer and other appropriate executives and, if it has not adopted such a code, to state why it has not done so. Item 406 defines a code of ethics to be written standards that are reasonably designed to deter wrongdoing and to promote: honest and ethical conduct, including handling of conflicts of interest; full, fair, accurate, timely and understandable disclosure in reports and documents filed with the Commission and in other public communications; compliance with applicable governmental laws, rules and regulations; prompt internal reporting of violations of the code; and accountability for adherence to the code. A reporting company is also required to file a copy of its code of ethics with the Commission as an exhibit to its annual report, or to post the text of the code on its Web site. Item 406 mandates disclosure as to whether a code of ethics exists, but does not require the adoption of a code. The major exchanges, including the NYSE, AMEX and the NASDAQ Stock Market, go further and require, as part of their listing standards, the adoption of a code of ethics meeting the fundamental requirements embodied in Item 406, and extend the coverage to the directors and employees of listed companies.[93] As is the case with the audit committee standards described above, issuers not subject to listing standards requiring the adoption of a code of ethics are not obligated to do so under Commission rules. We believe that the adoption and enforcement of a code of ethics is both cost effective and appropriate for smaller public companies that receive relief from the attestation requirements of Section 404. A recent integrity survey undertaken by KPMG Forensic noted

[93] New York Stock Exchange Rule 303A.10; NASDAQ Stock Market Rule 4350(n); AMEX Company Guide Sec. 807.

that employees who work in companies with comprehensive ethics and compliance programs reported fewer observations of misconduct and higher levels of confidence in management's commitment to integrity.[94]

With regard to the penultimate sentence of the recommendation above, we simply wish for the Commission to make clear, to the extent clarity is lacking, that those smaller public companies qualifying for exemptive relief will continue to be required to (1) maintain a system of internal control sufficient to provide reasonable assurance that, among other things, transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP, (2) disclose any modifications to internal control over financial reporting and (3) certify such disclosures.

Recommendation III.P.2:

> **Unless and until a framework for assessing internal control over financial reporting for smallcap companies is developed that recognizes the characteristics and needs of those companies, provide exemptive relief from external auditor involvement in the Section 404 process to smallcap companies with less than $250 million but greater than $10 million in annual revenues, subject to their compliance with the same corporate governance standards as detailed in the recommendation above.**[95]

Smallcap companies that qualify for the Section 404 external audit of internal control relief still would be subject to the rest of Section 404's requirements, all otherwise applicable federal securities law requirements and, in addition, in the case of companies not listed on the NYSE, AMEX or NASDAQ Stock Market, all of the corporate governance standards specified above applicable to companies so listed. Among the federal securities law requirements that would remain applicable to all smallcap companies that qualify for the Section 404 external audit of internal control exemptive relief would be the requirements to:

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[94] KPMG Forensic Integrity Survey 2005-2006.

[95] Mr. Schact dissented from the majority vote on this recommendation. [A summary of the reasons for his dissent is contained in Part VII of this report.]

- maintain a system of internal controls that provides reasonable assurances as to accuracy, as required by Exchange Act Section 13(b)(2)(B) enacted under the FCPA;
- complete and report on management's assessment of internal control under Section 404;
- provide chief executive officer and chief financial officer certifications under Section 302;
- receive external financial audits;
- comply with the requirements of Item 9A of Form 10-K and Item 4 of Part I of Form 10-Q; and
- disclose, consistent with current Section 404 rules, all material weaknesses known to management, including those uncovered by the external auditor and reported to the audit committee.

For smallcap companies that comply with these requirements, we envision that Section 404 external audit of internal control relief would be effective immediately.[96]

[96] We are aware that questions have arisen regarding the Commission's authority to provide exemptive relief from full compliance with the requirements of Section 404 in accordance with this recommendation and the recommendation above. As a committee, we are not authorized or capable of rendering legal opinions on this issue. We are aware, however, that Section 3(a) of the Sarbanes-Oxley Act, 15 U.S.C. 7202(a), provides the Commission with broad authority to promulgate "such rules and regulations as may be necessary or appropriate in the public interest or for the protection of investors" in furtherance of Section 404. We believe that the relief we propose satisfies this standard and that the reasoning we have provided for our recommendations demonstrates the reasonableness of this conclusion. Furthermore, we are aware of the view expressed by the Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law that the Commission has authority to provide exemptive relief for smaller public companies from strict adherence to technical requirements of Section 404, as follows:

> "We believe the Commission's authority [to provide relief from the auditor attestation requirements in Section 404(b) for smaller public companies] stems from both the [Exchange Act] and [the Sarbanes-Oxley Act] itself. Section 36(a)(1) of the Exchange Act gives the Commission broad exemptive authority under the Exchange Act. [Sarbanes-Oxley] section 3(b)(1) provides that a violation of [the Act's provisions] will be treated as a violation of the Exchange Act. Therefore, under Exchange Act Section 36(a)(1), the Commission can adopt rules exempting classes of persons (here, smaller public companies) from compliance with [Sarbanes-Oxley] provisions, including . . . Section 404(b)."

Letter of Committee on Federal Regulation of Securities, American Bar Ass'n, to SEC, p.4 n.2 (Nov. 28, 2005) (on file in SEC Public Reference Room File Nos. S7-40-02 & S7-06-03), available at http://www.sec.gov/rules/proposed/s70603/aba112805.pdf. We also are aware that the Commission's broad rulemaking authority under Section 36(a)(1) of the Exchange Act may be exercised to provide exemptive relief from the requirements of Section 13(b)(2)(B) of the Exchange Act, the provision that requires public companies to devise and maintain the systems of internal accounting controls that are the subject of management's internal control report and the auditor's report required under Section 404. We also are aware that the Commission itself already has provided exemptive relief from Section 404 for certain reporting entities, such as asset-backed issuers, indicating that the SEC believes it has exemptive authority to provide relief from technical compliance with Section 404. We believe the Commission could cite these and other authorities to demonstrate

Recommendation III.P.3:

While we believe that the costs of the requirement for an external audit of the effectiveness of internal control over financial reporting are disproportionate to the benefits, and have therefore adopted the second Section 404 recommendation above, we also believe that if the Commission reaches a public policy conclusion that an audit requirement is required, we recommend that changes should be made to the requirements for implementing Section 404's external auditor requirement to a cost-effective standard, which we call "ASX," providing for an external audit of the design and implementation of internal controls.[97]

If the Commission decides to pursue this non-preferred alternative recommendation, we recommend that it direct the PCAOB to take certain steps, and consider taking certain other steps, in connection with developing the necessary new Audit Standard No. X, or ASX, described below. If those steps have been taken and considered, respectively, and complementary additional guidance is available that enables management to assess internal controls in a cost-effective manner,[98] this alternative recommendation should be made effective for fiscal years starting one year after the PCAOB issues ASX.[99]

The Commission should direct the PCAOB to take the following steps:

- develop a new audit standard for smaller public companies (ASX) that provides guidance for the external audit of only the design and implementation of internal controls to make the work performed by auditors on internal controls more effective and efficient for these companies;

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its authority to provide exemptive relief from the requirements of Section 404. In addition, the Commission could consider applying the canon of construction known as "in pari materia" to construe Section 404 as subject to the Commission's broad exemptive authority in the Exchange Act because the two statutes relate to the same subject matter and must be construed harmoniously.

[97] Messrs. Barry and Jensen abstained from the vote on this recommendation. Messrs. Schlein and Veihmeyer dissented from the majority vote on this recommendation. . [A summary of the reasons for their dissent is contained in Part VII of this report.]

[98] The recommendation immediately below provides details regarding the additional guidance.

[99] We expect that the alternative recommendation could be effective for fiscal years beginning after December 31, 2007.

- have the standard specify a report that would that be similar in scope to the report described in Section 501.71 of Standards for Attestation engagements (plus walkthroughs) of the AICPA; and
- help to ensure that the standard would meet the cost-effectiveness requirement of the alternative recommendation, by performing a cost-benefit analysis before the standard is issued in proposed form and a follow-up analysis before the standard is considered for adoption.

The Commission should direct the PCAOB to consider taking the following steps in developing ASX:

- involve all stakeholders in audits of internal control and include a field trial period to ensure that the approach is practical and results in achievement of required objectives;
- take into account that a company and its auditor would more likely choose to implement an AS2 audit as the company gets more complex and the auditor plans or needs to place a high degree of reliance on internal controls to significantly reduce substantive audit procedures (but an auditor still would be permitted to place reliance on controls to reduce substantive testing in selected areas by testing specific controls without performing an AS2 audit); and
- require that:
    - the same auditor perform and integrate the ASX and financial statement audits;
    - the auditor evaluate control deficiencies identified during the financial statement audit to determine their impact as to the ASX audit; and
    - an auditor who identifies material weaknesses in either the design or operation of controls, should disclose the material weaknesses in its report and state that internal controls are not effective.

<u>Internal Control Over Financial Reporting—Secondary Recommendations</u>

In addition to the foregoing primary recommendations in the area of internal control over financial reporting, we also set forth below for the Commission's consideration the following secondary recommendations:

Recommendation III.S.1:

> **Provide, and request that COSO and the PCAOB provide, additional guidance to help facilitate the assessment and design of internal controls and make processes related to internal controls more cost-effective; assess when it would be advisable to reevaluate and consider amending AS2.**

Clear guidance does not yet exist for microcap company managers on how to develop and support a proper Section 404 assessment of the effectiveness of internal control.

Section 404 requires management to report on its assessment of the effectiveness of the company's internal controls and requires an external auditor to report on its audit of management's assessment and control effectiveness. As the COSO framework is currently the most widely used internal control framework in the U.S., managements and auditors have used it to assess internal control. Based on the input provided by COSO on its framework, we have concluded that clear guidance does not yet exist for microcap company managers on how to support a proper Section 404 assessment of internal control absent AS2.

While COSO has proposed additional guidance for smaller companies, there is currently little practical guidance available to assist smaller companies in implementing the COSO framework in a cost-effective manner. AS2 provides guidance for an auditor to assess internal control effectiveness. It was not intended to provide management guidance. As a practical matter, however, because AS2 provides detailed guidance for assessing internal control, it is by default the standard that management uses. We do not think that COSO's revised guidance for smaller companies will result in a cost effective or proportional alternative for implementing Section 404.

The Commission should ask COSO to provide additional guidance to help management of smaller companies assess internal controls because of the lack of practical guidance and the absence of a standard to enable management of smaller companies to address internal control without an AS2 report.

The Commission could, for example, ask COSO to:

- add post-year one monitoring guidance with selective testing where appropriate (in this regard, we note that the PCAOB, in its January 17, 2006 comment letter to COSO, noted that "auditability should not be the primary goal of the guidance."); and
- emphasize that "materiality" for the purposes of evaluating a "material weakness" is to be determined on an annual but not on a quarterly basis.

The Commission should also ask the PCAOB to:

- address the ability to rely on compensating controls (especially for smaller public companies);
- describe ways to reduce compliance costs relating to information technology controls, a significant source of internal control compliance costs, consistent with the underlying risks; and
- provide for smaller public companies:
    - if no external audit of internal control is required, guidance on how management, in general, can assess internal controls efficiently and on a stand-alone (i.e., no external auditor involvement) basis;[100] and
    - if ASX is required, guidance on how management, in general, can assess internal controls efficiently and in satisfaction of the requirements of the external auditor acting under ASX without following the auditor-directed guidance in ASX or AS2.

[100] While AS2 provides a way to assess internal controls, it is designed for external auditors rather than management and has not proven to be a cost-effective tool in regard to smaller companies.

The PCAOB in its January 17, 2006 comment letter to COSO recommended that COSO reconsider whether there is additional, more practical guidance that COSO could provide to smaller public companies. We support this goal and consider such practical guidance as critical to smaller public companies having a cost-effective approach to assessing their internal controls.

We believe that the Commission also should assess, in light of, among other factors, existing and suggested guidance, when it would be advisable to reevaluate and consider amending AS2. Furthermore, the Commission should provide additional guidance by clarifying considerations, and encouraging cost-effectiveness, relating to management's design and assessment of internal controls and by developing resources to enhance the availability of additional guidance.

In order to provide this clarification and encouragement, the Commission could, for example,

- emphasize that "materiality" for the purposes of assessing a "material weakness" under Section 404 is to be determined on an annual but not on a quarterly basis;[101]
- note the ability to rely on compensating controls, especially for smaller public companies; and
- suggest methods to reduce compliance costs relating to information technology controls, a significant source of internal control compliance costs, consistent with the underlying risks.

In order to develop resources to enhance the availability of additional guidance, the Commission could, for example, allocate resources to develop a free web site with a title such as "Center of Excellence for Reporting and Corporate Governance for Smaller Public Companies." The web site could contain, for example, best practices, frequently asked questions and complex transaction accounting advice.

The Commission should also ask the PCAOB to provide additional guidance to help clarify and encourage greater cost-effectiveness in the application of AS2. The Commission should, for example, ask the PCAOB to reinforce and re-emphasize (including through the inspection process) the helpful points

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[101] See SEC Staff on Management's Report on Internal Control Over Financial Reporting (May 16, 2005).

made in the May 16 and November 30, 2005 guidance and report, respectively, including, in particular, the following:

- a risk-based approach is needed;
- controls should provide management with reasonable assurance, not absolute or perfect certainty;
- "more than remote" means "reasonably possible";
- substantive testing to find material weaknesses should be scaled back (testing is not to find deficiencies and significant deficiencies);
- the financial and internal control audits should be integrated (especially at smaller companies);
- all restatements should not be treated as material weaknesses because accounting complexity not control deficiencies are at the root of many restatements;
- materiality for the purposes of assessing a "material weakness" under Section 404 should be determined on an annual rather than quarterly basis;
- management's consultation with the external auditor regarding the proper accounting for a transaction should not lead the auditor conclude a material weakness exists;
- describe ways to reduce compliance costs relating to information technology controls, a significant source of internal control compliance costs, consistent with the underlying risks; and
- consider and publicize additional ways to reduce the complexity of AS2 as currently being implemented.

Recommendation III.S.2:

> **Determine the necessary structure for COSO to strengthen it in light of its role in the standard-setting process in internal control reporting.**

COSO has been placed in an elevated role by virtue of being referenced in AS2 and the Commission's release adopting the Section 404 rules. While the rules do not require the use of the COSO framework in performing Section 404 assessments, COSO is by far the most widely used internal control framework for such purposes.

In addition, COSO has issued preliminary guidance for smaller public companies. As a result, COSO has become a de facto standard setting body for preparers of financial statements though it is not recognized as an official standard setter, nor is it funded and structured as one.

The Commission, in conjunction with other interested bodies, as appropriate, should determine the necessary structure for COSO, including a broader member constituency, to strengthen it in light of its important role in establishing and providing guidance with respect to the internal control framework used by most companies and auditors to evaluate the effectiveness of internal control over financial reporting.

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We fully agree with the goals of recent regulatory reforms, including the Sarbanes-Oxley Act, and believe that they have helped to improve corporate governance and restore investor confidence. These include reforms relating to board independence, management certifications and whistleblower programs. We disagree strongly, however, with the assertion that Section 404, as currently being implemented, is worth the significant "tax" it has placed on American business, in terms of dollars spent, time committed, and organizational mindshare that has been diverted from operating and growing their businesses.

The proportionately larger costs for small companies to comply with Section 404 may not

generate commensurate benefits, adversely affecting their ability to compete with both larger U.S. public companies and foreign competitors. Smaller companies would have to allocate their limited resources toward Section 404 compliance even though the required control processes may not add significant value to their financial statements. If their ability to compete is diminished, these smaller U.S. companies may find it more difficult to raise capital to engage in value-producing investments.

The significant, disproportionate compliance burden placed on the shareholders of smaller public companies has had a negative effect on their ability to compete with their larger U.S. public company competitors, and, to an even greater extent, their foreign competitors. This reduction in the competitiveness of U.S. smaller public companies will hurt their capital formation ability and, as a result, hurt the U.S. economy. Smaller companies have limited resources, which are being allocated unnecessarily to internal processes for Section 404 compliance. Since these processes play less of a role in the preparation of financial statements for smaller companies, this effort results in diminished shareholder value that makes these companies less attractive investments and, thereby, harms their capital formation ability.

The major drivers of the disproportionate burden are that smaller companies lack the scale to cost-effectively implement standards designed for large enterprises and that there are no guides available for management on how to make its own independent Section 404 assessment or for auditors on how to "right-size AS2" for smaller companies.

The "cost/benefit" challenge is being raised by companies of all sizes, but most acutely by smaller companies on which the burden of cost, time and mindshare diversion fall most heavily.

PART IV. CORPORATE GOVERNANCE, DISCLOSURE AND CAPITAL FORMATION

We have conducted a full review of corporate governance and disclosure requirements applicable to smaller public companies. We concluded that, in general, aside from the significant regulatory scaling deficiencies outlined above, the current securities regulatory system for smaller public companies works well to protect investors. The oral testimony and written statements we received generally supported this conclusion. We did identify some areas, however, where we believe changes in regulation could be made that would reduce compliance costs without compromising investor protection.

In terms of capital formation matters, we heard ample testimony and reviewed a significant amount of data regarding the disproportionate burden that the Sarbanes-Oxley Act, particularly Section 404, imposes on smaller companies. In terms of capital formation, we believe that the increased burden brought about by implementation of Section 404 and other regulatory measures have had a significant effect on both the nature of the relationship between private and public capital markets and on the attractiveness of the U.S. capital markets in relation to their foreign counterparts.

In our view, public companies today must be more mature[102] and sophisticated, have a more substantial administrative infrastructure and expend substantially more resources simply to comply with the increased securities regulatory burden. Additionally, the liquidity demands of institutional investors, the consolidation of the underwriting industry and the increased cost of going public have dictated that companies be larger,[103] and effect larger transactions, in order to undertake an initial public offering. Stated simply, we believe that it is today far more difficult and expensive to go–and to remain–public than

[102] With respect to venture-backed startups, the average time from initial venture financing to initial public offering has increased from less than three years in 1998 to more than five and a half years today. Rebecca Buckman, Tougher Venture: IPO Obstacles Hinder Start-ups, Wall St. J., Jan. 25, 2006, at C1.

just a few years ago, and as a consequence, companies are increasingly turning to the private capital markets to satisfy their capital needs.

In light of the newfound prominence of the private markets, and our perception that most of the more obvious regulatory impediments to the efficient formation of capital lie in the private realm, we are making a number of recommendations that we believe will add certainty and improve the ability of private companies to efficiently reach and communicate with investors, while continuing to protect those investors most in need of the protections afforded by registration under the Securities Act.

In terms of the public markets, there is a concern that U.S. markets may become less attractive for companies wishing to raise capital. The U.S. percentage of all money raised from foreign companies undertaking a new stock offering declined from 90% of all such money raised in 2000 to less than ten percent in 2005.[104]

To address these issues, and to promote healthier and more robust capital markets, will require removing duplicative regulation, enhancing disclosure and promoting an improved atmosphere for independent analyst coverage of smaller public companies.

Corporate Governance, Disclosure and Capital Formation—Primary Recommendations

We recommend that the Commission and other bodies, as applicable, effectuate the following:

Recommendation IV.P.1:

Incorporate the scaled disclosure accommodations currently available to small business issuers under Regulation S-B into Regulation S-K, make them available to all microcap companies, and cease prescribing separate specialized disclosure forms for smaller companies.

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[103] The median stock market value of a venture-backed company going public last was $216 million, a marked increase from the $138 million median value in 1997 and the just under $80 million median value in 1992. Id. at 3.

[104] G. Karmin and A. Luchetti, New York Loses Edge in Snagging Foreign Listings, Wall St. J., Jan. 26, 2006, at C1 ("[Undertaking an offering outside the U.S.] would have been an unusual move as recently as 2000, when nine out of every 10 dollars raised by foreign companies through new stock offerings were done in New York rather than London or Luxembourg . . . But by 2005, the reverse was true: Nine of every 10 dollars were raised through new company listings in London or Luxembourg, the biggest spread favoring London since 1990.").

As discussed above, we are recommending that the Commission establish a new system of scaled or proportional securities regulation for smaller public companies that would replace Regulation S-B and make scaled regulation available to a much larger group of smaller public companies. We are not recommending, however, that the scaled disclosure accommodations now available to small business issuers under Regulation S-B be discarded. Instead, we are recommending that they be integrated into Regulation S-K and made available to all microcap companies, defined as we recommend under "Part II. Scaling Securities Regulation for Smaller Companies." In Recommendation IV.P.2 immediately below, we recommend that all scaled financial statement accommodations now available to small business issuers under Regulation S-B be made available to all smaller public companies, defined as we recommend under "Part II. Scaling Securities Regulation for Smaller Companies." In addition, we are recommending that the Commission cease prescribing separate disclosure Forms 10-KSB, 10-QSB, 10-SB, SB-1 and SB-2 for smaller companies. All public companies would then use the same set of forms, such as Forms 10-K, 10-Q, 10, S-1 and S-3.

As discussed briefly above, Regulation S-B was adopted by the Commission in 1992 as an integrated registration and reporting system covering both disclosure and financial statement rules for "small business issuers."[105] "Small business issuer" is defined as an issuer that with both revenues and a public float of less than $25 million.[106] The system provides specialized forms under the Securities and Exchange Acts with disclosure and financial statement requirements that are somewhat less rigorous than the requirements applicable to larger companies under Regulation S-K, the integrated disclosure system,

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[105] Small Business Initiatives, SEC Release No. 33-6949 (Jul. 30, 1992) [57 FR 36442]. Regulation S-B is codified at 17 C.F.R. 228.10 et seq.
[106] In addition, small business issuers must be U.S. or Canadian companies, cannot be investment companies or asset-backed issuers and cannot be majority owned subsidiaries of companies that are not small business issuers. 17 C.F.R. 228.10(a)(1).

and Regulation S-X, the integrated financial statement system, for larger companies.[107] In general, Regulation S-B provides modestly less onerous disclosure obligations for small business issuers. A specialized set of disclosure forms is also prescribed for small business issuers, Form 10-KSB, Form 10-QSB, Form 10-SB, Form SB-1 and Form SB-2.

We reviewed the benefits and drawbacks of Regulation S-B and considered whether the accommodations in Regulation S-B should be expanded, contracted, or extended to a broader range of smaller public companies. We considered oral and written testimony as to the benefits and limitations of Regulation S-B, including testimony and discussion during a joint meeting with the Commission's annual Forum on Small Business Capital Formation.[108]

Listed below at the primary disclosure accommodations currently available to small business issuers under Regulation S-B. We are recommending that all of these be integrated into Regulation S-K and be made available to all microcap companies. Microcap companies would have the option of following the disclosure requirements for larger companies if they chose to do so.

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[107] Regulation S-K is codified at 17 C.F.R. 229.10 et seq. Regulation S-X, which provides accounting rules for larger companies, is codified at 17 CFR 210.01.01 et seq. The accounting rules for small business issuers using Regulation S-B are contained in Item 310 of Regulation S-B, 17 C.F.R. 228.310.

[108] See Record of Proceedings 48, 143, 148 (June 17, 2005) (testimony of William A. Loving, David N. Feldman and John P. O'Shea. See also Comment Letter of Brad Smith (May 24, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/bsmith2573.htm; Comment Letter of Kathryn Burns (May 24, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/kburns052405.pdf; Comment Letter of David N. Feldman (May 30, 2005)(on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/dnfeldman053005.htm; Comment Letter of Michael T. Williams (May 30, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/mtwilliams6614.pdf; Comment Letter of KPMG (May 31, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/kpmg053105.pdf; Comment Letter of BDO Seidman (May 31, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/bdoseidman053105.pdf; Comment Letter of Stephen M. Brock (May 31, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/smbrock1317.pdf; Comment Letter of Ernst & Young (May 31, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/ey053105.pdf; Comment Letter of Small Business & Entrepreneurship Council (May 31, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/kkerrigan8306.pdf; Comment Letter of Society of Corporate Secretaries & Governance Professionals (June 7, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/sspc-slc-scsgp060705.pdf; Comment Letter of Mark B. Barnes (August 2, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/mbbarnes080205.pdf; and Letter of Gregory C. Yardley, Jean Harris, Stanley Keller, A. John Murphy, and A. Yvonne Walker to Committee (Sept.

- Under Item 101 of Regulation S-B, small business issuers are required to provide a less detailed description of their business and to disclose business development activities for only three years, instead of the five years required of larger companies by Regulation S-K.
- Regulation S-B currently does not include an Item 301 (selected financial data) or Item 302 (supplementary financial information), which are included in Regulation S-K, meaning that small business issuers are not required to disclose this information.
- Regulation S-B provides for more streamlined disclosure for management's discussion and analysis of financial condition and results of operations by allowing two years of analysis instead of the three years required of larger companies under Regulation S-K.[109]
- Regulation S-B does not require smaller companies to provide a tabular disclosure of contractual obligations like larger companies must do under Item 303(a)(5) of Regulation S-K.[110]
- Regulation S-B does not require small business issuer filings to contain quantitative and qualitative disclosure about market risk section as required of larger companies under Item 305 of Regulation S-K.[111]
- Under Item 402 of Regulation S-B, small business issuers currently are not required to include a compensation committee report or a stock performance graph in their executive compensation disclosures, as larger companies are required to do under Item 402 of Regulation S-K.[112]

12, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/gcyadley091205.pdf.

[109] MD&A requirements are found in Item 303 of both Regulation S-K and Regulation S-B, 17 C.F.R. 229.303 & 17 C.F.R. 228.303.

[110] 17 CFR 229.303(a)(5).

[111] 17 CFR 229.305.

[112] Executive compensation disclosure requirements are found in Item 402 of both Regulation S-K and Regulation S-B, 17 C.F.R. 228.402 and 17 C.F.R. 229.402. The Commission recently proposed major amendments to the executive compensation disclosure rules under both Regulation S-B and Regulation S-K. See Executive Compensation and Related Party Disclosure,

Our reasons for recommending the abandonment of Regulation S-B as a separate, standalone integrated disclosure system, including the abandonment of separate prescribed forms for small business issuers, are multifold. The drawbacks associated with Regulation S-B include a lack of acceptance of "S-B filers" in the marketplace, a possible stigma associated with being an S-B filer, and the complexity for the SEC and public companies and their counsel of maintaining and staying abreast of two sets of disclosure rules that are substantially similar. Further, we received input that many securities lawyers saying they are not familiar with Regulation S-B and therefore are hesitant to recommend that their clients use this alternative disclosure system.[113] We heard numerous comments to the effect that the thresholds for using Regulation S-B are too low and should be increased to permit a broader range of smaller public companies to be eligible for its benefits, particularly in light of the increased costs associated with reporting obligations under the Exchange Act since passage of the Sarbanes-Oxley Act.[114]

In summary, we believe that incorporating the disclosure accommodations currently available to small business issuers under Regulation S-B into Regulation S-K, rather than retaining them in a separate

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SEC Release No. 33-8655 (Jan. 27, 2006) [71 FR 6541]. We recommend that the Commission apply whatever executive compensation disclosure rules ultimately are adopted for smaller issuers to microcap companies as we propose to define that term rather than only to small business issuers as currently defined under Regulation S-B.

[113] See Record of Proceedings 48, 143, 148 (June 17, 2005) (testimony of William A. Loving, David N. Feldman and John P. O'Shea).

[114] See Letter from Brad Smith to Committee (May 24, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/bsmith2573.htm); Letter of Kathryn Burns to Committee (May 24, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/kburns052405.pdf; Letter of David N. Feldman to Committee (May 30, 2005)(on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/dnfeldman053005.htm; Letter of Michael T. Williams to Committee (May 30, 2005)(on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/mtwilliams6614.pdf; Letter of KPMG to Committee (May 31, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/kpmg053105.pdf; Letter of BDO Seidman to Committee (May 31, 2005) (on file SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/bdoseidman053105.pdf; Letter of Stephen M. Brock to Committee (May 31, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/smbrock1317.pdf; Letter of Ernst & Young to Committee (May 31, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/ey053105.pdf; Letter of Small Business& Entrepreneurship Council to Committee (May 31, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/kkerrigan8306.pdf; Letter of Society of Corporate Secretaries & Governance Professionals to Committee (June 7, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/sspc-slc-scsgp060705.pdf; Letter of Mark B. Barnes to Committee (August 2, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/mbbarnes080205.pdf; and Letter of Gregory C. Yardley, Jean

but similar and parallel system, will result in many benefits. Among them, any stigma associated with taking advantage of the accommodations would be lessened. In addition, this would reduce the complexity of SEC rules, in keeping with the overarching goal expressed in our Committee Agenda of "keeping things simple."

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 smaller public companies, including both microcap companies and smallcap companies.**

As discussed above, we are recommending that the Commission establish a new system of scaled or proportional securities regulation for smaller public companies that would replace Regulation S-B. In Recommendation IV.P.1 immediately above, we recommend that the disclosure accommodations currently available to small business issuers under Regulation S-B be made available to all microcap companies, as we have recommended that term be defined in "Part II. Scaling Securities Regulation for Smaller Companies" above. In this recommendation, we recommend that the primary financial statement accommodations currently afforded to small business issuers under Regulation S-B be made available to all "smaller public companies" as we have recommended that term be defined above. Adopting this recommendation would mean that both microcap companies and smallcap companies, as we would have the Commission define those terms, would be entitled to take advantage of financial statement accommodations now available only to small business issuers.

The primary financial statement accommodation now afforded to small business issuers is provided under Item 310 of Regulation S-B. That provision permits small business issuers to file two years of audited income statements, cash flows, and changes in stockholders equity and one year of audited balance sheet data in annual reports and registration statements. Larger public companies are

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Harris, Stanley Keller, A. John Murphy, and A. Yvonne Walker to Committee (Sept. 12, 2005) (on file in SEC Public

required to file three years of audited income statement and other data and two years of audited balance sheet data under Regulation S-X.[115] We recommend that smaller public companies be required to file only two years of audited income statements, cash flows, and changes in stockholders equity but two years of audited balance sheet data in annual reports and registration statements.

We believe that requiring a second year of audited balance sheet data for smaller public companies provides investors with a basis for comparison with the current period, without substantially increasing audit costs. On the other hand, we believe that eliminating the third year of audited income statement, cash flow and changes in stockholders equity data for smaller public companies will reduce costs and simplify disclosure while not adversely impacting investor protection in any significant way. Third year data and corresponding analysis is generally less relevant to investors than the more current data and third year data is often readily obtainable online.[116] If the company has been a reporting company for three years, the third year data should be readily accessible through the Commission's EDGAR system and other sources. Investors today have access to numerous years of financial information about any reporting company because of the significant technological advances in obtaining financial information about reporting issuers. We do not believe that investors will be harmed in any significant way if the Commission adopts this recommendation.

Moreover, we believe that eliminating the third year of income statement, cash flow and stockholders equity data for smaller public companies will reduce costs and simplify disclosure. Eliminating the third year of audited income statement and other data may serve to reduce costs associated with changing audit firms by eliminating certain of the expenses and processes associated with

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Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/gcyadley091205.pdf.

[115] 17 CFR 210.1-01 et seq. The financial statement rules applicable to small business issuers appear in Item 310 as part of Regulation S-B, whereas the financial statement rules applicable to larger companies appear in Regulation S-X, an entirely separate regulation. We take no position on whether the financial statement rules that would apply to all smaller public companies under our recommendation should appear in Regulation S-K as a separate set of rules applicable to all smaller public companies or in Regulation S-X.

[116] See Internet Availability of Proxy Materials, SEC Release No. 34-52926 (Dec. 15, 2005) [70 FR 74598].

predecessor auditor consent requirements. An issuer's prior auditors must execute consents in order for financial statements previously audited by that firm to be included in SEC reports and registration statements. Adopting this recommendation may make it easier for smaller public companies to change their auditors, thereby increasing competition among auditing firms.

In addition, we believe that the following financial statement accommodations currently provided to small business issuers would be afforded to all smaller public companies if this recommendation is adopted:

- In an initial public offering, small business issuers have a longer period of time in which they do not have to provide updated audited financial statements in their registration statements. For example, for non-small business issuers, if the effective date of the registration statement for the initial public offering falls after 45 days of the end of the issuer's fiscal year, the non-small business issuer must provide audited financial statements in their registration statement for the most recently completed year, with no exceptions. For small business issuers, if the effective date of the registration statement falls after 45 days but within 90 days of the end of the small business issuer's fiscal year, the small business issuer is not required to provide the audited financial statements for such year end, provided that the small business issuer has reported income for at least one of the two previous years and expects to report income for the recently-completed year.[117]
- Issuers filing a registration statement under the Exchange Act (which is currently filed on Form 10-SB but would be filed on Form 10 if our previous recommendation is adopted) need not audit the financial statements for the previous year if those financial statements have not been audited previously. This also applies to any financial statements of recently

[117] See 17 CFR 228.310(g)(2).

acquired businesses or pending acquisitions that are included in an Exchange Act registration statement.

- Small business issuers need not provide financial statements of significant equity investees, as required by Rule 3-09 of Regulation S-X, in any document filed with the SEC.

Small business issuers domiciled in Canada may present their financial statements in accordance with Canadian GAAP and reconcile those financial statements to U.S. GAAP. Any non-small business issuer filing a registration statement on a domestic form, such as Form S-1, S-3 or S-4, must present its financial statements in accordance with U.S. GAAP and provide all disclosures required under U.S. GAAP.

Recommendation IV.P.3:

> **Allow all reporting companies to be eligible to use Form S-3, if they have been reporting under the Exchange Act for at least one year and are current in their reporting at the time of filing.**

Form S-3[118] is a short-form registration statement under the Securities Act that allows companies eligible to use it maximum use of incorporation by reference to information previously filed with the Commission. As discussed below, we recommend that the efficiencies associated with the use of Form S-3 be made available to all companies that have been reporting under the Exchange Act for at least one year, and are current in their Exchange Act reporting at the time of filing. Additionally, we recommend elimination of the current condition to the use of Form S-3 that the issuer has timely filed all required reports in the last year.

Current SEC rules allow issuers with over $75 million in public float to use Form S-3 in primary offerings. Additionally, Form S-3 may be used for secondary offerings for the account of any person other than the issuer if securities of the same class are listed and registered on a national securities

[118] Form S-3 can be found at Fed. Sec. L. Rep. (CCH) ¶ 8061. See Revisions of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, SEC Release No. 33- 6383 (Mar. 3, 1982) [47 FR 11380].

exchange or are quoted on NASDAQ. Many smaller public companies are not eligible to use Form S-3 in primary offerings because their public float is below $75 million; they also cannot use Form S-3 in secondary offerings because their securities are not listed on a national securities exchange or quoted on NASDAQ.

Since 1999, the NASD has required companies traded on its Over-the-Counter Bulletin Board ("OTCBB")[119] to file reports under the Exchange Act. Under Exchange Act rules, registrants must file annual and quarterly reports disclosing information about their companies. Registrants also have an obligation to file current reports when certain events occur. All reporting companies have the same disclosure obligations as the largest of public companies. Their disclosure should be sufficient to protect investors and inform the marketplace about developments in these companies. As online accessibility to previously filed documents on corporate and other websites, including the SEC's EDGAR web site, increases; smaller public companies should be permitted to take advantage of the efficiency and cost savings of incorporation by reference to information already on file. The Commission has recently taken several steps acknowledging the widespread accessibility over the Internet of documents filed with the SEC. In its recent release concerning Internet delivery of proxy materials,[120] the Commission noted that recent data indicates that up to 75% of Americans have access to the Internet in their homes, and that this percentage is increasing steadily among all age groups. As a result, we believe that investor protection would not be materially diminished if all reporting companies were permitted to utilize Form S-3 and the associated benefits of incorporation by reference. Further, the smaller public companies that would be newly entitled to use Form S-3 if this recommendation is adopted would not enjoy the automatic effectiveness of registration statements, as is the case with well known seasoned issuers under the SEC's

[119] The OTCBB is a regulated quotation service that displays real-time quotes, last-sale prices, and volume information in over-the-counter (OTC) equity securities. An OTC equity security generally is any equity security that is not listed or traded on NASDAQ or a national securities exchange.

[120] See Internet Availability of Proxy Materials, SEC Release No. 34-52926 (Dec. 15, 2005) [70 FR 74598].

recent Securities Act Reform rules.[121] Accordingly, the SEC staff can elect to review the registration statement and documents of smaller public companies incorporated by reference if it chooses to do so. Additionally, the Sarbanes-Oxley Act has required more frequent SEC review of periodic reports as well as enhanced processes, such as disclosure controls and procedures and certifications by the chief executive and chief financial officers, which further enhances investor protection. We believe the adoption of this recommendation will also facilitate capital formation by reducing costs of smaller public companies and providing more rapid access to the capital markets. We further recommend that corresponding changes be made to other forms providing similar streamlined disclosure for S-3 eligible issuers, such as Form S-4.

We acknowledge that some members of the public may believe that recommending Form S-3 eligibility for all reporting companies is contrary to our recommendation seeking relief from Sarbanes-Oxley Act Section 404 but we believe strongly that all reporting companies should have the same efficient access to the market as large reporting companies. Microcap companies have the same reporting obligations as the largest of reporting companies and should not be penalized because of size. The changes in reporting requirements of microcap companies on the OTCBB support this recommendation.

We recommend that the Commission eliminate the requirement that the registrant has filed in a timely manner all reports required to be filed during the preceding 12 calendar months as a condition to the use of Form S-3, if the issuer has been reporting under the Exchange Act for at least 12 months and, at the time of such filing, has filed all required reports. We believe that the risk of SEC enforcement action, delisting notifications and accompanying disclosure, and associated negative market reactions are

[121] See Securities Offering Reform, SEC Release No. 33-8591 (July 19, 2005) [70 FR 44722].

sufficient and more appropriate deterrents to late filings, and depriving late filers of an efficient means to access the capital markets is unduly burdensome to issuers, both large and small.[122]

General Instructions to Form S-3 limit the use of that form for secondary offerings to securities "listed and registered on a national securities exchange or . . . quoted on the automated quotation system of a national securities association," a restriction that by definition excludes the securities of OTCBB issuers. As a consequence, OTCBB issuers that undertake private placements with associated registration rights, or that are required to register affiliate or Rule 145 shares, are required to file a registration statement on Form S-1 or Form SB-2 and incur the substantial burden and expense that the continuous updating of those forms require.

When the Commission adopted Form S-3 in 1982, the distinction drawn between OTCBB and exchange and NASDAQ-traded securities was logical. OTCBB issuers were not at the time required to file Exchange Act reports with the SEC. In 1999, however, the NASD promulgated new eligibility rules that required all issuers of securities quoted on the OTCBB to become SEC reporting companies and be current in its Exchange Act filings, making the need for such a distinction less apparent. [123]
We concur with the Commission's original analysis in 1982 that "most secondary offerings are more in the nature of ordinary market transactions than primary offerings by the registrant, and, thus, that Exchange Act reports may be relied upon to provide the marketplace information needed respecting the registrant."[124] In light of the current requirement that OTCBB issuers also be SEC reporting companies, we believe that extending Form S-3 eligibility for secondary transactions to OTCBB issuers is consistent with the rationale underlying Form S-3 at the time of its adoption. Moreover, allowing such use of Form S-3 would benefit OTCBB issuers by (1) eliminating unnecessary, duplicative disclosure while ensuring

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[122] To prevent issuers from taking advantage of the system by, for instance, becoming current on Day 1 and filing a Form S-3 on Day 2, the Commission could require that the issuer be current for at least thirty days before filing the S-3.
[123] Press Release, NASD, NASD Announces SEC Approval of OTC Bulletin Board Eligibility Rule (Jan. 6, 1999).

that security holders, investors and the marketplace are provided with the necessary information upon which to base an investment decision and (2) substantially reducing the costs associated with undertaking a private financing.

Recommendation IV.P.4:

> **Adopt policies that encourage and promote the dissemination of research on smaller public companies.**

The trading markets for public companies are assisted in great measure by the dissemination of quality investment research. Investment research coverage for public companies in general, and for smaller public companies in particular, has declined dramatically in recent years, however, as economic and regulatory pressures have led the financial industry to dramatically reduce research budgets.[125] The problem is particularly pronounced in the case of smallcap companies, of which less than half receive coverage by even a single analyst, and in the microcap universe, where analyst coverage is virtually non-existent.[126]

The existing regulatory framework and business environment exacerbates this problem, and commission rates have declined for firms that historically used these revenue streams to fund research. Business models have emerged to create published research in order to fill the resulting void, although their involvement with independent research providers that also participate in the global settlement agreement has until recently been uncertain.[127]

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[124] See Revisions of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, SEC Release No. 33-6383, at 10 (Mar. 3, 1982) [47 FR 11380].

[125] A recent article notes, for instance, that fewer companies are receiving analyst coverage today than at anytime since 1995. Where's the Coverage?, CFO Magazine (Jan. 20, 2005), available at http://www.cfo.com/article.cfm/3516678/c_3576955?f=home_todayinfinance

[126] Testimony provided to the Committee indicated that approximately 1,200 of 3,200 of NASDAQ-listed companies, and 35% of all public companies, receive no analyst coverage at all. See Record of Proceedings 17 (June 17, 2005)(testimony of Ed Knight, Vice President and General Counsel of NASDAQ). Statistics provided by the SEC Office of Economic Analysis indicate that in 2004 approximately 52% of companies with a market capitalization between $125 million and $750 million and 83% of companies with a market capitalization less than $125 million had no analyst coverage.

[127] In the course of its proceedings, we were made aware of one informal clarification regarding administration of the global settlement agreement in the recent analyst coverage enforcement cases that will likely have a beneficial effect on the availability of independent research. As members of the Commission are aware, one aspect of the global settlement agreement

A lack of independent analyst coverage has several adverse effects, both for individual companies and for the capital markets as a whole:

- companies with no independent analyst coverage have a reduced market capitalization in comparison with companies that do have such coverage, and are subject to higher financing costs when compared with their analyst-covered peers;[128]
- a lack of coverage by independent analysts limits shareholders' and prospective shareholders' ability to obtain an informed outsider's perspective on identifying strengths and weaknesses and areas for improvement;
- the lack of coverage lessens the entire "mix of information" made available to investment bankers, fund managers and individual investors, which make markets less efficient; and
- because analyst reports trigger the buying and selling of shares, the lack of such reports frustrates the formation of a robust trading market.[129]

In order to address the need for more independent research for smaller public companies, we recommend that the Commission:

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provides that, for a period of five years commencing in 2004, investment banks that are parties to the settlement are required to provide to their U.S. customers independent research reports alongside their own research reports on certain companies that their analysts cover. Entities that provide independent research reports to the settling banks ("independent research providers" or "IRPs") cannot also conduct "paid-for" research i.e., research done on behalf of, and paid for by, individual companies. Because many IRPs do not want to be excluded from participating in the global settlement, the effect of this prohibition—at least in the view of some—was to limit the number of entities willing to undertake paid-for research on behalf of individual companies.

In October 2005, the five regulators overseeing implementation of the global settlement informed the independent consultants (essentially the persons responsible for procuring the independent research under the settlement) of how the settlement applies to independent research intermediaries that match companies and IRPs on a "blind pool" basis (i.e., a complete wall is maintained between the entity that purchases the research, most likely the company being analyzed, and the selection of an IRP to conduct the research). Although no formal pronouncement was issued, regulators responsible for the enforcement of the global settlement told the independent consultants that they have the discretion to decide whether or not to procure independent research from IRPs that also contract with independent research intermediaries, provided that certain conditions are met.

[128] A recent study on the effects of Regulation FD finds that when smaller companies lost analyst coverage after the regulation was enacted their cost of capital increased significantly. See Armando Gomes et al., SEC Regulation Fair Disclosure, Information, and the Cost of Capital (Rodney L. White, Center for Fin. Research, Wharton, Working Paper No. 10567) (July 8, 2004).

[129] Rebecca Buckman, Tougher Venture: IPO Obstacles Hinder Start-ups, Wall St. J., Jan. 25, 2006, at C1.

- Maintain policies that allow company-sponsored research to occur with full disclosure by the research provider as to the nature of the relationship with the company being covered. Entities providing such research should disclose and adhere to a set of ethical standards that ensure quality and transparency and minimize conflicts of interest.[130]
- Continue to permit "soft dollar" payments (i.e., the use of client commissions to pay for research services) under the safe harbor provisions of current Exchange Act Section 28(e), as amplified by guidance set forth in SEC Release No. 34-52635.

We acknowledge that these two recommendations do not request significant changes in existing SEC policies, but rather, call for more or less continuation of existing policies. Despite a shared conviction that independent analyst coverage is critical to the success of smaller public companies and to the efficient operation of our capital markets, we were unable to identify specify regulatory impediments that could be modified in a manner that would be consistent with the Commission's investor protection mandate. We nonetheless have included these two recommendations in order to highlight for the Commission the existing problem, to ask that existing policies be maintained and to request that the Commission continue to search for new ways to promote analyst coverage for smaller public companies.

Recommendation IV.P.5:

> **Adopt a new private offering exemption to 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.**

[130] Section 17(b) of the Securities Act provides that: "It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof."

The ban on general solicitation and advertising in connection with exempt private offerings dates back to some of the earliest SEC staff interpretations of the Securities Act.[131] Although the initial intention of the ban is straightforward, over time its application has become complex. Few bright-line tests exist, and issuers are required to make highly subjective determinations concerning whether their actions might be construed as impermissible. Among the factors considered in determining if a general solicitation has occurred are: the number of offerees; the identity of the offerees and their suitability as potential investors; the manner of the offering; and whether or not the offerees have a pre-existing relationship with the issuer.

Beyond the difficulty of applying the rules, however, the current ban on general solicitation effectively prohibits issuers from taking advantage of the tremendous efficiencies and reach of the Internet to communicate with potential investors who do not need all the protections of the Securities Act's registration requirements. In our view, this creates a significant impediment to the efficient formation of capital for smaller companies, one that could easily be corrected by modernizing the existing prohibitions on advertising and general solicitation.

Traditionally, both federal and state private offering exemptions have been conditioned on the absence of "advertising or general solicitation." These concepts and SEC interpretations have not provided bright-line objective criteria for issuers and their advisers. Nevertheless, when it comes to exempt transactions, issuers face draconian risks to the viability of the entire offering for non-compliance with just one of the many required exemption elements. For example, even if all purchasers (A) are accredited investors, (B) have pre-existing business relationships with the issuing company and (C) are contacted in face-to-face meetings, some case law supports the view that the exemption will nevertheless be lost for the entire offering if other issuer activities are found to have involved general solicitation or

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[131] See, e.g., SEC Release No. 33-285 (Jan. 24, 1935).

advertising. This could occur, for example, if the issuer made offers at a social function to 50 prospective purchasers, all of whom were social friends of the issuing company's principals but with whom the company did not enjoy pre-existing business relationships. A similar adverse result could occur if the issuer or an agent of the issuer placed an advertisement on a local cable TV show, Internet web page or newspaper that featured the issuer's capital formation interests. In these examples, the exemption could be lost (and all purchasers could seek a return of their invested funds) even though none of the offerees contacted in an impermissible manner became purchasers. As a result, prudence dictates that the available methods used to contact offerees be very limited. In our view, concerns with avoiding improper general solicitation or advertising have the effect of focusing a disproportionate amount of time and effort on persons who may never purchase securities—rather than on the actual investors and their need for protection under the Securities Act.

Accordingly, we recommend the adoption of a new private offering exemption that would permit sales made only to certain eligible purchasers who do not require the full protections afforded by the securities registration process under the Securities Act because of (1) financial wherewithal, (2) investment sophistication, (3) relationship to the issuer or (4) institutional status. An offering whose purchasers consisted solely of eligible purchasers of these types would qualify for the exemption regardless of the means by which they were contacted—even through advertising or general solicitation activities, subject to the restrictions noted below.

- The class of eligible purchasers would be comprised of several categories of natural persons and legal entities and would be defined in a manner similar to that used in Regulation D under the Securities Act[132] to define the term "accredited investors."[133]

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[132] 17 C.F.R. 230.501-504.

[133] See Securities Act Rule 501(a) under Regulation D, 17 C.F.R. 230.501(a).

- Natural persons would qualify as eligible purchasers based on (1) wealth or annual income, (2) investment sophistication,[134] (3) position with or relationship to the issuer (officer, director, key employee, existing significant stockholder, etc.) or (4) pre-existing business relationship with the issuer. Persons closely related to or associated with eligible purchasers would also qualify as eligible purchasers.
- The financial wherewithal standards for natural person to qualify as eligible purchasers would be substantially higher than those currently in effect for natural person Accredited Investors.[135] We suggest $2 million in joint net worth or $300,000 in annual income for natural persons and $400,000 for joint annual income.[136]
- Legal entities would qualify as eligible purchasers if they qualify as accredited investors under Regulation D.
- The SEC should adopt the new exemption amending Regulation D or adopt an entirely new amendment under Section 4(2) of the Securities Act, so that securities sold in reliance on the new exemption would be "covered securities" within the meaning of Section 18 of the Securities Act and generally exempted from the securities registration requirements of individual state securities laws. This course of action is crucial to the efficacy of the new exemption.
- The new exemption will need a two-way integration or aggregation[137] safe harbor similar to that included in SEC Rule 701.[138] Under such a safe harbor, offers and sales made in compliance with

[134] Under Regulation D, investment sophistication is the ability, acting alone or with the assistance of others, to understand the merits and risks of making a particular investment.

[135] Under Regulation D as currently in effect, natural person accredited investors must have a net worth of $1 million (including property held jointly with spouse) or $200,000 in individual or $300,000 joint annual income. Rule 501(a)(6).

[136] There was support in the subcommittee for recommending the use of the financial wherewithal standards for natural person Accredited Investor in Regulation D for the eligible purchaser standards. It was our impression from informal discussions with federal and state regulatory officials that an increase in the financial wherewithal standards for natural persons was the sine qua non for obtaining regulatory support for this proposal.

[137] As the Commission is aware, "integration" refers to the SEC doctrine by which all offers and sales separated by time or other factors are nevertheless treated as part of a single offering. Offers and sales believed to be part of separate offerings that are integrated into a single offering are required to either comply with a single exemption from registration or be registered.

the new exemption would not be subject to integration or aggregation with offers and sales made under other exemptions or in registered offerings. Similarly, offers and sales made under other exemptions or in registered offerings would not be subject to integration or aggregation with transactions under the new exemption.

- As a means of guarding against potential abuse, we envision that all solicitations made by means of mass media (e.g., newspapers, magazines, mass mailings or the Internet) would be restricted in scope to basic information about the issuer, similar to that found in Securities Act Rule 135c (currently a permissive rather than restrictive provision, and one applicable only to Exchange Act reporting companies).[139] Solicitations made in face-to-face meetings would not be subject to these restrictions.

The proposed exemption would not remove the SEC's authority to regulate offers of securities. All offering activities conducted under the new exemption would continue to be fully subject to the antifraud provisions of the federal securities laws. Moreover, disclosure restrictions modeled after the current safe harbor found in Rule 135c would ensure that issuers could not utilize the Internet, television, radio, newspapers and other mass media to engage in "pump and dump" or other manipulative schemes.

The proposed exemption is not a radical change in the fundamental regulatory rationale regarding exempt private offerings. In all the private offerings since the beginning of regulatory time, no offeree has ever lost any money unless he or she became a purchaser. The new exemption reduces the issuer's obligations regarding non-investors and refocuses on the need (or lack thereof) that actual purchasers have for the protections afforded by the securities registration process.

Otherwise, they will violate Section 5 and trigger rescission rights for all purchasers. The SEC integration doctrine underpins much of the existing Securities Act registration exemption framework; without it, evading the Securities Act's registration requirements would be possible by artificially separating an otherwise non-exempt offering into two more distinct transactions and claiming an exemption for each transaction.

[138] 17 C.F.R. 230.701.

We believe that this suggested change can be viewed as a logical continuation of an established regulatory trend to loosen the restrictions on what can be done with non-purchasers consistent with investor protection. The SEC has relaxed restrictions on offers in other, less bold ways.[140] Almost a decade ago, Linda Quinn, the long-time Director of the Division of Corporation Finance, proposed adopting an exemption substantially similar to that being recommended.[141]

This recommendation represents a corollary to the recommendation immediately above concerning a lifting of the ban on general solicitation when sales are made to certain eligible purchasers who do not need the full protection of Securities Act registration. Whereas the former would generally maintain investor protection by limiting sales of securities to persons that time and experience have demonstrated do not need protections afforded by full registration, this recommendation would do so by limiting the information included in a general solicitation similar to that allowed in a Regulation A "test

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[139] 17 C.F.R. 230.135c. A somewhat similar structure has been established by the North American Securities Administrators Association and adopted in 23 states. See, e.g., Texas Administrative Code Rule 139.19 which sets forth the information that can be included in the announcement.

[140] Rule 254, 17 U.S.C. 230.254, which is available for use only in Regulation A exempt offerings, allows issuers before approval of the offering by the SEC to "test the waters" with activities that would otherwise be considered improper advertising or general solicitation; because of the extremely infrequent use of Regulation A offerings and an incompatibility with comparable state securities laws, "test the waters" has been of little practical utility to the capital formation process. In addition, the SEC staff has issued interpretive letters advising registered broker-dealers that certain limited generic solicitation activities (including Internet-based solicitation) would not amount to impermissible advertising or general solicitation. See, e.g., Interpretative Letters E. F. Hutton Co. (Dec. 3, 1985), H. B. Shaine & Co, Inc. (May 1, 1987) and IPOnet (July 26, 1996). But for these favorable interpretations, the conduct described in the letters might have been interpreted as impermissible advertising and general solicitation. In this regard, the staff has not extended its interpretation to cover conduct by issuers (or other non-broker-dealers) that would allow them to engage in the solicitation activities described in the broker-dealer interpretative letters.

[141] Expressing her views about securities reform when she was leaving the staff of the Division of Corporation Finance, Ms. Quinn endorsed modifications in the Securities Act exemption regime consistent with the proposed exemption. See L. Quinn, Reforming the Securities Act of 1933: A Conceptual Framework, 10 Insights 1, 25 (Jan. 1996). Ms. Quinn supported the use of "public offers" in exempt private offerings whose purchasers were limited to "qualified buyers":

> In sum, offers would not be a Section 5 event and therefore would not be a source of Section 12(1) liability . . . . Offering communications would and should still be subject to the antifraud laws . . . . This approach could be effected by the Commission defining these communications as outside the scope of offers for purposes of Section 5 of the Securities Act, subject to conditions deemed appropriate. The test-the-waters proposal makes such use of the Commission's definitional authority . . . . Id. at 27.

the waters" solicitation.[142] Both measures would, in our view, significantly ease the difficulties that smaller companies, the largest users of private offering exemptions, encounter in locating suitable investors.

Although we defer to the Commission as to the exact parameters of permissible solicitation, we anticipate that any soliciting materials would be subject to restrictions modeled on those found in current Rule 254.[143] Issuers would be required to include disclosure to the effect that no money or other consideration is being solicited, that an indication of interest by a prospective investor involves no obligation or commitment of any kind, and that no sales of securities will be made until after the suitability of a potential investor for purposes of the applicable Regulation D exemption has been determined. Companies would also be required to include contact information, in order to communicate with those expressing interest and thereafter establish whether they fit within the suitability/accreditation standards for the offering before making a formal offer of securities, and a disclaimer to the effect that the offering itself may only be made to investors that satisfy the standards of the Securities Act exemption upon which the company intends to rely.[144] As with Rule 254 solicitations, the Commission could preserve its oversight role by requiring that issuers submit a copy of any written document or the script of any broadcast on or before the day of first use. By restricting solicitations in this manner, we believe that much benefit, and very little harm, would result from a relaxation of the current advertising/solicitation ban of Rule 502(c).

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[142] 17 C.F.R. 230.254.

[143] Rule 254 was adopted in 1992 and has not been updated. We recommend that the SEC staff review the provisions of Rule 254 and harmonize the recommended changes to take into account the changes in SEC policy and practice since 1992, including the SEC's recently adopted securities offering reforms.

[144] As noted by a former Director of the SEC Division of Corporation Finance, the use of such disclaimers is an accepted practice under existing securities laws: "Almost all 50 states recognize that if you advertise on the Internet but disclaim that you are not selling securities to their residents, and, in fact, do not sell to their residents, you have not made an illegal offering in that state. The Commission has used the same approach for offerings posted by foreign companies on their web sites. As long as foreign companies indicate they are not offering securities to U.S. citizens, their Internet posting is not an offering in the United States subject to the registration requirements of the federal securities laws. Why then prohibit a private placement as long as (1) it includes a warning that it will not sell to investors who do not meet the definition of an accredited investor and

As with the recommendation immediately above, in order to work effectively the new exemption will need to be implemented by adoption of a new or amended rule under Section 4(2) of the Securities Act, such that securities sold in reliance on the new exemption would be "covered securities" within the meaning of Section 18 of the Securities Act and consequently exempted from state securities registration requirements.

Recommendation IV.P.6:

Spearhead a multi-agency effort to create a streamlined NASD registration process for finders, M&A advisors and institutional private placement practitioners.

As detailed in a recent report published in the Business Lawyer,[145] there exists an unregulated underground "money finding" community that services companies unable to attract the attention of registered broker-dealers, venture capitalists or traditional angel investors.[146] Many smaller companies rely on this community to assist them in raising capital. A separate community of unregistered and therefore unregulated M&A consultants who assist buyers and sellers with services and receive compensation substantially similar to those provided and earned by traditional registered investment bankers also exists. Virtually all of the services provided in support of capital formation and M&A activities amount to unregistered broker-dealer activities that violate federal and state broker-dealer registration and regulation law. For the most part, the services provided do not involve holding customers' funds, which is a traditional function of many registered broker-dealers. These unregulated service providers have a great reluctance to register as broker-dealers under the current regulatory framework. The enforcement activity against them seems minimal. The cost and administrative burdens

(2) does not, in fact, sell to unsophisticated investors? Who is harmed?" Speech by Brian J. Lane to the American Bar Association (Nov. 13, 1999).

[145] Task Force on Private Placement Broker-Dealers, ABA Section of Business Law, Report and Recommendations of the Task Force on Private Placement Broker-Dealers, 60 Bus. Lawyer 959-1028 (May 2005), available at http://www.abanet.org/buslaw/tbl/tblonline/2005_060_03/home.shtml#1. We note that the Texas State Securities Board is also drafting a finder proposal.

of the current regulatory scheme are daunting to both the money finding and M&A communities. The absence of a workable registration scheme means that issuers cannot currently use broker-dealer registration as an element in differentiating between such providers. The proposal seeks to foster a scheme of registration and regulation, substantially in accordance with the ABA Task Force Proposal outlined in the Business Lawyer article referenced above, that will be cost-effective for the unregistered community and support the investor protection goals of securities regulation.

An unregistered money finder will never "come in from the cold" to register if the regulators reserve the right to institute enforcement actions based solely on past failure to register. Accordingly, a workable amnesty program is also crucial to the success of the proposal. Regulatory amnesty should not extend to fraud nor be a defense against private causes of action.

The private placement broker-dealer proposal is not new. It has been "on the table" for a number of years, and indeed, has been a top recommendation of the annual SEC Government-Business Forum on Small Business Capital Formation for nine of the past ten years. This demonstrates that other individuals and groups agree with our view that this proposal is important to improve small business capital formation. To date, however, none of the affected regulatory bodies have taken action. We believe the SEC must provide leadership if this proposal is to succeed. That leadership must come first from the Commission itself, and then the agency must reach out to the NASD and the state regulators.

Corporate Governance, Disclosure and Capital Formation—Secondary Recommendations

In addition to the foregoing primary recommendations in the area of corporate governance, disclosure and capital formation, we also submit for the Commission's consideration the following secondary recommendations:

[146] Section 15(a)(1) of the Exchange Act defines broker-dealers as persons who "effect any transaction in, or . . . induce or attempt to induce the purchase or sale of, any security" and makes it unlawful to carry on broker-dealer activities in the absence of SEC registration or exemption. Most state securities laws include similarly broad general definitions and prohibitions.

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.[147]

In order for our recommendation that the Commission establish a new system of scaled or proportional securities regulation for smaller public companies to apply uniformly and to adequately protect investors, the rules under which companies are required to enter and allowed to exit the underlying disclosure system must not be subject to manipulation and circumvention. By law, companies must enter the system under Section 12(b) of the Exchange Act when they register a class of securities on a national securities exchange, under Section 12(g) of the Exchange Act when they have 500 equity shareholders of record and $10 million in assets, and under Section 15(d) of the Exchange Act when they have filed a registration statement under the Securities Act that becomes effective.[148] Companies may be entitled to exit the system when their securities are removed from listing on a national securities exchange and when they have fewer than 300, or sometimes fewer than 500, equity shareholders of record.[149] The rules for entering and exiting the Exchange Act reporting system have come into increasingly sharp focus in recent years, due in part to the increasing costs associated with complying with the reporting and other obligations of reporting companies under the Exchange Act.

We have concluded that, because of the way that SEC rules permit the counting of equity shareholders "of record" under Exchange Act Rule 12g5-1,[150] circumvention and manipulation of the entry and exit rules for the SEC's public company disclosure system is possible and occurs. Rule 12g5-1, which was adopted by the Commission in 1965, interprets the term "security held of record" in Section

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[147] Although overall this recommendation passed unanimously, Messrs. Schact and Dennis dissented from the majority vote with respect to that portion of the recommendation specifying that holders of unexercised stock options issued in compliance with Rule 701 not be included as holders for purposes of Rule 12g5-1.
[148] 15 U.S.C. 78l(b), 78l(g) & 78o(d).
[149] 17 C.F.R. 240.12h-3 and 17 C.F.R. 240.12g-4.

12(g) for U.S. companies to include only securities held by persons identified as holders in the issuing company's stock ledger.[151] This excludes securities held in street or nominee name, which is very common today, because shares held in street or nominee name are listed in the stock ledger as held in the names of brokers, dealers, banks and nominees. This interpretation originally was adopted to simplify the process of determining whether an issuer is required to report under Section 12(g).

As noted above, Congress added Section 12(g) to the Exchange Act in 1964 to extend the reach of most of the Exchange Act's public company reporting and disclosure provisions to equity securities traded over-the counter. That provision requires all companies with a class of equity securities held of record by at least 500 persons to register with the Commission.[152] Companies registered with the Commission are required to file annual and quarterly reports with the SEC and to comply with the other rules and regulations applicable to public companies.[153]

Exchange Act Rules 12g-4[154] and 12h-3[155] regulate when an issuer can exit the reporting system under Section 12(g) or Section 15(d). These rules allow an issuer to terminate its Exchange Act reporting with respect to a class of securities held of record by fewer than 300 persons, or fewer than 500 persons where the total assets of the issuer have not exceeded $10 million on the last day of the three most recent fiscal years.

The Nelson Law Firm, on behalf of a group of institutional investors, recently filed a rulemaking petition with the SEC requesting the Commission to take immediate action to amend Rule 12g5-1 to

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[150] 17 C.F.R. 240.12g5-1.
[151] 17 C.F.R. 240.12g5-1.
[152] 15 U.S.C. §78l(g). Section 12(g) does not require registration if the company does not have a minimal level of assets. The level was $1 million in the original statute, but the Commission had raised this number to $10 million by rule by 1996. See Relief from Reporting by Small Issuers, SEC Release No. 34-37157 (May 1, 1996) [61 FR 21354].
[153] Section 13(a) of the Exchange Act requires companies registered with the Commission to file annual and quarterly reports with the SEC.
[154] 17 C.F.R. 240.12g-4.
[155] 17 C.F.R. 240.12h-3.

count all accounts as holders of record.[156] This petition highlighted the practice by some issuers of using street or nominee holders as a technique to reduce the number of record holders below 300 and exit the Exchange Act reporting system. The petition cited numerous companies that had fewer than 300 record holders as determined in accordance with Rule 12g5-1, but thousands of beneficial owners and total assets of approximately $100 million or more. We also received a letter discussing and supporting the rulemaking petition.[157] We also received other letters in support of rulemaking in this area.[158]

The trend of going dark is an area of concern to us. An issuer "goes dark" when holders of record of all classes of securities fall below the 300 holder threshold and it files a Form 15 terminating its reporting obligations under Section 12(g) or suspends its obligations under Section 15(d).[159] This procedure of going dark is contrasted with the going private procedures pursuant to Rule 13e-3.[160] Companies that go private typically buy back securities from shareholders through an offering document using Rule 13e-3 which is filed with the Commission.

When the Commission first adopted Rule 12g5-1 in 1965, approximately 23.7% of securities were held in nominee or street name.[161] In late 2002, it was estimated that over 84% of securities were held in nominee or street name.[162] The Nelson Law Firm and other proponents of such an amendment to Rule

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[156] See Rulemaking Petition of Nelson Law Firm to SEC (July 3, 2003), available at http://www.sec.gov/rules/petitions/petn4-483.htm.

[157] Letter from Nelson Obus to Committee (Apr. 7, 2005)(on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/26523-1.pdf.

[158] Letter from James Brodie to Committee (Apr. 12, 2005 (on file in SEC Public Reference Room File No. 265-23),available at http://www.sec.gov/rules/other/265-23/jabrodie9204.htm); Letter from Stephen Nelson to Committee (June 8, 2005(on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/sjnelson060805.pdf.

[159] See Christian Leuz et al., Why do Firms go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations, Wharton Fin'l Inst. Center Paper No. 04-19 (Nov. 2004), available at http://fic.wharton.upenn.edu/fic/papers/04/0419.pdf); see also Andras Marosi & Nadia Massoud, Why Do Firms Go Dark? (3d ver. Nov. 2004), available at http://www.umanitoba.ca/faculties/management/cgafinance/Massoud.pdf#search='Andras%20Marosi%20Why%20firms%20go%20dark%3F.

[160] 17 C.F.R. 240.13e-3. For a detailed explanation of going private transactions, see Marc Morgenstern & Peter Nealis, Going Private: A Reasoned Response to Sarbanes-Oxley?, (2004) (available at http://www.sec.gov/info/smallbus/pnealis.pdf).

[161] Final Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other than the Name of the Beneficial Owner of Such Securities Pursuant to Section 12(m) of the Securities Exchange Act of 1934, at 53-55 (Dec. 3, 1976) (the "Street Name Study").

[162] As of June 23, 2004 the DTCC estimated that approximately 85% of the equity securities listed on the NYSE, and better than 80% of equity securities listed on the NASDAQ and AMEX, are immobilized. See Letter from Jill M. Considine,

12g5-1 believe that the current definition of "held of record" allows companies to manipulate its number of record holders to circumvent the intent of Section 12(g) of the Exchange Act.

The substantial increase in securities held by nominees or in street name has led to the circumvention of the intention of Section 12(g) by enabling issuers with a significant number of shareholders to avoid registration, or deregister, if their equity holders are aggregated into a smaller number of nominee or record holders.

In light of the above considerations, we recommend that the Commission amend Rule 12g5-1 or its interpretation so that all beneficial owners are counted for purposes of calculating the number of shareholders for purposes of Section 12(g) of the Exchange Act and the rules thereunder. We recommend that the Commission request its Office of Economic Analysis or some other professional organization conduct a study to determine the effects on the number of companies required to register if this recommendation is adopted. The Commission or Congress can then decide whether the intent of Section 12(g) would be better served by changing the number of shareholders that triggers Exchange Act reporting from 500 to some other number. We believe that such a study is important because of the possibility of circumvention and manipulation of the SEC's rules for entering and exiting the disclosure system. The significant increase of costs associated with compliance with the registration and ongoing reporting obligations of the Exchange Act make this issue urgent.

We also received testimony[163] suggesting that employee stock options (those issued in compensatory transactions) not be considered a class of equity securities for purposes of triggering the registration requirements under Section 12(g) of the Exchange Act. We support this view. As

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Chairman and CEO of DTCC, commenting on Securities Transaction Settlements, SEC Release No. 33-8398 (Mar. 18, 2004) [69 FR 12922]. The DTCC immobilization program is aimed at eliminating physical securities certificates and its ultimate objective is to place all equity securities ownership in a direct registration system which is a street name system. (http://www.sec.gov/rules/concept/s71304/s71304-26.pdf).

[163] Record of Proceedings 64 (Sept. 19, 2005) (testimony of Ann Walker, Esq. before the joint meeting of the Committee and the Small Business Forum), available at http://www.sec.gov/rules/other/265-23/jh-sk-ajm-ayw-gcy091205.pdf).

exemplified by the policy underlying the Rule 701 exemption under the Securities Act, we believe that holders of employee stock options received in compensatory transactions are less likely to require the full protections afforded under the registration requirements of the federal securities laws. Therefore, we believe that such stock options should not be a factor in determining the point an issuer becomes subject to the burdens of a reporting company under the Exchange Act.

Recommendation IV.S.2:

Make public information filed under Rule 15c2-11.

A major problem with the market for over-the-counter securities, where many issuers are not required to file reports with the SEC, is the lack of reliable, publicly available information on issuers.[164] In theory, Exchange Act Rule 15c2-11, which prohibits brokers from publishing quotations on an OTC security unless they have obtained and reviewed current information about the issuer, could operate as a modest disclosure system under which investors could access basic issuer information if the company is not required to become a reporting company under Section 12(g) or 15(d). In practical terms, however, access to 15c2-11 information is extremely limited. Broker-dealers are required to file 15c2-11 information with the NASD only,[165] to retain such information in their files and to provide such information, upon request, to individual investors. Broker-dealers are not required to publish this information in a widely available location or provide it to investors on an ongoing and systematic basis. The result is an over-the-counter market in which the securities of literally thousands of issuers are traded, but about which current public information is uneven and in some cases non-existent. In our view, these conditions create the potential for fraud and manipulative abuse.

[164] For statistics concerning over-the counter issuers not required to file reports with the SEC, see Appendix I.

[165] See NASD Rule 6740 (Submission of Rule 15c2-11 Information on Non-NASDAQ Securities). To demonstrate compliance with both NASD Rule 6740 and SEC Rule 15c2-11, a member must file with NASD a Form 211, together with the information required under SEC Rule 15c2-11(a), at least three business days before the quotation is published or displayed.

In order to address this problem, we recommend that the Commission take action to provide for public availability of Rule 15c2-11 information. Although we defer to the Commission on the exact means by which this information would be made available, we feel that an orderly and reliable disclosure system adopted under the SEC's antifraud authority could place the burden of disclosure on issuers, by requiring that they post a minimal level of documentation on their company web site, and on the NASD, by requiring that it create and maintain an information repository of Form 211s it has received, rather than on brokers and market-makers.

Recommendation IV.S.3:

> **Form a task force, consisting of officials from the SEC and appropriate federal bank regulatory agencies to discuss ways to reduce inefficiencies associated with SEC and other governmental filings, including synchronizing filing requirements involving substantially similar information, such as financial statements, and studying the feasibility of extending incorporation by reference privileges to other governmental filings containing substantially equivalent information.**

We received a number of comment letters from banks and banking trade associations expressing concern about what they consider duplicative filing requirements of the SEC and other governmental agencies and the costs and efficiencies that have resulted.[166] Additionally, banks have advised us that they are subject to duplicative internal control requirements of various governmental regulators. We believe this recommendation is extremely important. Although we leave it to the Commission's

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[166] See Letter of Independent Community Bankers of America to Committee (Mar. 31, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/info/smallbus/acspc/icba.pdf; Letter from Christopher Cole of Independent Community Bankers of America to Committee (Apr. 8, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/ccole040805.pdf; Letter of Kathryn Burns, Vice President and Director of Finance, Monroe Bank to Committee (May 24, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/kburns052405.pdf; Record of Proceeding 48 (June 17, 2005) (testimony of William A. Loving, Chairman and CEO of Pendleton County Bank representing the Independent Community Bankers of America (June 17, 2005); Letter of Charlotte Bahin, Senior Vice President, America's Community Bankers to Committee (July 19, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/acbankers071905.pdf; Letter of Mark A. Schroeder, President and CEO, German American Bankcorp to Committee (August 3, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/maschroeder080305.pdf; Letter of Charlotte Bahin, Senior Vice President, America's Community Bankers to Committee (August 9, 2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/cmbahin080905.pdf; Letter of David Bochnowski, President and CEO of Northwest Indiana Bancorp to Committee (Aug. 9,

discretion as to how best to implement this recommendation, we further believe that the introduction of XBRL may make this recommendation a more attractive option in today's world. We wish to state that in making this recommendation, we are in no way advocating an expansion of disclosure of personal bank information beyond what is currently permitted.

Recommendation IV.S.4:

> **Allow companies to compensate market-makers for work performed in connection with the filing of a Form 211, with full disclosure of such compensation arrangements.**

The filing of a Form 211, and compliance with the diligence and NASD review and comment process that such a filing entails, generally requires that a market-maker expend substantial time, effort and funds. Current NASD rules, however, prohibit market-makers from recouping any compensation or reimbursement for their outlay.[167] While acknowledging the need for restrictions on payments by issuers to market-makers, we believe that in the limited context of the Form 211 filing process, NASD rules act to discourage market-making activity and impede the creation of a fair and orderly trading market in securities of over-the-counter companies, most of which are smaller public companies. If Rule 15c2-11 is to remain focused on broker-dealer broker-dealers rather than issuer disclosure (see our recommendation immediately above) then we recommend that the Commission encourage the NASD to modify its rules to allow issuers to compensate market-makers for work they perform in connection with the filing of a Form 211 (including diligence costs and costs associated with the NASD review process), if the compensation arrangement is fully disclosed. We believe this approach will encourage dealers to engage in market-making and foster a more efficient and viable market for over-the-counter securities issuers.

2005) (on file in SEC Public Reference Room File No. 265-23), available at http://www.sec.gov/rules/other/265-23/dbochnowski080905.pdf.

[167] NASD Rule 2460 (Payments for Market Making) provides that "No member or person associated with a member shall accept any payment or other consideration, directly or indirectly, from an issuer of a security, or any affiliate or promoter thereof, for publishing a quotation, acting as market-maker in a security, or submitting an application in connection therewith."

Recommendation IV.S.5:

> **Evaluate upgrades or technological alternatives to the EDGAR system so that smaller public companies can make their required SEC filings without the need for third party intervention and associated costs.**

Since the SEC's EDGAR system[168] was inaugurated in 1993, significant technological advances have occurred, including pervasive market deployment of Internet standards and protocols, software interoperability and embedded features. Computers with Internet capability are available in almost all workplaces and most homes and public libraries. The EDGAR system has not been updated to reflect these advances.

Many companies, but especially smaller public companies, find the EDGAR system unnecessarily complex and costly, and usually must engage costly third party vendors to file their reports with the Commission. We believe that the system's complexity and cost serves as an unnecessary burden on capital formation for smaller public companies.

In this regard, we encourage the Commission to pursue the use of Internet standards (e.g. eXtensible Business Reporting Language, or XBRL) and protocols (e.g., web services) in the announced EDGAR modernization project as a method to reduce costs associated with the preparation of registrant filings and the subsequent access and use of filed information by the Commission's staff and the financial community. We believe that the use of highly interoperable business reporting formats will lower information access costs by the analyst and investor community and thereby enhance the analysis and liquidity of the securities of smaller public companies.

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[168] EDGAR is an abbreviation for the SEC's Electronic Data Gathering, Analysis, and Retrieval System, which must be used by reporting companies to file their reports with the SEC.

Recommendation IV.S.6:

Make it easier for microcap companies to exit the Exchange Act reporting system.

As noted elsewhere in this report,[169] we have found that the costs associated with implementing the requirements of the Sarbanes-Oxley Act are borne disproportionately by smaller public companies. For a significant percentage of companies—particularly those at the lower end of the market capitalization spectrum, many of which went public in the pre-Sarbanes-Oxley era—these disproportionate costs are compounded because they enjoy none of the traditional benefits of being public: their stock receives little or no analyst coverage, has a limited trading market, provides limited liquidity for their shareholders, and attracts little institutional investment. They also experience a diminished ability to gain access to investment capital in the public markets, particularly during a market downturn. For such companies, the burdens of public company status may far outweigh the benefits.

At the same time, current SEC regulations require companies that wish to go private to submit to a lengthy SEC review process, in which a company must provide detailed disclosure as to the fairness of the transaction. The going private process generally includes the participation of investment banking firms, law firms and accountants, and hence results in substantial transaction costs.

While the significance of the transaction and the possibility for conflicts of interest and insider abuse in a true "going private" transaction (i.e. one in which a controlling group undertakes a corporate transaction in order to acquire the entire equity interest in a corporation) justify this heightened scrutiny, the Committee believes that microcap companies that wish to go dark should be entitled to a simplified SEC review process conditioned on the issuer undertaking to provide the remaining shareholders with periodic financial and other pertinent information, such as unaudited quarterly financial statements, annual GAAP audited financial statements and narrative information about basic corporate governance,

executive compensation and related party transactions as long as their shares trade in a public market. This approach would ensure that investors in such companies receive information necessary for operations transparency and protection of their interests.

Recommendation IV.S.7:

> **Increase the disclosure threshold of Securities Act Rule 701(e) from $5 million to $20 million.**

The SEC adopted Rule 701 in April 1988 to provide an exemption from the registration requirements under the Securities Act for offers and sales of securities by non-reporting companies to their employees. The Commission amended Rule 701 in 1999, among other things, to replace the fixed aggregate $5 million offering ceiling contained in the original rule with a more flexible limit that required, among other items, disclosure of financial statement and risk factor information if the aggregate amount of securities sold under Rule 701 exceeded $5 million in any 12-month period.

Over time, Rule 701 has proved to be an extraordinarily useful exemption for both small businesses and large private companies, and for the most part continues to work well. Nonetheless, the disclosure of financial statement information has been problematic for growing companies in recent years as a result of the recent trend towards longer IPO incubation periods, particularly in a "down" market environment, as well as the increased use of equity awards as an incentive for attracting/retaining employees. For private companies that hope to maintain the confidentiality of their financial information for competitive reasons, the increasing need for equity compensation presents a dilemma: disclose such information, and expose yourself to potential competitive harm (particularly relative to other private companies that are not required to disclose such information), or restrict equity awards to a limit below that which business conditions and sound judgment might otherwise dictate.

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[169] See discussion under the caption "Part II. Scaling Securities Regulation for Smaller Companies."

Based on the foregoing, we believe that an increase in the disclosure threshold of Rule 701(e) to $20 million represents a more appropriate balance between the informational needs of employee-investors and the confidentiality needs of private company issuers. The $5 million threshold was actually established in 1988, based upon the Commission's small issue exemptive limit at the time.[170] The Committee's proposed increase would account for the amount of the original threshold that has been diminished due to inflation (as a point of reference, $5 million in 1988 would equal approximately $8.35 million today) as well as provide issuers with increased flexibility for granting equity awards without compromising confidentiality.

In the event that the Commission finds such increase in the disclosure threshold to be inadvisable, we recommend as an alternative that the financial statement disclosure requirements be eliminated or modified significantly if (1) options are non-transferable except by law and (2) options may only be exercised on a "net" basis with no employee funds paid to the issuer/employer.

Recommendation IV.S.8

Extend the "access equals delivery" model to a broader range of SEC filings.

Since 1995, the Commission has published guidance regarding the electronic delivery of materials under the federal securities laws.[171] Recent studies indicate that 75% of Americans have access to the Internet in their homes, and that this percentage is increasing steadily among all age groups.[172]

The SEC recently has taken several steps to facilitate electronic delivery of filed documents filed with the Agency. In connection with the recent Securities Offering Reform effort, the Commission adopted Securities Act Rule 172 implementing an "access equals delivery" model in the context of final

[170] Rule 701 was originally adopted under Securities Act Section 3(b), which has a $5 million limit, but was re-adopted in 1999 under Securities Act Section 28, which was no such limit. See Rule 701 – Exempt Offerings Pursuant to Compensatory Arrangements (Mar. 8, 1999) [64 FR 11095].

[171] Use of Electronic Media for Delivery Purpose; Action: Interpretation; Solicitation of Comment, SEC Release No. 33-7233 (Oct. 6, 1995) [60 FR 53458], provided the initial guidance on electronic delivery of prospectuses, annual reports, and proxy materials under the Securities and Exchange Acts.

prospectus delivery. The Commission has also recently proposed a rule facilitating the electronic delivery of proxy materials.[173] In that release, the Commission stated that its members "believe that continuing technological developments and the expanded use of the Internet now merit consideration of alternative methods for the dissemination of proxy materials."[174] In the access equals delivery model investors would be assumed to have access to the Internet thereby allowing delivery to be accomplished solely by an issuer posting a document on the issuer's or third party's web site. This presumption differs from the current consent model where an investor must affirmatively consent to receiving documents electronically.

We strongly support the proposed amendments to the proxy delivery rules. We believe these changes will reduce the printing and mailing costs associated with furnishing proxy materials to shareholders, while not impairing investor protection, as shareholders desiring paper versions of such documents are able to obtain them at no cost under the proposal. We believe, however, that the Commission should go further and recommend that the Commission extend the access equals delivery model for delivery to all SEC filings, thereby providing the efficiencies and cost savings of electronic delivery to all documents required to be delivered under the federal securities laws. The only exception to our recommendation is delivery of preliminary prospectuses in initial public offerings in Rule 15c2-8.[175]

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[172] See Internet Availability of Proxy Materials, SEC Release No. 34-52926 (Dec. 8, 2005) [70 FR 74597], citing Three Out of Four Americans Have Access to the Internet, Nielson/NetRatings (Mar. 18, 2004).
[173] Id.
[174] See Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, SEC Release No. 34-46464 (Apr. 8, 2003) [67 FR 58480]; Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports; Correction, SEC Release No. 34-46464A (Sept. 5, 2003) [67 FR 17880].

[175] 17 C.F.R. 240.15c2-8.

Recommendation IV.S.9

Shorten the integration safe harbor from six months to 30 days.

The concept of integration, discussed above,[176] has been the subject of intense criticism, almost since its inception, [177] and small business issuers and their legal advisors have long expressed concerns about the absence of clarity in being able to determine the circumstances under which integration does (or does not) apply. Though the SEC attempted to introduce more certainty into the determination by introduction of a five-factor test in 1961,[178] as a practical matter the question of integration remains for smaller companies an area fraught with uncertainty–and therefore risk.[179]

Because of the link between integration and the availability of Regulation D and other registration exemptions, and consequently the ability of a smaller company to undertake a private financing, we believe that the SEC should provide smaller companies with clearer guidance concerning the circumstances under which two or more apparently separate offerings will or will not be integrated. After considering the difficulties of modifying the five-factor test in order to encompass the entire range of potential offering scenarios, we concluded that shortcomings of the existing framework can most easily be addressed by shortening the six-month safe harbor of Regulation D and applying the shortened safe harbor across the entire universe of private offering exemptions.

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[176] See text accompanying note 208.
[177] See Stanley Keller, Basic Securities Act Concepts Revisited, Insights, May 1995.
[178] See, e.g., Perry E. Wallace, Jr., Integration of Securities Offerings: Obstacles to Capital Formation Remain for Small Business 49 Emory L.J. 437, 935 (integration doctrine "frustrates issuers engaged in the capital formation process, engulfing them in a sea of ambiguity, uncertainty and potential liability" and "of the various sources of angst facing the small issuer, none has proved more frustrating and elusive than the doctrine of integration of securities offerings"). Faced with these difficulties, academics and practitioners have long argued for change to the existing system, with some even arguing that the very concept of integration should be abolished. In our view, however, this goes too far, as issuers could then split there offerings among several different exemptions, thus vitiating the registration process upon which the Securities Act is premised.
[179] The confusion over making an integration determination is made more difficult because the SEC staff does not currently render advice or provide no-action relief concerning integration questions

The Regulation D safe harbor provides generally that offers and sales made more than six months before the start of a Regulation D offering or more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering.[180] The safe harbor is particularly significant for smaller companies, who rely heavily on Regulation D exemptions. Although it provides certainty, however, the safe harbor does so at the expense of flexibility, as it requires that as much as a full year elapse between offerings. For smaller companies, whose financing needs are often erratic and unpredictable, the duration of the safe harbor period is often problematic; even a well meaning issuer that needs access to capital, because of changed circumstances or greater than anticipated need for funding, may be unable to access such funds without running afoul of Section 5.

Inasmuch as the alternative to the safe harbor is the inherent uncertainty of the five-factor test, the practical effect of the waiting period between Regulation D offerings is to undermine issuers' flexibility and impede them from obtaining financing at a time that business goals, and good judgment, would otherwise dictate.

In short, we believe that the dual six-month safe harbor period represents an unnecessary restriction on companies that may very well be subject to changing financial circumstances, and weighs too heavily in favor of investor protection, at the expense of facilitating capital formation. We believe that a shorter safe harbor period between offerings of 30 days strikes a more appropriate balance between the financing needs of smaller companies and investor protection, while preserving both investor protection and the integrity of the existing registration/exemption framework.

[180] Rule 502(a) provides in pertinent part: "Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those offers or sales of securities under an employee benefit plan as defined in Rule 405 under the Act [17 C.F.R. 230.405].

Recommendation IV.S.10:

Clarify the Sarbanes-Oxley Act Section 402 loan prohibition.

Section 402, of the Sarbanes-Oxley Act, which added Section 13(k)[181] to the Exchange Act, prohibits public companies from extending personal loans to directors or executive officers.[182] The prohibition was enacted following abuses associated with company loans in several well-publicized corporate scandals. To date, the SEC's Division of Corporation Finance has not provided interpretive guidance with respect to Section 13(k). We believe that confusion exists among public companies and their attorneys concerning the applicability of the loan prohibition to a number of transactions that could be construed as loans.

We strongly support the loan prohibition contained in Section 13(k) of the Exchange Act. We recommend that the SEC staff seek to provide clarifying guidance as to the types of transactions that fall outside the prohibition.

In particular, the we recommend that the SEC's Division of Corporation Finance clarify whether Section 13(k) prohibits the cashless exercise of stock options, indemnity advances, relocation accommodations to new hires and split dollar life insurance polices. We believe that these transactions, if approved by independent directors, are unlikely to lead to the abuses envisioned under Section 402 of the Sarbanes-Oxley Act.

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[181] 15 U.S.C. 78m(k).
[181] 17 C.F.R. 230.405.
[182] Pub. L. 107-04 § 402, 166 Stat. 745(2002).

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.

In fulfillment of our basic mandate–to identify methods of minimizing costs and maximizing benefits–we believe it is important to increase uniformity and cooperation between federal and state securities regulatory systems by eliminating unnecessary and duplicative regulations.

In our view, this can be accomplished by both (1) defining "qualified purchaser" as permitted by the National Securities Markets Improvement Act of 1996,[183] or NSMIA, allowing transactions to involve "covered securities" and (2) making NASDAQ Capital Market and OTCBB stocks "covered securities," thereby preempting most state securities registration provisions.

In connection with its passage of NSMIA, Congress authorized the SEC to define the term "qualified purchaser" under Securities Act Section 18 to include, among others, "sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary." Section 18 also provides that sales to "qualified purchasers" are by definition "covered securities." The effect of defining "qualified purchasers," therefore, would be to exempt offers and sales to persons included in the definition from unnecessary state registration requirements.

The Commission in 2001 issued a release in which it proposed to define "qualified purchaser" to have the same meaning as the term "accredited investor" under Rule 501(a) of Regulation D.[184] Although

[183] Pub. L. No. 104-290, 110 Stat. 3416 (1996).
[184] Defining the Term "Qualified Purchaser" Under the Securities Act, SEC Release No. 33-8041 (Dec. 19, 2001) [66 FR 66839].

the Commission solicited comment from interested parties, it took no further action on the proposal, in part because of the opposition of state securities regulators.[185]

The Committee applauds the SEC's initiative in issuing the qualified purchaser release, and recommends that the ideas expressed in the release, principally, that all "accredited investors" be deemed "qualified purchasers," be adopted substantially as proposed. The release states, and we agree, that defining "qualified purchaser" to mean "accredited investor" would strike the appropriate balance between the need for investor protection and meaningful regulatory relief from duplicative state regulation for issuers offering securities, in particular small businesses.[186] Investor protection would be maintained, as accredited investors have long been deemed not to require the full protection of Securities Act registration and have sufficient bargaining power to gain access to information with which to make informed investment decisions.

As the Commission is aware, in 1996 NSMIA realigned the relationship between federal and state regulation of the nation's securities markets in order to eliminate duplicative costs and improve market efficiency, while maintaining necessary investor protections. Although NSMIA greatly benefited large businesses, it had a more limited effect on small businesses, the securities of many of which trade on the NASDAQ Capital Market and the OTCBB and consequently do not qualify for the favorable exemptive treatment accorded "covered securities." For these smaller public companies, the added burden, complexity and transaction costs that result from a need to comply with numerous sets of laws and regulations, rather than just one, places them at a distinct disadvantage in comparison with their larger counterparts.

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[185] See, e.g., Letter of Joseph P. Borg, NASAA President and Director, Alabama Securities Commission, on behalf of the North American Securities Administrators Association to Committee (Mar. 4, 2002), available at http://www.sec.gov/rules/proposed/s72301.shtml.
[186] Supra note 227 at 4.

In our view, the two-tiered regulatory structure to which the NASDAQ Capital Market and OTCBB-traded securities are subject represents an unnecessary and duplicative level of regulation that impedes the free flow of capital, while adding little in terms of investor protection. All companies traded in both markets are required to be Exchange Act reporting companies. Therefore, we recommend that the Securities Act Section 18(b) definition of "covered securities" be expanded to include the shares of all NASDAQ Capital Market and OTCBB issuers, provided that such companies (1) are current in their Exchange Act filings and (2) adhere to the corporate governance standards, detailed in Part III of this Committee report, that companies would be required to observe in order to get relief from certain requirements of Sarbanes-Oxley Act Section 404. We believe that this action would be consistent with the sentiment expressed in Securities Act Section 19(d), which mandates greater federal and state cooperation in securities matters in order to provide both maximum uniformity in federal and state regulatory standards and to minimize interference with capital formation. Further, investor protection would be preserved, as states would retain their anti-fraud authority and the SEC would maintain its supervisory role through review of issuer registration statements and Exchange Act filings.

A final word should be said concerning the manner in which this recommendation is implemented. Although not entirely clear, it appears that the express language of Section 18 may not provide the Commission with the authority to expand the definition of "covered securities" to encompass NASDAQ Capital Market and OTCBB securities without further Congressional action. In such event, we recommend that the Commission petition Congress to enact legislative changes to Section 18 in order to effect such changes.

Recommendation IV.S.12:

> **Clarify the interpretation of or amend the language of the Rule 152 integration safe harbor to permit a registered initial public offering to commence immediately after the completion of an otherwise valid private offering the stated purpose of which was to raise capital with which to fund the IPO process.**

Rule 152 provides an integration safe harbor that protects against integration of a private offering followed closely by a registered public offering. By its terms, the language of Rule 152 appears to require that an issuer "decide" to file for the public offering after the private offering.[187] In other words, the safe harbor protection from integration would not appear to be available to an issuer that contemporaneously plans a private placement (for among other reasons, to raise funds necessary to sustain it through the IPO process) and a subsequent registered offering. Moreover, Rule 152 does not apply to private offerings undertaken pursuant to Rules 504 or 505, which are exempt pursuant to Securities Act Section 3(b), not Section 4(2) as set forth in the rule. Although the staff of the Division of Corporation Finance has indicated that it does not interpret Rule 152 literally, and will extend safe harbor treatment even in cases where an issuer concurrently plans a private placement and registered offering,[188] we believe that it is time to clarify or amend the language of the rule appropriately.

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[187] Rule 152 provides as follows: "The phrase 'transactions by an issuer not involving any public offering' in Section 4(2) shall be deemed to apply to transactions not involving any public offering at the time of said transaction although subsequently thereto the issuer decides to make a public offering and/or files a registration statement (emphasis added)."
[188] See, e.g., Verticom, Inc. (Feb. 12, 1986).

PART V. ACCOUNTING STANDARDS

We devoted a considerable amount of time and effort surveying the current state of U.S. GAAP that apply to smaller public companies and certain of the processes related to the audits of their financial statements. In general, we believe that current regulations and processes in these areas serve smaller public companies and their investors very well. We did, however, identify several concerns in this area which, we acknowledge, are not all unique to smaller public companies. In decreasing order of concern, these areas are:

- Excessive risk aversion in today's financial reporting system;
- Lack of competition in the auditing industry;
- Complexity of current accounting standards;
- Strictness of application of auditor independence rules; and
- Lack of professional education requirements covering SEC reporting matters for auditors of smaller public companies.

Accounting Standards—Primary Recommendations

We recommend that the Commission and other bodies, as applicable, effectuate the following:

Recommendation V.P.1:

Develop a "safe-harbor" protocol for accounting for transactions that would protect well-intentioned preparers from regulatory or legal action when the process is appropriately followed.

This recommendation represents an attempt by us to address the issue of excessive risk aversion in today's financial reporting system. This is a very serious issue for smaller public companies. Testimony taken by us, as well as written communications we received, strongly supported this view.[189]

[189] One witness testified that several public equity offerings in which he was involved experienced unprecedented delays due to the inability or unwillingness of the auditors to provide timely responses during the registration process with the SEC. He believes that auditors can no longer be looked to for advice on how to handle various issues, as it seems that almost every issue now needs to be "run through the national office" of the auditor. He notes that as auditor responses may now take weeks

Accounting standards for public companies vary in nature, ranging from standards containing principles and implementation guidance on broad accounting topics to those containing guidance pertaining to specific business transactions or industry events. Even with the broad spectrum of existing accounting standards, transactions or other business events frequently arise in practice for which there is no explicit guidance. In these situations, public companies and their auditors consider other relevant accounting standards and evaluate whether it would be appropriate to apply the guidance in those standards by analogy. Preparers often find it difficult to make these determinations, particularly in new or emerging areas. Even when accounting guidance is applied by analogy, questions frequently arise as to whether the analogy is appropriate based on a company's particular facts and circumstances. The result is that companies frequently end up adopting a more conservative approach than is necessary, because they may perceive their auditors to be excessively risk averse, they have concerns about regulators questioning those judgments, or for other reasons.

In view of this situation, we are recommending that a "safe-harbor" protocol be developed that would protect well-intentioned preparers from regulatory or legal action when a prescribed process is appropriately followed and results in an accounting conclusion that has a reasonable basis. A possible outline for the protocol for the preparer to follow would be as follows:

- Identify all relevant facts.
- Determine if there is appropriate "on-point" accounting guidance.
- If no on-point guidance exists, develop and timely document the preparer's conceptual basis for their conclusion as to the appropriate accounting treatment.

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longer to be produced than was the case a couple of years ago, he believes such delays leave potential issuers subject to additional market risk that did not exist in the past. Record of Proceedings 176 (Aug. 9, 2005) (testimony of James P. Hickey, Principal, Co-Head of Technology Group, William Blair & Company). See also Record of Proceedings 33 (June 17, 2005) (testimony of Alan Patricof, Co-Founder, Apax Partners, explaining that an unnatural relationship has developed between companies and their auditors as accountants have become more gun shy about taking a risk-focused approach to their audit and

- Determine and timely document how the proposed accounting treatment reflects the economic realities of the transaction.
- Disclose in the financial statements and in Management's Discussion & Analysis the nature of the transaction, the possible alternative accounting treatments, and the rationale for the approach adopted.

We believe that a "safe harbor" approach is suitable for dealing with this problem. In general, a safe harbor provision in a law serves to excuse liability if an attempt to comply in good faith can be demonstrated. Safe harbor provisions are used in many areas of the federal securities laws. One well-known safe-harbor that may serve as a model for crafting a safe-harbor for accounting transactions is the safe-harbor for forward-looking statements under the Private Securities Litigation Reform Act of 1995. The PSRLA provides a safe harbor from liability in private claims under the Securities Act and Exchange Act to a reporting company, its officers, directors and employees, as well as underwriters, for projections and other forward-looking information that later prove to be inaccurate, if certain conditions are met. The PSLRA's safe-harbor was based on aspects of SEC Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act.[190] Both of these rules, adopted in 1979, provide a safe-harbor for certain forward-looking statements published in documents filed with the SEC, provided the filer had a reasonable basis to make the statement and was acting in good faith. By combining aspects of, but not eliminating, Rules 175 and 3b-6 with the judicially created "bespeaks caution" doctrine, Congress created a statutory safe-harbor based on the belief that the existing SEC rule-based and judicial safe-harbor

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express concerns about the pressure to comply with PCAOB requirements which has caused the relationship between auditors and companies to go from one of cooperation and consultation to that of an adversarial nature).

[190] 17 C.F.R. 230.175, 240.3b-6.

protections did not provide adequate protections to reporting companies from abusive private securities litigation.[191]

We believe that implementation of this recommendation has the potential to assist smaller public companies when working with their audit firms and other parties involved in the financial reporting system. This, in turn, should reduce excessive and unnecessary regulatory burdens on smaller public companies.

We do not believe that implementation of our recommendation would fully address the problem of risk aversion present in today's financial reporting system. This is a deep seated problem related to the excessive litigiousness of our society.[192] Accordingly, we urge the Commission, other regulators and federal and state legislators to continue to search for appropriate and effective ways to lessen this problem and reduce unnecessary regulatory burdens on smaller companies.

Recommendation V.P.2:

> **In implementing new accounting standards, the FASB should permit microcap companies to apply the same extended effective dates that it provides for private companies.**

New accounting standards typically introduce new accounting requirements or change existing requirements. In order to allow sufficient time for companies to gather information required by the new accounting standards, the FASB does not require new standards to be effective immediately upon issuance. Instead, the FASB establishes a date in the future when the accounting standards should be

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[191] The PSLRA provides a safe-harbor from liability under the Securities Act and Exchange Act to the reporting company, its officers, directors, employees and underwriters, if the forward-looking statements later prove to be inaccurate, if:

1. the forward-looking statement is identified as such and is accompanied with meaningful cautionary statements identifying important factors that could cause actual results to differ materially; or
2. the forward-looking statement is immaterial; or
3. the plaintiff fails to prove the statement was made with actual knowledge that it was materially false or misleading.

See The Safe Harbor for Forward-Looking Statements Under the Private Securities Litigation Reform Act of 1995, Practising Law Institute, Jay B. Kasner (Sept. 2000); See also Safe Harbors for Forward-Looking Statements: An Overview for the Practitioner, Practising Law Institute, Stephen J. Schulte and Alan R. Glickman (Nov. 1997).

adopted, or become effective. The amount of time allowed by the FASB between the issuance of a new standard and its effective date varies and depends on the nature of the accounting requirements and the number of companies impacted. In addition, the FASB may establish different effective dates for private companies and public companies.[193]

In some cases, a company will need to gather and analyze a significant amount of information in order to adopt an accounting standard. Smaller public companies oftentimes may not have the resources of larger companies to assist with this effort.[194] For example, companies may not have sufficient information technology or valuation specialists on staff and would need to consider hiring external parties. In addition, as business transactions have become more complex in recent years, accounting standards also have become more complex, requiring greater study and expertise by the preparers and auditors' of financial statements.[195]

We note that some of the more complicated accounting standards recently issued by the FASB permit private companies an extended period of time in which to adopt the new standard.[196] We believe that allowing microcap companies more time to implement new accounting standards is appropriate. We are recommending that microcap companies be allowed to apply the same effective dates that the FASB provides for private companies in implementing new accounting standards. The Committee considered and rejected the notion that smallcap companies, in addition to microcap companies, also should be

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[192] See Record of Proceedings 95-100 (June 16, 2006) (statements of George Batavick, Adv. Comm. Observer, and Mark Jensen, Adv. Comm. Member, on the importance of tort reform to reduce litigation costs and facilitate a return to principles-based accounting).

[193] FASB standards that distinguish between private and public companies usually define those terms. For examples where the FASB has deferred the effective dates for non-public entities, as defined therein, see FASB Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, May 2003, paragraph 29, and FASB Staff Position 150-3, Nov. 2003.

[194] See letters to the Committee of Ernst & Young LLP (May 31, 2005) and the American Bankers Association (Aug. 31, 2005) to the Committee.

[195] See letter to from BDO Seidman, LLP to the Committee (May 31, 2005).

[196] See Statement 150, paragraph 29. See also FASB Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, paragraphs 69 and B248 (permitting small business issuers, as defined, to defer adoption of the standard on the basis that those companies may have fewer resources to devote to implementing new accounting standards and thus may need additional time to do so).

allowed extended effective dates. We believe that, in general, smallcap companies have more resources than microcap companies and should be able to adopt new accounting standards on the same time line as larger public companies.

While making this recommendation, we do not propose to establish different accounting standards for smaller and larger public companies. Primarily through our Accounting Standards Subcommittee, we devoted a considerable amount of time considering the so-called Big GAAP versus Little GAAP debate. This debate involves the advisability of adopting two different accounting standards for smaller and larger public companies, and whether U.S. GAAP should be made scalable for smaller public companies. The Committee considered whether the needs of users of smaller public company financial statements are different from the needs of users of larger public company financial statements, whether smaller public companies incur disproportionate costs to provide certain financial information, and whether such information is actually used. The Committee discussed whether smaller public companies should have accounting standards with recognition, measurement and/or disclosure requirements that are different from those of larger public companies, and whether unintended adverse consequences would result from having two sets of GAAP.

We have determined that different accounting standards should not be created for smaller and larger public companies. We believe such an approach would confuse investors and that, in many cases, the financial community would require smaller public companies to follow the more stringent accounting standards applicable to larger companies. We noted that some smaller public companies have indicated that, if a two-tiered system of accounting standards existed, they would voluntarily follow the more stringent standards, so as not to be perceived as less sophisticated. We also believe that two different accounting standards for public companies would add significant costs to the financial reporting system and could potentially increase the cost of capital to smaller public companies, as risk premiums could

attach to what might be perceived as less stringent accounting standards.[197] Finally, we did not see evidence of any overwhelming support for a two-tiered system of accounting standards in the written and oral submissions we received.[198]

Recommendation V.P.3:

> **Consider additional guidance for all public companies with respect to materiality related to previously issued financial statements.**

We heard testimony related to a perceived recent increase in financial statement restatements for previously undetected accounting errors.[199] The Committee is concerned that these restatements are occurring where the impact of the error is not likely to be meaningful to a reasonable investor. The determination as to whether an event or transaction is material to the financial statements can be highly subjective and judgmental. One source of information for public companies to consider when making this determination is SEC Staff Accounting Bulletin No. 99, Materiality (SAB 99). SAB 99 expresses the staff's views regarding reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements. One issue that is not addressed

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[197] See , e.g., Letter of Council of Institutional Investors to the Committee (Aug. 26, 2005).

[198] See Record of Proceedings 24-26, 42 (Oct. 14, 2005) (testimony of Jane Adams, Maverick Capital Ltd., New York, New York, stating that companies by virtue of size should not be able to choose among multiple GAAP's to structure transactions and keep relevant information from investors, and if different standards are permitted, whether GAAP or internal controls, any financial statements and filings prepared under this light version should warn investors that this information did not come with the full package of protections and controls). See also letters to the Committee from PricewaterhouseCoopers LLP (Sept. 2, 2005), Grace & White, Inc. (Oct. 6, 2005), and Glass Lewis & Co. (dated Sept. 14, 2005).

[199] Record of Proceedings 30-31 (Sept. 19, 2005) (testimony of Lynn E. Turner, Professor and Director of the Center for Quality Financial Reporting, Colorado State University, Fort Collins, Co., noting that Huron Consulting Group reported that 75% of the restatements over the last five years have come from small companies); Record of Proceedings 105 (Sept. 19, 2005) (testimony of Michael McConnell, Managing Director, Shamrock Capital Advisors, Burbank, Calif., citing several studies that show half to three quarters of the restatements of public companies in the last several years have been by companies with either revenues under a half billion or market cap under $100 million). But see Record of Proceedings 108 (Sept. 19, 2005) (statement of Robert E. Robotti, Adv. Comm. Member, noting that the amount of restatements by smaller companies is proportionate to that of larger companies, since microcap companies represent 50% of all public companies). Institutional investor advisory firm, Glass, Lewis & Co., estimates that a record 1,200 of the total 15,000 public companies will have announced accounting restatements by the time annual reports are filed for 2005. This compares with 619 restatements in 2004, 514 in 2003, 330 in 2002 and 270 in 2001, the year before the Sarbanes Oxley Act was passed. Approximately 1,000 companies are expected to report material weaknesses in their internal controls in their most recent quarterly filings for the period ended December 31, 2005. The threat of criminal penalties for executives and the focus on internal controls by the Sarbanes Oxley Act has created an environment of second-guessing by auditors, where minor accounting errors can now result

in SAB 99 relates to the assessment of materiality in quarterly reporting periods, including quarterly reporting periods of previously reported annual periods.

We discussed whether one reason for these restatements might be the lack of guidance pertaining to assessing materiality in quarterly periods. We recommend that the SEC consider providing additional guidance for all public companies with respect to materiality related to previously issued financial statements, to ensure that investor confidence in the U.S. capital markets is not being adversely impacted by restatements that may be unwarranted. Two specific fact patterns should be considered in developing additional guidance:

- The effect of the previously undetected error is not material to any prior annual or quarterly financial statements, the effect of correcting the cumulative error is not expected to be material to the current annual period, but the impact of correcting the cumulative error is material to the current quarter's financial statements. In this circumstance, we recommend the SEC consider whether the appropriate treatment would be to correct the cumulative error in the current period financial statements, with full and clear disclosure of the item and its impact on the current quarter, with no restatement of prior year or quarterly financial statements. We believe this treatment is consistent with the guidance in paragraph 29 of Accounting Principles Board Opinion No. 28, Interim Financial Reporting.[200]
- The effect of a previously undetected error is not material to the financial statements for a prior annual period, but is material to one or more of the quarters within that year. In addition, the impact of correcting the cumulative error in the current quarter's financial statement would be material to the current quarter, but is not expected to be material to the

in a full investigation of a company's accounting procedures. Excavations in Accounting: To Monitor Internal Controls, Firms Dig Ever Deeper Into Their Books, The Washington Post, Jan. 30, 2006 at D1.

current annual period. In this circumstance, we recommend the SEC consider whether the appropriate treatment would be the same as described above since the impact on the previously issued annual financial statements is not material. In this event, full disclosure in the current quarter financial statements should be required.

Recommendation V.P.4:

Implement a de minimis exception in the application of the SEC's auditor independence rules.

The Commission's rules on the independence of public company auditors include a general standard of auditor independence.[201] In determining whether a relationship or provision of a service not specifically prohibited by the rules impairs the auditor's independence, four principles must be considered.[202] The Commission's rules also set forth specific prohibitions on financial, employment, and business relationships between an auditor and an audit client, as well as prohibitions on an auditor providing certain non-audit services to an audit client, and augment the general standard and related principles.[203] One of the principles is that an auditor cannot audit his or her own work. The Committee considered whether the current auditor independence rules should be modified for smaller public companies to make it clear that an auditor may provide some assistance.

In May 2005, the Commission issued a statement related to internal control reporting requirements that also discussed this issue.[204] The Commission stated that as long as management makes the final determination regarding the accounting to be used for a transaction and does not rely on the auditor to design or implement internal controls related to that accounting, it did not believe that the auditor's

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[200] The Accounting Principles Board (APB) was the predecessor entity to the FASB.
[201] The most recent revision to the auditor independence rules occurred in Jan. 2003. See Strengthening the Commission's Requirements Regarding Auditor Independence, SEC Release No. 33-8183 (Jan. 28, 2003).
[202] See Remarks by Edmund W. Bailey, Senior Associate Chief Accountant, U.S. Securities and Exchange Commission, Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments ("Bailey 2005 AICPA Remarks") (discussing principles regarding auditor independence).
[203] See Preliminary Note to Rule 2-01of Regulation S-X and Item 201(c)(4) of Regulation S-X, 17 C.F.R. 210.2-01(c)(4); Exchange Act Section 10A(g).

providing advice or assistance, in itself, constitutes a violation of the independence rules. The Committee considered whether this guidance would enable an auditor to provide assistance to smaller public company related to new and/or complicated accounting standards or with unusual/complicated transactions.

Ultimately, we concluded that no modification to the Commission's independence rules is warranted with respect to auditors providing assistance to smaller public companies. In making this recommendation, we noted the principle that auditors should not audit their own work and believes this basic premise is critical to ensuring auditor independence and the resulting confidence of investors in the financial statements of all companies, including smaller public companies. The Committee concluded that a separate set of auditor independence rules for larger and smaller publicly-held companies would be inappropriate. We believe that our recommendation to apply the same extended effective dates for microcap companies that the FASB provides for private companies will help serve to alleviate the pressure and costs to microcap companies in implementing new accounting standards and reduce their need for significant assistance from their auditors.

As a separate matter, we acknowledged that the current auditor independence rules do not provide relief for violations of the rules based on materiality considerations. As a result, we believe that a seemingly insignificant violation of the auditor independence rules could have significant consequences.[205] These consequences could require a company to immediately change audit firms, to declare its previous filings invalid and to engage an audit firm to re-audit its prior financial statements, creating significant cost and disruption to the company and its stockholders. The Committee therefore

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[204] See Commission Statement on Implementation of Internal Control Reporting Requirements, May 16, 2005.

[205] One witness testified that audit firms are somewhat paranoid about violating these independent rules and rightfully so. The SEC and PCAOB need to go further to provide very clear guidelines for audit firms as to what they can do and cannot do. In order to facilitate audit firms assist smaller public companies with their SEC reporting, some degree of proportionality in limiting the amount of the penalty for an inadvertent violation of the auditor independence rules should be used. Record of Proceedings 14 (Aug. 9, 2005) (testimony of Mark Schroeder, Chief Executive Officer, German American Bancorp).

recommends that the SEC examine its independence rules and consider establishing a rule provision that provides relief for certain types of violations that are de minimis in nature as long as these are discussed with and approved by the company's audit committee.[206]

Accounting Standards—Secondary Recommendations

In addition to the foregoing primary accounting standards recommendations, we also submit for the Commission's consideration the following secondary recommendations:

Recommendation V.S.1:

> **Together with the PCAOB, promote competition among audit firms by using their influence to include non-Big Four firms in committees, public forums, and other venues that would increase the awareness of these firms in the marketplace.**

This recommendation represents our best attempt to deal with the very serious problem of the lack of competition in the auditing industry, stemming in large part from market concentration. Smaller companies are seriously harmed by this state of affairs.[207]

A large concentration of both large and small public companies is audited by the Big Four audit firms.[208] Notwithstanding that the Big Four audit firms have earned a well-deserved reputation of expertise in auditing public companies, we heard testimony from several non-Big Four audit firms that

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[206] See Bailey 2005 AICPA Remarks (discussing some of the information considered by the SEC Office of the Chief Accountant when making assessments regarding the impact of an independence rules violation).

[207] One witness testified that smaller public companies are having trouble timely filing their annual and quarterly reports with the SEC, because the Big Four audit firms are dropping them as clients, generally because they fall outside the Big Four's profiles for acceptable risk. Record of Proceedings 12 (June 17, 2006) (testimony of Edward S. Knight, Executive Vice President and General Counsel, The NASDAQ Stock Market, Inc.). Another witness testified that, due to changes in the accounting industry resulting from the Sarbanes Oxley Act and consequent pressure from institutional and retail investors, increasing importance has been placed on using a Big Four firm. As a result, smaller public companies, who are the least prepared to negotiate, are increasingly facing oligopolies, resulting in a disruption in the normally balanced relationship between a company and its accounting firm. Young smaller public companies are now in constant fear that their auditors will either increase their audit fees or abandon them because of the pressure on the auditing firm to obtain more profitable business from larger companies. He recommended that emphasis be placed on the acceptability of more regional accounting firms for use by smaller public companies, as well as the establishment or encouragement of a fifth or sixth Big Four audit firm to restore a more appropriate balance between accounting firms and their client companies in order to contain costs and at the same time provide an alternative audit firm that is generally accepted by the investment community. Record of Proceedings 32-33, 37-38 (June 17, 2005) (testimony of Alan Patricof, Co-Founder, Apax Partners).

indicated that they too are capable of serving smaller public companies.[209] The PCAOB has registered and oversees over 900 U.S. public audit firms. The experience of some of our members, as well as submissions made to us, confirms a trend for smaller public companies to consider options other than the Big Four audit firms.[210] We believe that market forces ultimately will determine which firms will audit public companies. We recognize the Commission's and the PCAOB's limited authority to affect concentration in the auditing industry. The Department of Justice and the Federal Trade Commission exercise direct regulatory authority over most market concentration in the United States through their enforcement of the antitrust laws. We also recognize that some of our recommendations concerning internal control may increase the concentration of smaller public companies with revenues over $250 million who are audited by the Big Four, an

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[208] See United States General Accounting Office's Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, Public Accounting Firms, Mandated Study on Consolidation and Competition (GAO-03-864) (July 2003).

[209] Record of Proceedings 19 (Sept. 19, 2005) (testimony of Richard Ueltschy, Executive, Crowe Chizek and Company, LLC) ("[S]maller public companies, virtually all of them could be served adequately by more than the Big Four, certainly the eight largest firms that are subject to annual review by the PCAOB. And, in fact, many of those smaller public companies could also be effectively served by the dozens of qualified regional C.P.A. firms."); Record of Proceedings 129, 130-133 (Aug. 9, 2005) (testimony of Bill Travis, Managing Partner, McGladery & Pullen, commenting that his firm, as well as many other second-tier non-Big Four audit firms, have a level of expertise and resource capabilities that can certainly serve the needs of very large mid-market companies with global facilities around the world, as well as a much greater percentage of small and mid-size publicly-traded companies). See also Record of Proceedings 92 (Oct. 14, 2005) (testimony of Gerald I. White, Grace & White, Inc., New York, New York) ("I don't see any evidence that the large firms do any better job than the small ones.").

[210] One witness testified that, although the bottom line is whether audit committees and investment banks are willing to advise choosing a non-Big Four firm, current market conditions are fortunately driving some changes in the industry out of necessity. Big Four firms have limited resources and are allocating their resources to wherever the best use of those resources may be used by their major clients. Non-Big Four firms are benefiting from this market development in that very high quality public companies have to go find other non-Big Four firms to do their audits. Accordingly, he indicated that firms like his are receiving many inquiries as to whether they are capable of doing the work, and are in fact wining the work, including such firms as Grant Thornton, LLP and BDO Seidman, LLP. Accordingly, he believes that market conditions are doing a lot more to win work for the non-Big Four audit firms than any marketing communications could have done. See Record of Proceedings 130-131 (Aug. 9, 2005) (testimony of Bill Travis, Managing Partner, McGladery & Pullen). See also Record of Proceedings 19 (Sept. 19, 2005) (testimony of Richard Ueltschy, Executive, Crowe Chizek and Company, LLC) ("We are seeing today many companies at…the smaller end of the large company classification, as this group's defined it, that are now choosing to look outside the Big Four for their audit services. And they're doing so largely because of an attempt to introduce a bit of market competition into the pricing for the service….[T]here's a fair amount of activity in terms of auditor change, there's real price competition being introduced into that process."); Record of Proceedings 92 (Oct. 14, 2005) (testimony of Gerald I. White, Grace & White, Inc., New York, New York) ("[S]maller firms seem to be clearly gravitating away from the largest auditors to smaller auditors. And I suspect that not just audit costs, but 404 costs are driving that process.").

We nevertheless believe that government efforts to promote competition in the auditing industry is essential to maintain pricing discipline in the auditing fees that smaller public companies pay. We are therefore recommending that the SEC and the PCAOB promote competition among audit firms by ensuring that these non-Big Four firms are included in committees, public forums, and other venues that would increase the awareness of these firms in the marketplace.[211]

Recommendation V.S.2:

> **Formally encourage the FASB to continue to pursue objectives-based accounting standards.[212] In addition, simplicity and the ease of application should be important considerations when new accounting standards are established.**

This recommendation is an attempt to deal with the issue of excessive complexity in accounting standards.[213] This complexity disproportionately impacts smaller public companies due to their lack of resources. Complexity is created because of:

- An unfriendly legal and enforcement environment that diminishes the use and acceptance of professional judgment because of fears of second-guessing by regulators and the plaintiff's bar.[214]

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[211] See , e.g., Record of Proceedings 84 (June 17, 2005) (testimony of Wayne A. Kolins, National Director of Assurance and Chairman of the Board, BDO Seidman, LLP, encouraging the use of symposiums, whereby the CEO's and CFO's of smaller public companies meet to discuss their experiences using non-Big Four audit firms); Record of Proceedings 130 (Aug. 9, 2005) (testimony of Bill Travis, Managing Partner, McGladery & Pullen, encouraging non-Big Four audit firms to become more active with regulatory organizations like the PCAOB and SEC and others to build awareness of the capabilities of the non-Big Four audit firms); Record of Proceedings 63-64 and 82-83 (June 17, 2005) (testimony of Alan Patricof, Co-Founder, Apax Partners, recommending that regulatory bodies use the bully pulpit and moral suasion to increase awareness and acceptance of the good quality of regional non-Big Four auditing firms, including encouraging investment banking firms to rely upon these non-Big Four firms).

[212] See SEC Staff's Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System, released in July 2003, ("Principles-Based Accounting System Staff Study") ("objectives-oriented" standards are distinguished from "principles-based" or "rules-based" standards).

[213] See Remarks by Robert H. Herz, Chairman, Financial Accounting Standards Board, Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments, December 6, 2005 (discussing the complexity in financial reporting). See also Remarks by Christopher Cox, Chairman, U.S. Securities and Exchange Commission, Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments, December 5, 2005; and Remarks by Scott A. Taub, Acting Chief Accountant, U.S. Securities and Exchange Commission, Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments, December 5, 2005.

[214] One witness encouraged a move towards more of a principles-based and a judgment-based approach to accounting so that competent people on the audit committees, in management and in the audit firms can work together to use their respective intellect, judgment and knowledge of the business to determine where best to spend their time each year, in such areas, for example, as internal control compliance with Section 404 of the Sarbanes Oxley Act. He commented that all the guidance provided so far by the SEC and the PCAOB on the use of professional judgment is tempered, however, by the current

- Development of complex business arrangements and accounting-motivated transactions.[215]
- Constituent concerns about earnings volatility and desire for industry-specific guidance and exceptions.[216]
- Frequent requests by preparers and auditors for detailed accounting guidance to limit potential inconsistencies in the application of accounting standards and second-guessing by the legal community and enforcement authorities.[217]

Certain accounting standards create complexity because:

- The lack of a fully developed conceptual framework leads to inconsistent concepts and principles being applied across accounting standards.[218]
- Scopes in standards are at times unclear and may contain exceptions.[219]
- The standards have different measurement attributes (such as historical cost versus fair value) and treatment alternatives.[220]

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uncertainty as to what will be the expectations of company management, the audit committee and the auditor once there is a major failure due to an unintended mistake reported in the system. Until we see the results of such a mistake, he believes there will continue to be conservatism in the practice of audit firms, management teams and audit committees. Record of Proceedings 117-118 (Aug. 9, 2005) (testimony of Bill Travis, Managing Partner, McGladery & Pullen, LLP).

[215] The SEC Staff's report entitled Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers ("Off-Balance Sheet Staff Study"), released in June 2005, refers to an accounting-motivated structured transaction as a transaction structured in an attempt to achieve reporting results that are not consistent with the economics of the transaction. As an example, the report cites to the restructuring of lease arrangements to avoid the recognition of liabilities on the balance sheet following the issuance of the FASB's Statement No. 13, Accounting for Leases, released in 1976.

[216] See Principles-Based Accounting System Staff Study (listing three of the more commonly-accepted shortcomings of rules-based standards, such as numerous bright-line tests, exceptions to principles underlying the accounting standards, and complexity in and uncertainty about the application of a standard reflected in the demand for detailed implementation guidance).

[217] Id. See also FASB Staff Position No. 123(R)-2, Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R), (Oct. 18, 2005).

[218] For example, related to the accounting for revenue transactions, FASB Statement of Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, states that revenues are not recognized until earned. FASB Statement of Concepts No. 6, Elements of Financial Statements, defines revenues as inflows or other enhancements of assets or liabilities. The FASB currently has a revenue recognition project on its agenda designed in part to eliminate this inconsistency. The FASB also has on its agenda a joint project with the International Accounting Standards Board to develop a common conceptual framework that is complete and internally consistent.

[219] For example, FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, clarifies the scope of FASB Statement No. 5, Accounting for Contingencies.

- Rules and bright-line standards provide opportunities for accounting-motivated transactions that are not necessarily driven by economics.[221]
- The standards themselves have become extremely lengthy and difficult to read.[222]

Additional complexity in accounting standards also comes about because:

- In prior years, multiple parties set standards, such as the SEC, the FASB, the AICPA, the Auditing Practices Board (APB), and the Emerging Issues Task Force (EITF).
- Differing views exist on the application of fair value measurement techniques and models.[223]
- Phased projects produce only interim changes.[224]

We believe that the current financial reporting environment could be modified to reduce the reporting burden on smaller public companies, as well as larger public companies, while improving the quality of financial reporting.

We commend the efforts of the SEC and FASB to pursue "objectives-based accounting standards," as this should help to reduce complexity.[225] The Committee recognizes that success will require preparers, financial advisors and auditors to apply the intent of the rules to specific transactions rather than using "bright-line" interpretations to achieve a more desirable accounting treatment. The Committee also believes that simplicity and the ease of application of accounting standards should be important considerations when new, conceptually-sound accounting standards are established. Success

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This interpretation excludes certain guarantees from its scope and also excludes other guarantees from the initial recognition and measurement provisions of the interpretation.

[220] See , e.g., FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, (providing classification alternatives for investments in debt and equity securities, resulting in different measurement alternatives).

[221] See Off-Balance Sheet Staff Study.

[222] See , e.g., FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (June 1998) (exceeding 800 pages of authoritative guidance and over 180 implementation and interpretive issues).

[223] The FASB currently has a project on its agenda to provide guidance regarding the application of the fair value measurement objective in generally accepted accounting principles.

[224] For example, FASB Statement No. 150 is part of the FASB's broad project on financial instruments that was added to the FASB's agenda in 1986.

[225] See , e.g., SEC Staff Study, The Principles-Based Accounting System. See also FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System, June 2004.

will also require regulators and the courts to accept good faith judgments in the application of objectives-based accounting standards. We believe these goals will only be accomplished by long-term changes in culture versus short-term changes in regulations. This will allow for greater consistency and comparability between financial statements.

Accordingly, we offer the following suggestions aimed at simplifying future accounting standards:

- There should be fewer (or no) exceptions for special interests.
- Industry and other considerations that do not necessarily apply to a broad array of companies should be addressed by FASB staff positions rather than in FASB statements.
- FASB statements should attempt to reduce or eliminate "bright-line tests" in accounting standards, and in cases where the standard-setter intends that a "bright-line" test be applied make that clear in the guidance.

The Committee is making this recommendation in lieu of recommending modifications to certain existing accounting standards for smaller public companies. Primarily through our Accounting Standards Subcommittee, we devoted a considerable amount of time identifying certain accounting standards where modifications might be considered in the future for smaller public companies. The Committee recognized that smaller public companies, as well as larger public companies, struggle with the application of certain accounting standards, such as FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities. The Committee also looked for certain common themes in those standards that could be used to develop recommendations regarding accounting pronouncements.

In reviewing existing accounting standards, we considered the effect of their measurement and disclosure requirements on smaller public companies. The Committee also considered possible screening criteria that could be used to determine whether an accounting standard should be modified for smaller public companies. The objective of our efforts was to determine whether for certain accounting

standards, the information is very costly for a small business to prepare and yet the information is not being utilized by its investors or other users of its financial statements.

After deliberating these questions, we unanimously concluded that, since we believe it is inappropriate to create different standards of accounting for smaller public companies (i.e., Big GAAP versus Little GAAP), we should not propose recommendations to modify existing accounting standards for smaller public companies.

In sum, we agreed that the current financial reporting environment could be improved to reduce the reporting burden on both smaller public companies, as well as for larger public companies, while improving the quality of financial reporting. In this light, we formulated the above recommendation to have the SEC formally encourage the FASB to continue to pursue objectives-based accounting standards. The Committee also recommended that simplicity and the ease of application should be key considerations when establishing new conceptually-sound accounting standards.

Recommendation V.S.3:

> **Require the PCAOB to consider minimum annual continuing professional education requirements covering topics specific to SEC matters for firms that wish to practice before the SEC.**

Of the 900 U.S. audit firms registered with the PCAOB, we noted that approximately 82% of them audit five or fewer public companies. We believe that continuing professional education pertaining to SEC-related topics would be useful to the professional personnel of registered firms, especially for those firms that do not audit many public companies and for which this training would improve their ability to serve public companies. While several different groups and governmental bodies, such as the individual state licensing boards, establish continuing professional education requirements for accountants, the PCAOB does not currently have any minimum annual training standards for registered firms' partners and employees who serve public companies. The Committee suggests, therefore, that minimum annual SEC

training requirements be established for applicable partners and employees of audit firms registered with the PCAOB.

Recommendation V.S.4:

> **Monitor the state of interactions between auditors and their clients in evaluating internal controls over financial reporting and take further action to improve the situation if warranted.**

The recent implementation of Sarbanes-Oxley Act Section 404 by certain public companies has raised many questions and issues. One issue that has been identified pertains to the adverse impact Section 404 has had on the relationship between audit firms and the management of smaller public companies and the nature and extent of their communications on accounting and financial reporting matters.[226] We noted the substantial amount of testimony on this issue.[227] We also noted that the PCAOB

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[226] The SEC Staff's Statement on Management's Report on Internal Control Over Financial Reporting, released in May 2005, stated that feedback from both auditors and registrants revealed that one potential unintended consequence of implementing Section 404 and Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements, has been a chilling effect in the level and extent of communications between auditors and management regarding accounting and financial reporting issues.

[227] One witness commented that audit firms are too fearful to provide guidance and advice to any inquiry by a public client, as such inquiry could be interpreted as an admission of an internal control weakness by the company in that area. Although he recognizes that auditing firms cannot provide non-audit services to their clients, he believes that they should be able to point their clients in the right direction so that the client can do the work. He indicated that audit firms are unclear as to where the line of auditor independence is drawn. As a result, when in doubt, audit firms take the safe route and do nothing out of fear that if they cross the line, they will put the entire audit firm at risk. Record of Proceedings 24 (Aug. 9, 2005) (testimony of Mark Schroeder, Chief Executive Officer, German American Bancorp.). Similarly, another witness testified that auditors and audit committees are too fearful of lawsuits to rely upon their judgment in implementing Section 404 internal controls. He believes explicit common sense standards applied universally to all companies of a given size need to be developed by the regulators to indicate clearly what the auditors need to cover, and what the materiality levels are. Record of Proceedings 189 (Aug. 9, 2005) (testimony of James P. Hickey, Principal, Co-Head of Technology Group, William Blair & Co.). See also Record of Proceedings 126-127, 139 (August 9, 2005) (testimony of Bill Travis, Managing Partner, McGladery & Pullen, commenting that once there is greater consistency and clarification on what is expected by the PCAOB and its inspectors with regard to Auditing Standard No. 2, the time, effort and costs incurred by the auditors will be reduced and the willingness of auditors to use their professional judgment will increase); Record of Proceedings 9-18, 56 (Oct. 14, 2005) (testimony of Thomas A. Russo, Russo & Gardner, Lancaster, Penn., describing a very stark tension growing between companies and their auditors, due to the lack of PCAOB Section 404 guidelines which has resulted in a zero percent sort of materiality test as auditors are unwilling to exercise judgment, but rather go to the end of the earth to confirm the integrity of control systems); Record of Proceedings 57 and 61 (Sept. 19, 2005) (testimony of Kenneth Hahn, Senior Vice President, Chief Financial Officer, Borland Software Corp., Cupertino, Calif., commenting that the dynamics of risk make it virtually impossible for the control portion of Section 404 to be cost effective for small and mid-size companies, as both auditors and boards will make the decision to over-engineer the testing of a company's internal control systems); Record of Proceedings 100 (June 17, 2005) (testimony of Prof. William J. Carney, Emory University School of Law, referring to a study indicating that auditing fees have increased by as much as 58%, due to the increased costs associated with the new requirements of the Sarbanes Oxley Act). But see Record of Proceedings 33-34 and 41 (Sept. 19, 2005) (testimony of Lynn E. Turner, Prof. and Dir., Colorado State University, predicting the costs of Section 404 internal controls to come down after the first year of implementation, and

and the SEC had issued guidance in May 2005 regarding the implementation of Section 404 and the interaction between an auditor and its client.[228]

It appears that audit firms are starting to become more comfortable with the idea that it is acceptable to advise their clients with respect to new accounting standards and/or complicated transactions, consistent with the guidance issued by the PCAOB and SEC, while remaining fully cognizant of the need for company management to take full responsibility for its financial statements and the underlying decisions on the application of accounting principles. We recommend that the SEC and the PCAOB remain vigilant in monitoring the impact of its guidance through the Spring of 2006 reporting season. If the guidance is being appropriately applied, no further action with respect to the interaction of the auditor and its clients would be required, except for implementation of our recommendation on implementing a de minimis exception for certain immaterial violations of the SEC's independence rules.

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commenting that both in-house accountants and external auditors are working together to make the implementation of Section 404 internal controls for smaller companies much more difficult than warranted); Record of Proceedings 18-19 (Sept. 19, 2005) (testimony of Richard Ueltschy, Executive, Crowe Chizek and Company, LLC, anticipating costs to implement Section 404 internal controls for the second year to fall, and noting that auditors are now willing to provide fixed fee quotes both for smaller public companies in their second year of 404 implementation, as well as for new accelerated filers undertaking their fist year of 404 implementation); Record of Proceedings 106 (Sept. 19, 2005) (testimony of Michael McConnell, Managing Director, Shamrock Capital Advisors, Burbank, Calif., indicating that most investors, including both direct investors and institutional capital, do not have a problem with the costs of Section 404, as opposed to the capital raising agency community, such as the lawyers, bankers and managers, that are uncomfortable in general with any heightened standards of accountability).

[228] See SEC Statement on Implementation of Internal Control Reporting Requirements, May 16, 2005. See also PCAOB Statement on AS2.

PART VI. EPILOGUE

[Content of Part VI to be included in Final Report.]

PART VII. SEPARATE STATEMENT OF MESSRS. [___________ AND ___________]

[Content of Part VII to be included in Final Report.]

APPENDICES*

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* The text of Appendices I, J, K and M are included in this draft. The information in the other appendices should be readily available to members of the Advisory Committee and the general public.

Appendix I

Background Statistics: Market Capitalization & Revenue of Public Companies

August 1, 2005 revision

All Public Companies		***Table***
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***** The number of observations may be reduced on some variables. These tables reflect data that is publicly available, which may disproportionately exclude certain types of companies (such as smaller companies). See the footnotes to the tables for descriptions of relevant data sources and number of observations.

Background Statistics

For

All Public Companies

Table 1
Distribution of Companies, by Market Capitalization
March/June 2005*

Market Capitalization	Number of Companies	Average Market Capitalization (in millions)	Median Market Capitalization (in millions)	Percent of Companies	Cumulative Percent of Number of Companies	Percent of Market Capitalization	Cumulative Percent of Market Capitalization
$ 0 to $ 25m	2,641	$8.2	$6.3	28.0%	28.0%	0.1%	0.1%
$ 25m to $ 50m	965	36.1	35.0	10.2%	38.2%	0.2%	0.3%
$ 50m to $ 75m	565	62.0	62.0	6.0%	44.2%	0.2%	0.5%
$ 75m to $100m	418	86.9	86.5	4.4%	48.7%	0.2%	0.8%
$100m to $200m	1,020	143.3	140.9	10.8%	59.5%	0.9%	1.6%
$200m to $500m	1,270	325.0	314.6	13.5%	73.0%	2.4%	4.1%
$500m to $700m	393	597.8	601.8	4.2%	77.1%	1.4%	5.5%
$700m to $ 1b	408	839.1	831.8	4.3%	81.5%	2.0%	7.5%
$1b to $ 5b	1,195	2,173.6	1,839.3	12.7%	94.1%	15.4%	22.9%
$5b to $10b	234	7,099.6	6,851.2	2.5%	96.6%	9.8%	32.7%
$10b or more	319	35,637.8	18,803.5	3.4%	100.0%	67.3%	100.0%

*Source: Public data includes 9,428 companies from CRSP for NYSE and AMEX firms as of March 31, 2005 and from NASDAQ for NASDAQ and OTC Bulletin Board firms as of June 10, 2005. Includes companies with a total market capitalization of $16,891 billion listed on the NYSE, AMEX, NASDAQ and OTC Bulletin Board for which market capitalizations are reported through those sources. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 2
Distribution of Companies, by Percentile of Total Market Capitalization
March/June 2005*

Percentile of Total Market Capitalization	Additional Number of Companies	Cumulative Number of Companies	Cumulative Percent of Number of Companies	Mean Market Capitalization (in millions)	Median Market Capitalization (in millions)	Maximum Market Capitalization (in millions)
<=0.5%	4,077	4,077	43.2%	$20.8	$14.2	$70.1
0.5%-1%	881	4,958	52.6%	96.3	94.7	128.2
1%-2%	947	5,905	62.6%	179.3	174.1	244.4
2%-3%	561	6,466	68.6%	302.7	303.3	368.5
3%-4%	397	6,863	72.8%	427.2	426.0	494.5
4%-5%	300	7,163	76.0%	566.8	568.0	641.0
5%-6%	239	7,402	78.5%	707.9	710.5	787.1
6%-7%	199	7,601	80.6%	853.5	851.5	930.1
7%-8%	169	7,770	82.4%	1,008.3	1,008.7	1,083.2
8%-9%	145	7,915	84.0%	1,166.8	1,167.0	1,259.7
9%-10%	127	8,042	85.3%	1,335.8	1,338.5	1,414.8
10%-25%	902	8,944	94.9%	2,823.9	2,441.3	6,171.3
25%-50%	359	9,303	98.7%	11,817.5	10,662.6	22,892.3
50%-75%	98	9,401	99.7%	42,631.3	39,197.1	78,243.6
75%-100%	27	9,428	100.0%	156,542.0	133,536.8	382,233.1

Source: Public data includes 9,428 companies from CRSP for NYSE and AMEX firms as of March 31, 2005 and from NASDAQ for NASDAQ and OTC Bulletin Board firms as of June 10, 2005. Includes companies with a total market capitalization of $16,891 billion listed on the NYSE, AMEX, NASDAQ and OTC Bulletin Board for which market capitalizations are reported through those sources. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 3
Distribution of Companies, by Listing Venue
March/June 2005*

Listing Venue	Total Market Capitalization (in billions)	Percent of Companies By Market Capitalization	Average Market Capitalization (in millions)	Median Market Capitalization (in millions)	Number of Companies Listed	Percent of Number of Companies
NYSE	$13,192	78.1%	$5,167.2	$1,041.3	2,553	27.1%
AMEX	370	2.2%	495.6	63.3	747	7.9%
Nasdaq NMS	3,104	18.4%	1,203.0	251.2	2,580	27.4%
Nasdaq Small Cap	38	0.2%	64.5	34.4	593	6.3%
OTC Bulletin Board	187	1.1%	63.4	9.1	2,955	31.3%
Total	$16,891				9,428	

*Source: Public data includes 9,428 companies from CRSP for NYSE and AMEX firms as of March 31, 2005 and from NASDAQ for NASDAQ and OTC Bulletin Board firms as of June 10, 2005. Includes companies with a total market capitalization of $16,891 billion listed on the NYSE, AMEX, NASDAQ and OTC Bulletin Board for which market capitalizations are reported through those sources. This table was compiled by members of the staff of the Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the staff.

Table 4
Distribution of Companies, by Listing Venue and by Market Capitalization
March/June 2005*

Panel A: Percent of Companies (Number) by Listing Venue and Market Capitalization

Listing Venue	$0-$25m	$25m-$50m	$50m-$75m	$ 75m-$100m	$100m-$200m	$200m-$500m	$500m-$700m	$700m-$1b	$1b-$5b	$5b-$10b	$10b or more	Total
NYSE	0.33%	0.41%	0.70%	0.66%	2.66%	4.31%	2.07%	2.20%	8.89%	1.99%	2.86%	27.08%
AMEX	1.61%	1.87%	0.99%	0.72%	1.23%	0.89%	0.11%	0.14%	0.25%	0.06%	0.05%	7.92%
Nasdaq NMS	1.05%	1.92%	1.88%	1.76%	5.09%	7.50%	1.94%	1.93%	3.44%	0.42%	0.43%	27.37%
Nasdaq Small Cap	2.38%	1.65%	0.73%	0.52%	0.66%	0.30%	0.02%	0.02%	0.01%	0.00%	0.00%	6.29%
OTC Bulletin Board	22.65%	4.38%	1.70%	0.77%	1.18%	0.48%	0.03%	0.04%	0.08%	0.00%	0.03%	31.34%
Total	28.01%	10.24%	5.99%	4.43%	10.82%	13.47%	4.17%	4.33%	12.68%	2.48%	3.38%	100.00%

Panel B: Percent of Market Capitalization ($Millions) by Listing Venue and Market Capitalization

Listing Venue	$0-$25m	$25m-$50m	$50m-$75m	$ 75m-$100m	$100m-$200m	$200m-$500m	$500m-$700m	$700m-$1b	$1b-$5b	$5b-$10b	$10b or more	Total
NYSE	0.00%	0.01%	0.02%	0.03%	0.22%	0.81%	0.69%	1.03%	11.17%	7.95%	56.17%	78.10%
AMEX	0.01%	0.04%	0.03%	0.03%	0.10%	0.15%	0.03%	0.07%	0.24%	0.24%	1.24%	2.19%
Nasdaq NMS	0.01%	0.04%	0.07%	0.08%	0.41%	1.35%	0.65%	0.90%	3.87%	1.65%	9.33%	18.37%
Nasdaq Small Cap	0.02%	0.03%	0.03%	0.03%	0.05%	0.05%	0.01%	0.01%	0.01%	0.00%	0.00%	0.23%
OTC Bulletin Board	0.09%	0.09%	0.06%	0.04%	0.09%	0.08%	0.01%	0.02%	0.08%	0.00%	0.56%	1.11%
Total	0.13%	0.21%	0.21%	0.22%	0.87%	2.44%	1.39%	2.03%	15.38%	9.84%	67.30%	100.00%

*Source: Public data includes 9,428 companies from CRSP for NYSE and AMEX firms as of March 31, 2005 and from NASDAQ for NASDAQ and OTC Bulletin Board firms as of June 10, 2005. Includes companies with a total market capitalization of $16,891 billion listed on the NYSE, AMEX, NASDAQ and OTC Bulletin Board for which market capitalization is reported through those sources. This table was compiled by members of the staff of the Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the staff.

Background Statistics

For Companies With Available Data

By Market Capitalization

Table 5
Market Capitalization, Total Assets and Revenue for Companies, by Market Capitalization
March 2005*

Market Capitalization	Number of Companies	Cumulative Percent of Companies	Mean Market Capitalization (in millions)	Median Market Capitalization (in millions	Mean Total Assets (in millions)	Median Total Assets (in millions)	Mean Revenue (in millions)	Median Revenue (in millions)
$ 0 to $ 25m	1,406	20.8%	$9.1	$7.5	$27.6	$5.4	$25.0	$4.0
$ 25m to $ 50m	557	29.1%	36.5	36.0	102.5	33.2	64.6	18.9
$ 50m to $ 75m	386	34.8%	61.7	60.8	175.9	59.8	92.3	29.6
$ 75m to $100m	287	39.0%	87.8	88.5	224.4	100.5	105.1	38.5
$100m to $200m	750	50.1%	144.9	143.4	338.7	134.0	178.0	54.6
$200m to $500m	1,002	65.0%	326.7	313.2	545.5	249.2	294.8	127.9
$500m to $700m	350	70.2%	599.4	601.5	930.6	534.1	574.8	319.1
$700m to $ 1b	362	75.5%	841.9	835.8	1,309.4	775.0	769.5	478.4
$1b to $ 5b	1,114	92.0%	2,224.4	1,921.8	3,407.9	1,882.3	1,916.7	1,029.2
$5b to $10b	228	95.4%	7,195.8	7,181.6	11,524.4	7,182.5	6,150.7	4,093.0
$10b or more	312	100.0%	36,502.8	18,406.0	75,887.8	21,767.5	22,977.3	11,590.4

* Source: Public data includes 6,754 companies from Compustat as of March 31, 2005. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted into market capitalization sizes using end of fiscal year data from Compustat. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 6
Volatility, Trading Volume, Execution Speed and Spread, by Market Capitalization
January-December 2004*

Market Capitalization	Number of Companies	Mean Market Capitalization (in millions)	Annual Volatility Of Stock Return	Mean Stock Price	Mean Daily Trading Volume (in hundreds)	Mean Execution Speed (in seconds)	Mean Raw Quoted Spread (in cents)	Mean Relative Effective Spread
$ 0 to $ 25m	1,451	$9.7	0.04619	$8.07	547	110.1	11.72	2.94%
$ 25m to $ 50m	683	36.8	0.03507	10.14	757	112.7	13.15	1.83%
$ 50m to $ 75m	508	61.7	0.03039	12.44	860	106.4	15.27	1.46%
$ 75m to $100m	367	87.7	0.02707	13.60	1,064	104.7	13.11	1.14%
$100m to $200m	1,018	146.2	0.02613	13.93	1,504	85.9	9.96	0.83%
$200m to $500m	1,313	325.4	0.02577	18.01	2,286	58.6	7.56	0.45%
$500m to $700m	437	600.6	0.02241	22.36	3,143	44.3	5.38	0.27%
$700m to $ 1b	439	837.0	0.02239	24.22	4,450	35.6	4.24	0.21%
$1b to $ 5b	1,258	2,189.7	0.01927	34.16	7,620	29.4	5.44	0.14%
$5b to $10b	241	7,120.6	0.01701	46.90	19,413	19.1	2.45	0.07%
$10b or more	330	36,259.1	0.01466	47.19	47,075	15.9	3.27	0.05%

*Source: Public data includes 8,045 companies from CRSP, Compustat and Dash-5 reports (in accordance with SEC Rule Ac-5) for 2004. Includes companies for which relevant data are available. Companies are sorted in market capitalization sizes using December 31, 2004 data from CRSP. Relative Effective Spread is calculated by dividing the raw effective spread by average price. The Raw Effective Spread is restricted to market and marketable limit orders. It is also weighted by executed shares. For buy orders, it is calculated as double the amount of difference between the execution price and the midpoint of the consolidated best bid and offer (BBO) at the time of order receipt. For sell orders, it is computed as double the amount of difference between the midpoint of the consolidated best bid and offer (BBO) at the time of order receipt and the execution price. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 7
Analyst Coverage and Institutional Holdings, by Market Capitalization
December 2004*

Market Capitalization	Number of Companies	Cumulative Percent of Companies	Mean Number of Analysts	Median Number of Analysts	Mean Percent of Shares Held by Institutions	Median Percent of Shares Held by Institutions
$ 0 to $ 25m	1,406	20.8%	0.0	0.0	2.16%	0.00%
$ 25m to $ 50m	557	29.1%	0.2	0.0	10.05%	4.01%
$ 50m to $ 75m	386	34.8%	0.4	0.0	15.10%	9.97%
$ 75m to $100m	287	39.0%	0.6	0.0	18.34%	12.59%
$100m to $200m	750	50.1%	1.4	1.0	27.81%	23.37%
$200m to $500m	1,002	65.0%	2.9	2.0	42.75%	41.61%
$500m to $700m	350	70.2%	4.5	4.0	54.03%	57.67%
$700m to $ 1b	362	75.5%	5.3	4.5	62.50%	73.76%
$1b to $ 5b	1,114	92.0%	7.9	7.0	59.62%	70.59%
$5b to $10b	228	95.4%	13.0	13.0	58.78%	69.44%
Greater than $10b	312	100.0%	17.2	18.0	57.49%	66.59%

*Source: Public data includes 6,754 companies from Vickers, I/B/E/S and Compustat as of December 31, 2004. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted in market capitalization sizes using end of fiscal year data from Compustat as of March 31, 2005. Institutional holdings from Vickers are from Form 13(f) filings. The number of sell-side analysts is the number of 1-year ahead earnings forecasts as of December 2004. Missing values for institutional holdings and number of analysts are set equal to zero. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 8
Audit Fees in Millions of Dollars, by Market Capitalization
End of Fiscal Year 2004*

Market Capitalization	Average Number of Companies Per Year	Percent Of Average Number of Companies Per Year	Median Audit Fee (in millions)					Median Yearly Percent Change in Audit Fee			
			2000	2001	2002	2003	2004	2001	2002	2003	2004
$ 0 to $ 25m	1,810	18.5%	$0.08	$0.08	$0.06	$0.05	$0.05	3.83%	10.34%	8.78%	10.35%
$ 25m to $ 50m	704	7.2%	0.10	0.11	0.11	0.10	0.10	5.05%	13.04%	12.77%	11.94%
$ 50m to $ 75m	464	4.7%	0.11	0.10	0.12	0.13	0.12	6.01%	19.25%	14.13%	11.17%
$ 75m to $100m	345	3.5%	0.13	0.11	0.14	0.12	0.15	4.53%	13.70%	14.28%	16.05%
$100m to $200m	778	8.0%	0.15	0.14	0.19	0.17	0.25	6.74%	19.82%	20.22%	37.96%
$200m to $500m	979	10.0%	0.19	0.20	0.30	0.30	0.49	11.47%	19.27%	18.13%	61.25%
$500m to $700m	326	3.3%	0.23	0.28	0.41	0.43	0.79	12.13%	30.77%	17.26%	64.09%
$700m to $ 1b	315	3.2%	0.29	0.35	0.46	0.54	1.01	13.40%	30.55%	17.79%	74.07%
$1b to $ 5b	873	8.9%	0.47	0.58	0.88	0.93	1.33	19.61%	25.20%	20.63%	70.36%
$5b to $10b	181	1.9%	1.08	1.57	2.01	2.20	2.84	12.32%	39.34%	19.00%	57.08%
Greater than $10b	239	2.4%	3.00	4.08	5.56	5.76	7.23	28.57%	19.04%	21.05%	42.21%
Not available	2,755	28.2%	0.05	0.05	0.04	0.04	0.04	4.91%	8.82%	8.50%	7.02%

*Source: Public data includes 48,845 observations on an average of 9,769 companies per year from 2000 to the end of the fiscal year 2004 from AuditAnalytics.com. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted in market capitalization sizes in each year first using data from Compustat and if market capitalization is not available from that source, from AuditAnalytics.com. Audit fee is defined as the sum of the variables Audit fee and Audit-Related fee provided by Audit Analytics and does not include other non-audit related fees such as Benefit Plan Related Fees, Tax Related Fees, or other Non-Audit Fees. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 9
Audit Fees as a Percent of Market Capitalization, by Market Capitalization
End of Fiscal Year 2004*

Market Capitalization	Average Number of Companies Per Year	Percent Of Average Number of Companies Per Year	Median Audit Fee/Market Capitalization					Median Yearly Percent Change in Audit Fee/Market Capitalization			
			2000	2001	2002	2003	2004	2001	2002	2003	2004
$ 0 to $ 25m	1,810	18.5%	0.92%	0.97%	1.23%	0.87%	0.86%	0.151%	0.276%	-0.125%	0.054%
$ 25m to $ 50m	704	7.2%	0.28%	0.30%	0.31%	0.27%	0.29%	0.002%	0.048%	-0.059%	-0.011%
$ 50m to $ 75m	464	4.7%	0.17%	0.17%	0.20%	0.20%	0.19%	-0.004%	0.021%	-0.039%	-0.001%
$ 75m to $100m	345	3.5%	0.15%	0.13%	0.17%	0.14%	0.17%	-0.003%	0.011%	-0.030%	0.001%
$100m to $200m	778	8.0%	0.10%	0.10%	0.13%	0.12%	0.18%	-0.002%	0.015%	-0.014%	0.011%
$200m to $500m	979	10.0%	0.06%	0.07%	0.09%	0.09%	0.15%	-0.001%	0.018%	-0.009%	0.021%
$500m to $700m	326	3.3%	0.04%	0.05%	0.07%	0.07%	0.13%	0.000%	0.011%	-0.007%	0.022%
$700m to $ 1b	315	3.2%	0.04%	0.04%	0.05%	0.07%	0.12%	0.002%	0.010%	-0.012%	0.024%
$1b to $ 5b	873	8.9%	0.02%	0.03%	0.04%	0.05%	0.07%	0.002%	0.007%	-0.004%	0.013%
$5b to $10b	181	1.9%	0.02%	0.02%	0.03%	0.03%	0.04%	0.003%	0.007%	-0.003%	0.005%
Greater than $10b	239	2.4%	0.01%	0.01%	0.02%	0.02%	0.03%	0.003%	0.005%	-0.001%	0.004%
Not available	2,755	28.2%									

*Source: Public data includes 48,845 observations on an average of 9,769 companies per year from 2000 to the end of the fiscal year 2004 from AuditAnalytics.com. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted in market capitalization sizes in each year first using data from Compustat and if market capitalization is not available from that source, from AuditAnalytics.com. Audit fee is defined as the sum of the variables Audit fee and Audit-Related fee provided by Audit Analytics and does not include other non-audit related fees such as Benefit Plan Related Fees, Tax Related Fees, or other Non-Audit Fees. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 10
Audit Fees as a Percent of Revenue, by Market Capitalization
End of Fiscal Year 2004*

Market Capitalization	Average Number of Companies Per Year	Percent Of Average Number of Companies Per Year	Median Audit Fee/Revenue					Median Yearly Percent Change in Audit Fee/Revenue			
			2000	2001	2002	2003	2004	2001	2002	2003	2004
$ 0 to $ 25m	1,810	18.5%	0.37%	0.44%	0.75%	1.00%	1.37%	0.011%	0.046%	0.038%	0.013%
$ 25m to $ 50m	704	7.2%	0.23%	0.28%	0.35%	0.49%	0.53%	0.010%	0.030%	0.020%	0.013%
$ 50m to $ 75m	464	4.7%	0.20%	0.21%	0.30%	0.36%	0.43%	0.003%	0.048%	0.025%	0.008%
$ 75m to $100m	345	3.5%	0.17%	0.19%	0.27%	0.32%	0.39%	0.006%	0.031%	0.018%	0.035%
$100m to $200m	778	8.0%	0.15%	0.15%	0.19%	0.27%	0.43%	0.007%	0.028%	0.019%	0.067%
$200m to $500m	979	10.0%	0.12%	0.11%	0.14%	0.18%	0.31%	0.007%	0.017%	0.012%	0.069%
$500m to $700m	326	3.3%	0.09%	0.09%	0.09%	0.14%	0.25%	0.007%	0.020%	0.007%	0.056%
$700m to $ 1b	315	3.2%	0.08%	0.08%	0.10%	0.13%	0.22%	0.004%	0.017%	0.003%	0.058%
$1b to $ 5b	873	8.9%	0.06%	0.06%	0.07%	0.09%	0.14%	0.004%	0.009%	0.005%	0.035%
$5b to $10b	181	1.9%	0.04%	0.04%	0.05%	0.06%	0.09%	0.003%	0.011%	0.003%	0.021%
Greater than $10b	239	2.4%	0.03%	0.03%	0.04%	0.05%	0.06%	0.004%	0.006%	0.003%	0.010%
Not available	2,755	28.2%	0.26%	0.38%	0.57%	1.28%	4.39%	0.010%	0.081%	0.008%	0.040%

*Source: Public data includes 48,845 observations on an average of 9,769 companies per year from 2000 to the end of the fiscal year 2004 from AuditAnalytics.com. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted in market capitalization sizes in each year first using data from Compustat and if market capitalization is not available from that source, from AuditAnalytics.com. Audit fee is defined as the sum of the variables Audit fee and Audit-Related fee provided by Audit Analytics and does not include other non-audit related fees such as Benefit Plan Related Fees, Tax Related Fees, or other Non-Audit Fees. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 11
Material Weaknesses, by Market Capitalization
June 2005*

Market Capitalization	Number Of Firms	Number of Firms with Material Weaknesses	Number of Firms without Material Weaknesses	Percent of Firms with Material Weaknesses	Mean Audit Fees (in millions) With Material Weakness	Mean Audit Fees (in millions) Without Material Weakness	Mean Audit Fees (in millions) Percent Difference	Median Audit Fees (in millions) With Material Weakness	Median Audit Fees (in millions) Without Material Weakness	Median Audit Fees (in millions) Percent Difference
$ 0 to $ 25m	13	6	7	46.2%	$0.83	$1.56	-46.8%	$0.83	$1.25	-33.8%
$ 25m to $ 50m	31	9	22	29.0%	0.90	1.18	-24.3%	0.63	0.60	5.5%
$ 50m to $ 75m	36	10	26	27.8%	0.96	0.76	26.5%	0.92	0.49	87.3%
$ 75m to $100m	75	14	61	18.7%	0.60	0.49	23.2%	0.70	0.44	59.5%
$100m to $200m	390	69	321	17.7%	0.97	0.60	62.0%	0.81	0.40	102.5%
$200m to $500m	598	90	508	15.1%	1.58	0.84	87.1%	1.03	0.70	47.1%
$500m to $700m	228	31	197	13.6%	1.29	1.31	-1.3%	1.07	1.02	4.8%
$700m to $ 1b	227	32	195	14.1%	2.41	1.55	55.3%	1.58	1.18	34.3%
$1b to $ 5b	770	68	702	8.8%	3.87	2.35	64.2%	2.46	1.66	48.4%
$5b to $10b	166	12	154	7.2%	12.69	4.25	198.8%	8.77	2.87	205.8%
Greater than $10b	223	9	214	4.0%	32.41	11.86	173.3%	15.66	7.73	102.5%
Not available	150	17	133	11.3%	1.58	2.00	-21.0%	0.77	0.77	0.2%
Total	2,907	367	2,540	12.6%						

*Source: Public data includes 2,907 companies from AuditAnalytics.com as of June 30, 2005. Includes companies for which audit fee data are available. Companies are sorted in market capitalization sizes based on market value provided by AuditAnalytics.com. The original dataset includes a total of 3,088 firms that report on the status of their internal controls. Two firms are excluded because they did not report their status and one observation is repeated. The breakdown of the data is as follows:

Total number of companies reporting on the status of internal controls 3,085
- Number of companies reporting no material weakness 2,687 (87.1%)
- Number of companies reporting a material weakness 398 (12.9%)

Total *number of companies reporting on the status of internal controls AND audit fees* 2,907
- Number of companies reporting no material weakness AND audit fees 2,540 (87.4%)
- Number of companies reporting a material weakness AND audit fees 367 (12.6%)

This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Background Statistics

For Companies With Available Data

By Percentile of Total Market Capitalization

Table 12

Market Capitalization, Total Assets and Revenue for Companies, by Percentile of Total Market Capitalization

March 2005*

Percentile of Total Market Capitalization	Number of Companies	Cumulative Percent of Companies	Mean Market Capitalization (in millions)	Median Market Capitalization (in millions	Mean Total Assets (in millions)	Median Total Assets (in millions)	Mean Revenue (in millions)	Median Revenue (in millions)
<=0.5%	2,641	39.1%	$31.3	$22.1	$86.6	$17.2	$52.3	$12.4
0.5%-1%	608	48.1%	135.7	136.7	331.2	128.2	171.8	51.8
1%-2%	678	58.1%	244.1	242.2	427.8	199.1	238.8	90.9
2%-3%	415	64.3%	397.7	396.6	636.0	286.3	343.7	153.7
3%-4%	296	68.7%	558.1	556.3	851.7	509.2	514.4	342.4
4%-5%	232	72.1%	714.8	709.1	1,155.3	680.7	696.7	361.1
5%-6%	188	74.9%	877.4	872.0	1,456.5	810.6	815.3	492.6
6%-7%	160	77.3%	1,036.7	1,038.7	1,511.2	887.5	907.4	404.0
7%-8%	136	79.3%	1,217.2	1,213.8	2,071.5	1,151.5	1,170.9	815.5
8%-9%	116	81.0%	1,424.3	1,429.3	2,216.9	1,246.8	1,117.8	775.8
9%-10%	102	82.5%	1,607.1	1,606.0	2,373.3	1,309.8	1,212.7	686.5
10%-25%	748	93.6%	3,314.3	2,931.6	5,230.7	2,798.4	2,914.1	1,643.4
25%-50%	321	98.3%	12,890.8	11,903.5	23,380.4	11,609.0	10,616.4	6,437.0
50%-75%	88	99.6%	46,853.8	42,320.6	116,508.2	38,350.2	28,206.7	20,328.5
75%-100%	25	100.0%	165,913.9	138,727.0	298,326.3	109,183.0	84,406.4	63,963.0

* Source: Public data includes 6,754 companies from Compustat as of March 31, 2005. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted into market capitalization percentiles using end of fiscal year data from Compustat. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 13

Volatility, Trading Volume, Execution Speed and Spread, by Percentile of Total Market Capitalization

January-December 2004*

Percentile of Total Market Capitalization	Number of Companies	Mean Market Capitalization (in millions)	Annual Volatility Of Stock Return	Mean Stock Price	Mean Daily Trading Volume (in hundreds)	Mean Execution Speed (in seconds)	Mean Raw Quoted Spread (in cents)	Mean Relative Effective Spread
<=0.5%	2,857	$31	0.03602	$10.46	762	110.2	13.33	1.98%
0.5%-1%	740	119	0.02671	14.18	1,373	91.0	11.23	0.94%
1%-2%	869	204	0.02607	15.08	1,611	75.2	9.28	0.64%
2%-3%	541	327	0.02528	18.69	2,288	58.7	7.11	0.43%
3%-4%	389	454	0.02553	19.05	3,024	44.8	5.42	0.34%
4%-5%	297	595	0.02237	22.75	3,107	43.6	5.62	0.27%
5%-6%	245	724	0.02209	23.99	3,893	38.9	4.33	0.22%
6%-7%	205	862	0.02245	23.24	4,595	34.5	4.12	0.22%
7%-8%	174	1,014	0.02138	27.60	4,201	33.1	5.42	0.25%
8%-9%	151	1,170	0.02017	30.97	5,963	35.0	3.28	0.17%
9%-10%	130	1,356	0.02143	29.36	6,024	34.2	4.53	0.17%
10%-25%	940	2,812	0.01864	36.09	9,096	26.7	5.65	0.11%
25%-50%	370	11,792	0.01593	48.79	25,257	17.6	2.53	0.06%
50%-75%	104	40,230	0.01402	47.06	52,449	16.1	2.76	0.05%
75%-100%	33	145,057	0.01191	49.57	141,766	12.9	9.97	0.04%

*Source: Public data includes 8,045 companies from CRSP, Compustat and Dash-5 reports (in accordance with SEC Rule Ac-5) for 2004. Includes companies for which relevant data are available. Companies are sorted in market capitalization percentiles using December 31, 2004 data from CRSP. Relative Effective Spread is calculated by dividing the raw effective spread by average price. The Raw Effective Spread is restricted to market and marketable limit orders. It is also weighted by executed shares. For buy orders, it is calculated as double the amount of difference between the execution price and the midpoint of the consolidated best bid and offer (BBO) at the time of order receipt. For sell orders, it is computed as double the amount of difference between the midpoint of the consolidated best bid and offer (BBO) at the time of order receipt and the execution price. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 14
Analyst Coverage and Institutional Holdings, by Percentile of Total Market Capitalization
December 2004*

Percentile of Total Market Capitalization	Number of Companies	Cumulative Percent of Companies	Mean Number of Analysts	Median Number of Analysts	Mean Percent of Shares Held by Institutions	Median Percent of Shares Held by Institutions
<=0.5%	2,641	39.1%	0.2	0.0	7.52%	0.00%
0.5%-1%	608	48.1%	1.3	1.0	25.98%	21.56%
1%-2%	678	58.1%	2.3	2.0	37.96%	36.03%
2%-3%	415	64.3%	3.3	3.0	47.24%	49.86%
3%-4%	296	68.7%	4.3	4.0	53.39%	57.73%
4%-5%	232	72.1%	5.4	5.0	58.91%	66.27%
5%-6%	188	74.9%	4.9	4.0	63.65%	74.56%
6%-7%	160	77.3%	5.7	5.0	55.54%	68.20%
7%-8%	136	79.3%	6.5	6.0	64.28%	75.39%
8%-9%	116	81.0%	6.5	5.0	57.49%	65.87%
9%-10%	102	82.5%	7.6	7.0	61.68%	77.53%
10%-25%	748	93.6%	9.5	9.0	59.71%	70.44%
25%-50%	321	98.3%	14.6	15.0	58.27%	70.27%
50%-75%	88	99.6%	19.4	20.0	56.71%	65.92%
75%-100%	25	100.0%	21.2	21.0	52.97%	58.82%

*Source: Public data includes 6,754 companies from Vickers, I/B/E/S and Compustat as of December 31, 2004. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted in market capitalization percentiles using end of fiscal year data from Compustat as of March 31, 2005. Institutional holdings from Vickers are from Form 13(f) filings. The number of sell-side analysts is the number of 1-year ahead earnings forecasts as of December 2004. Missing values for institutional holdings and number of analysts are set equal to zero. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 15
Audit Fees in Millions of Dollars, by Percentile of Total Market Capitalization
End of Fiscal Year 2004*

Percentile of Total Market Capitalization	Average Number of Companies Per Year	Percent Of Average Number of Companies Per Year	Median Audit Fee (in millions)					Median Yearly Percent Change in Audit Fee			
			2000	2001	2002	2003	2004	2001	2002	2003	2004
<=0.5%	2,954	30.2%	$0.09	$0.09	$0.08	$0.06	$0.07	4.35%	11.51%	10.32%	11.08%
0.5%-1%	695	7.1%	0.13	0.12	0.14	0.14	0.22	5.35%	17.10%	17.02%	27.86%
1%-2%	738	7.6%	0.16	0.16	0.20	0.21	0.36	8.42%	19.37%	20.42%	51.13%
2%-3%	436	4.5%	0.22	0.20	0.28	0.26	0.51	12.50%	17.74%	15.67%	66.20%
3%-4%	307	3.1%	0.24	0.26	0.34	0.37	0.68	10.00%	20.36%	20.83%	57.29%
4%-5%	234	2.4%	0.24	0.28	0.37	0.39	0.81	10.43%	28.29%	16.45%	67.94%
5%-6%	188	1.9%	0.32	0.35	0.43	0.51	0.90	14.47%	34.91%	21.69%	74.09%
6%-7%	155	1.6%	0.35	0.34	0.41	0.52	1.13	13.05%	30.15%	15.77%	74.47%
7%-8%	130	1.3%	0.35	0.38	0.59	0.56	0.98	19.98%	29.19%	17.37%	77.60%
8%-9%	110	1.1%	0.43	0.43	0.63	0.60	1.12	12.29%	31.23%	18.91%	72.70%
9%-10%	96	1.0%	0.45	0.50	0.71	0.65	1.06	18.33%	27.30%	20.13%	70.06%
10%-25%	648	6.6%	0.75	0.82	1.09	1.09	1.79	18.89%	25.20%	22.16%	66.90%
25%-50%	245	2.5%	2.20	2.60	3.26	3.15	5.05	30.39%	20.63%	20.98%	47.19%
50%-75%	60	0.6%	4.60	5.80	8.62	7.28	11.80	16.28%	36.08%	19.48%	34.85%
75%-100%	18	0.2%	10.75	13.00	18.49	18.15	25.22	18.76%	51.36%	21.87%	32.49%
Not available	2,755	28.2%	0.05	0.05	0.04	0.04	0.04	4.91%	8.82%	8.50%	7.02%

*Source: Public data includes 48,845 observations on an average of 9,769 companies per year from 2000 to the end of the fiscal year 2004 from AuditAnalytics.com. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted in market capitalization percentiles in each year first using data from Compustat and if market capitalization is not available from that source, from AuditAnalytics.com. Audit fee is defined as the sum of the variables Audit fee and Audit-Related fee provided by Audit Analytics and does not include other non-audit related fees such as Benefit Plan Related Fees, Tax Related Fees, or other Non-Audit Fees. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 16

Audit Fees as a Percent of Market Capitalization, by Percentile of Total Market Capitalization

End of Fiscal Year 2004*

Percentile of Total Market Capitalization	Average Number of Companies Per Year	Percent Of Average Number of Companies Per Year	Median Audit Fee/Market Capitalization					Median Yearly Percent Change in Audit Fee/Market Capitalization			
			2000	2001	2002	2003	2004	2001	2002	2003	2004
<=0.5%	2,954	30.2%	0.46%	0.51%	0.75%	0.54%	0.47%	0.018%	0.115%	-0.075%	0.004%
0.5%-1%	695	7.1%	0.12%	0.13%	0.17%	0.14%	0.19%	-0.004%	0.017%	-0.024%	0.006%
1%-2%	738	7.6%	0.08%	0.08%	0.13%	0.12%	0.17%	-0.002%	0.015%	-0.013%	0.016%
2%-3%	436	4.5%	0.06%	0.06%	0.10%	0.09%	0.15%	0.000%	0.019%	-0.014%	0.025%
3%-4%	307	3.1%	0.04%	0.06%	0.08%	0.09%	0.14%	-0.001%	0.014%	-0.007%	0.027%
4%-5%	234	2.4%	0.03%	0.04%	0.07%	0.07%	0.12%	0.000%	0.011%	-0.007%	0.023%
5%-6%	188	1.9%	0.04%	0.05%	0.07%	0.08%	0.11%	0.002%	0.012%	-0.007%	0.019%
6%-7%	155	1.6%	0.03%	0.04%	0.05%	0.07%	0.11%	0.001%	0.009%	-0.008%	0.032%
7%-8%	130	1.3%	0.03%	0.03%	0.06%	0.06%	0.08%	0.002%	0.014%	-0.016%	0.015%
8%-9%	110	1.1%	0.03%	0.03%	0.06%	0.06%	0.08%	0.000%	0.011%	-0.013%	0.015%
9%-10%	96	1.0%	0.02%	0.03%	0.05%	0.05%	0.07%	0.004%	0.009%	-0.005%	0.012%
10%-25%	648	6.6%	0.02%	0.03%	0.04%	0.04%	0.06%	0.002%	0.006%	-0.004%	0.012%
25%-50%	245	2.5%	0.01%	0.02%	0.03%	0.03%	0.04%	0.005%	0.005%	-0.001%	0.004%
50%-75%	60	0.6%	0.01%	0.01%	0.01%	0.02%	0.03%	0.002%	0.005%	-0.001%	0.003%
75%-100%	18	0.2%	0.01%	0.01%	0.01%	0.01%	0.01%	0.001%	0.004%	0.000%	0.001%
Not available	2,755	28.2%									

*Source: Public data includes 48,845 observations on an average of 9,769 companies per year from 2000 to the end of the fiscal year 2004 from AuditAnalytics.com. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted in market capitalization percentiles in each year first using data from Compustat and if market capitalization is not available from that source, from AuditAnalytics.com. Audit fee is defined as the sum of the variables Audit fee and Audit-Related fee provided by Audit Analytics and does not include other non-audit related fees such as Benefit Plan Related Fees, Tax Related Fees, or other Non-Audit Fees. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 17

Audit Fees as a Percent of Revenue, by Percentile of Total Market Capitalization

End of Fiscal Year 2004*

Percentile of Total Market Capitalization	Average Number of Companies Per Year	Percent Of Average Number of Companies Per Year	Median Audit Fee/Revenue					Median Yearly Percent Change in Audit Fee/Revenue			
			2000	2001	2002	2003	2004	2001	2002	2003	2004
<=0.5%	2,954	30.2%	0.28%	0.35%	0.54%	0.69%	0.75%	0.008%	0.040%	0.028%	0.014%
0.5%-1%	695	7.1%	0.16%	0.18%	0.27%	0.33%	0.42%	0.006%	0.036%	0.020%	0.048%
1%-2%	738	7.6%	0.14%	0.13%	0.19%	0.24%	0.37%	0.008%	0.028%	0.015%	0.071%
2%-3%	436	4.5%	0.12%	0.12%	0.15%	0.18%	0.31%	0.008%	0.018%	0.010%	0.076%
3%-4%	307	3.1%	0.09%	0.09%	0.13%	0.15%	0.24%	0.006%	0.013%	0.014%	0.050%
4%-5%	234	2.4%	0.08%	0.08%	0.10%	0.16%	0.26%	0.006%	0.016%	0.009%	0.061%
5%-6%	188	1.9%	0.07%	0.09%	0.09%	0.14%	0.20%	0.005%	0.021%	0.010%	0.058%
6%-7%	155	1.6%	0.06%	0.07%	0.10%	0.13%	0.22%	0.005%	0.010%	0.002%	0.055%
7%-8%	130	1.3%	0.07%	0.07%	0.10%	0.13%	0.18%	0.004%	0.018%	0.003%	0.058%
8%-9%	110	1.1%	0.06%	0.07%	0.09%	0.11%	0.16%	0.005%	0.019%	0.003%	0.033%
9%-10%	96	1.0%	0.06%	0.07%	0.09%	0.10%	0.16%	0.003%	0.013%	0.004%	0.050%
10%-25%	648	6.6%	0.05%	0.05%	0.06%	0.08%	0.12%	0.004%	0.008%	0.005%	0.029%
25%-50%	245	2.5%	0.04%	0.03%	0.04%	0.06%	0.07%	0.004%	0.006%	0.004%	0.014%
50%-75%	60	0.6%	0.02%	0.03%	0.04%	0.04%	0.06%	0.003%	0.008%	0.003%	0.008%
75%-100%	18	0.2%	0.02%	0.03%	0.04%	0.04%	0.05%	0.002%	0.010%	0.002%	0.003%
Not available	2,755	28.2%	0.26%	0.38%	0.57%	1.28%	4.39%	0.010%	0.081%	0.008%	0.040%

*Source: Public data includes 48,845 observations on an average of 9,769 companies per year from 2000 to the end of the fiscal year 2004 from AuditAnalytics.com. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted in market capitalization percentiles in each year first using data from Compustat and if market capitalization is not available from that source, from AuditAnalytics.com. Audit fee is defined as the sum of the variables Audit fee and Audit-Related fee provided by Audit Analytics and does not include other non-audit related fees such as Benefit Plan Related Fees, Tax Related Fees, or other Non-Audit Fees. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 18
Material Weaknesses, by Percentile of Total Market Capitalization
June 2005*

Percentile of Total Market Capitalization	Number Of Firms	Number of Firms with Material Weaknesses	Number of Firms without Material Weaknesses	Percent of Firms with Material Weaknesses	Mean Audit Fees (in millions) With Material Weakness	Mean Audit Fees (in millions) Without Material Weakness	Mean Audit Fees (in millions) Percent Difference	Median Audit Fees (in millions) With Material Weakness	Median Audit Fees (in millions) Without Material Weakness	Median Audit Fees (in millions) Percent Difference
<=0.5%	106	30	76	28.3%	$0.87	$0.89	-2.7%	$0.71	$0.55	30.6%
0.5%-1%	271	44	227	16.2%	0.89	0.57	54.2%	0.79	0.40	98.8%
1%-2%	384	68	316	17.7%	1.07	0.68	57.1%	0.85	0.53	60.0%
2%-3%	283	39	244	13.8%	1.80	0.90	100.1%	1.28	0.72	77.3%
3%-4%	179	30	149	16.8%	1.75	1.01	73.5%	1.14	0.86	32.1%
4%-5%	177	21	156	11.9%	1.65	1.46	13.5%	1.16	1.11	4.8%
5%-6%	117	17	100	14.5%	2.30	1.54	49.0%	1.60	1.13	41.9%
6%-7%	116	15	101	12.9%	2.13	1.93	10.3%	1.87	1.24	50.3%
7%-8%	106	12	94	11.3%	3.77	1.58	138.9%	2.43	1.14	113.2%
8%-9%	97	12	85	12.4%	4.22	1.74	142.5%	2.66	1.35	96.6%
9%-10%	66	5	61	7.6%	1.38	1.63	-15.2%	1.45	1.21	19.6%
10%-25%	560	41	519	7.3%	4.88	2.90	68.4%	3.67	2.14	71.2%
25%-50%	223	14	209	6.3%	16.67	7.45	123.7%	12.99	5.36	142.5%
50%-75%	57	0	57	0.0%	na	15.76	na	na	11.80	na
75%-100%	15	2	13	13.3%	80.90	30.59	164.4%	80.90	28.32	185.7%
Not available	150	17	133	11.3%	1.58	2.00	-21.0%	0.77	0.77	0.2%
Total	2,907	367	2,540	12.6%						

*Source: Public data includes 2,907 companies from AuditAnalytics.com as of June 30, 2005. Includes companies for which audit fee data are available. Due to the limited number of companies reporting on internal controls, companies are sorted according to the percentile of market capitalization using the 2004 cutoffs in Tables 15-17 using market capitalization from AuditAnalytics.com. The original dataset includes a total of 3,088 firms that report on the status of their internal controls. Two firms are excluded because they did not report their status and one observation is repeated. The breakdown of the data is as follows:

Total number of companies reporting on the status of internal controls 3,085
- Number of companies reporting no material weakness 2,687 (87.1%)
- Number of companies reporting a material weakness 398 (12.9%)

Total number of companies reporting on the status of internal controls AND audit fees 2,907
- Number of companies reporting no material weakness AND audit fees 2,540 (87.4%)
- Number of companies reporting a material weakness AND audit fees 367 (12.6%)

This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Background Statistics

For Companies With Available Data

By Revenue

Table 19

Market Capitalization, Total Assets and Revenue for Companies, by Revenue

March 2005*

Revenue	Number of Companies	Cumulative Percent of Companies	Mean Market Capitalization (in millions)	Median Market Capitalization (in millions)	Mean Revenue (in millions)	Median Revenue (in millions)	Mean Total Assets (in millions)	Median Total Assets (in millions)
Up to $ 1m	724	10.7%	$62.8	$10.6	$0.2	$0.0	$22.3	$1.7
$ 1m to $ 2m	147	12.9%	56.9	12.9	1.4	1.4	15.9	4.1
$ 2m to $ 5m	266	16.8%	59.5	12.9	3.4	3.3	25.2	5.6
$ 5m to $ 10m	287	21.1%	59.9	19.4	7.4	7.4	48.9	12.7
$ 10m to $ 20m	455	27.8%	73.0	34.0	14.8	14.6	93.8	22.4
$ 20m to $ 50m	837	40.2%	126.2	73.8	33.2	32.3	216.1	61.0
$ 50m to $100m	682	50.3%	234.8	149.3	71.1	69.2	324.6	104.9
$100m to $250m	846	62.8%	437.6	315.5	164.3	158.9	634.8	223.7
$250m to $500m	623	72.1%	807.4	602.5	360.6	351.8	1,127.3	460.3
$500m to $1b	591	80.8%	1,421.1	926.5	713.7	689.1	2,104.4	804.7
More than $1b	1,296	100.0%	11,143.1	3,508.2	8,390.0	2,826.2	22,332.2	3,665.1

*Source: Public data includes 6,754 companies from Compustat as of March 31, 2005. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted by revenue using end of fiscal year data from Compustat. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 20
Volatility, Trading Volume, Execution Speed and Spread, by Revenue
January-December 2004*

Revenue	Number of Companies	Mean Market Capitalization (in millions)	Annual Volatility Of Stock Return	Mean Price	Average Daily Trading Volume (in hundreds)	Mean Execution Speed (in seconds)	Mean Raw Quoted Spread (in cents)	Mean Relative Effective Spread
Up to $ 1m	668	$66	0.04903	6.17	2,903	70.7	4.26	1.44%
$ 1m to $ 2m	141	59	0.04806	5.72	2,125	71.2	4.81	1.54%
$ 2m to $ 5m	244	62	0.04790	5.86	2,857	77.3	7.16	1.96%
$ 5m to $ 10m	268	61	0.04067	8.95	1,660	94.8	15.29	2.23%
$ 10m to $ 20m	422	79	0.03946	9.64	1,893	86.8	14.40	1.94%
$ 20m to $ 50m	801	130	0.03258	12.56	1,326	87.4	15.22	1.52%
$ 50m to $100m	648	234	0.03237	13.53	3,305	73.1	10.70	1.09%
$100m to $250m	807	438	0.02819	18.39	2,771	61.4	7.95	0.69%
$250m to $500m	601	806	0.02496	21.72	4,059	46.5	5.64	0.41%
$500m to $1b	580	1,352	0.02299	26.54	5,165	39.8	5.22	0.30%
More than $1b	1,413	10,140	0.01847	36.23	16,161	29.8	3.88	0.15%

*Source: Public data includes 6,593 companies from CRSP, Compustat and Dash-5 reports (in accordance with SEC Rule Ac-5) for 2004. Includes companies for which relevant data are available. Companies are sorted by revenue using December 31, 2004 data from Compustat. Relative Effective Spread is calculated by dividing the raw effective spread by average price. The Raw Effective Spread is restricted to market and marketable limit orders. It is also weighted by executed shares. For buy orders, it is calculated as double the amount of difference between the execution price and the midpoint of the consolidated best bid and offer (BBO) at the time of order receipt. For sell orders, it is computed as double the amount of difference between the midpoint of the consolidated best bid and offer (BBO) at the time of order receipt and the execution price. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 21
Analyst Coverage and Institutional Holdings, by Revenue
December 2004*

Revenue	Number of Companies	Cumulative Percent of Companies	Mean Number of Analysts	Median Number of Analysts	Mean Percent of Shares Held by Institutions	Median Percent of Shares Held by Institutions
Up to $ 1m	724	10.7%	0.2	0.0	3.47%	0.00%
$ 1m to $ 2m	147	12.9%	0.4	0.0	6.12%	0.00%
$ 2m to $ 5m	266	16.8%	0.3	0.0	6.10%	0.00%
$ 5m to $ 10m	287	21.1%	0.3	0.0	6.92%	0.00%
$ 10m to $ 20m	455	27.8%	0.4	0.0	10.42%	1.94%
$ 20m to $ 50m	837	40.2%	0.7	0.0	15.37%	8.04%
$ 50m to $100m	682	50.3%	1.9	1.0	27.10%	20.34%
$100m to $250m	846	62.8%	3.1	2.0	39.22%	36.46%
$250m to $500m	623	72.1%	4.7	3.0	50.86%	53.61%
$500m to $1b	591	80.8%	5.8	4.0	57.90%	67.08%
More than $1b	1,296	100.0%	10.4	9.0	62.04%	72.33%

*Source: Public data includes 6,754 companies from Vickers, I/B/E/S and Compustat as of December 31, 2004. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted by revenue using end of fiscal year data from Compustat as of March 31, 2005. Institutional holdings from Vickers are from Form 13(f) filings. The number of sell-side analysts is the number of 1-year ahead earnings forecasts as of December 2004. Missing values for institutional holdings and number of analysts are set equal to zero. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 22
Audit Fees in Millions of Dollars, by Revenue
End of Fiscal Year 2004*

Revenue	Average Number of Companies Per Year	Percent Of Average Number of Companies Per Year	Median Audit Fee (in millions)					Median Yearly Percent Change in Audit Fee			
			2000	2001	2002	2003	2004	2001	2002	2003	2004
Up to $ 1m	436	4.5%	$0.05	$0.05	$0.03	$0.03	$0.03	6.09%	13.81%	10.42%	16.79%
$ 1m to $ 2m	144	1.5%	0.06	0.06	0.05	0.05	0.05	0.00%	12.45%	10.34%	11.48%
$ 2m to $ 5m	203	2.1%	0.05	0.05	0.04	0.05	0.05	4.18%	9.80%	6.67%	9.08%
$ 5m to $ 10m	457	4.7%	0.06	0.05	0.05	0.06	0.06	2.67%	7.77%	10.96%	11.43%
$ 10m to $ 20m	561	5.7%	0.07	0.06	0.07	0.07	0.08	3.92%	11.22%	12.05%	11.07%
$ 20m to $ 50m	892	9.1%	0.09	0.09	0.10	0.11	0.13	3.96%	14.67%	13.55%	16.08%
$ 50m to $100m	657	6.7%	0.13	0.13	0.17	0.20	0.28	6.43%	16.33%	17.17%	32.66%
$100m to $250m	791	8.1%	0.18	0.19	0.27	0.30	0.49	8.38%	24.06%	18.01%	51.94%
$250m to $500m	576	5.9%	0.27	0.29	0.39	0.45	0.80	13.81%	26.08%	20.40%	74.96%
$500m to $1b	497	5.1%	0.35	0.41	0.59	0.69	1.11	12.73%	26.97%	18.88%	74.70%
More than $1b	1,071	11.0%	1.00	1.22	1.52	1.80	2.64	19.03%	24.21%	20.65%	53.30%
Not available	3,485	35.7%	0.12	0.08	0.04	0.04	0.04	7.47%	8.28%	8.89%	7.56%

*Source: Public data includes 48,845 observations on an average of 9,769 companies per year from 2000 to the end of the fiscal year 2004 from AuditAnalytics.com. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted by revenue in each year using data from AuditAnalytics.com. Audit fee is defined as the sum of the variables Audit fee and Audit-Related fee provided by Audit Analytics and does not include other non-audit related fees such as Benefit Plan Related Fees, Tax Related Fees, or other Non-Audit Fees. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 23
Audit Fees as a Percent of Market Capitalization, by Revenue
End of Fiscal Year 2004*

Revenue	Average Number of Companies Per Year	Percent Of Average Number of Companies Per Year	Median Audit Fee/Market Capitalization					Median Yearly Percent Change in Audit Fee/Market Capitalization			
			2000	2001	2002	2003	2004	2001	2002	2003	2004
Up to $ 1m	436	4.5%	0.20%	0.33%	0.86%	0.39%	0.41%	0.053%	0.280%	-0.299%	0.031%
$ 1m to $ 2m	144	1.5%	0.29%	0.35%	0.61%	0.40%	0.40%	0.027%	0.060%	-0.170%	0.032%
$ 2m to $ 5m	203	2.1%	0.23%	0.28%	0.57%	0.44%	0.45%	0.006%	0.042%	-0.097%	0.002%
$ 5m to $ 10m	457	4.7%	0.32%	0.35%	0.45%	0.33%	0.29%	0.011%	0.028%	-0.040%	0.002%
$ 10m to $ 20m	561	5.7%	0.22%	0.22%	0.31%	0.22%	0.24%	-0.001%	0.013%	-0.033%	0.000%
$ 20m to $ 50m	892	9.1%	0.19%	0.19%	0.23%	0.17%	0.19%	-0.002%	0.015%	-0.027%	0.002%
$ 50m to $100m	657	6.7%	0.15%	0.15%	0.23%	0.16%	0.21%	-0.003%	0.026%	-0.023%	0.010%
$100m to $250m	791	8.1%	0.11%	0.10%	0.16%	0.12%	0.18%	0.000%	0.022%	-0.015%	0.022%
$250m to $500m	576	5.9%	0.07%	0.09%	0.13%	0.12%	0.16%	0.001%	0.022%	-0.005%	0.024%
$500m to $1b	497	5.1%	0.05%	0.06%	0.10%	0.09%	0.13%	0.002%	0.017%	-0.003%	0.020%
More than $1b	1,071	11.0%	0.04%	0.04%	0.06%	0.06%	0.08%	0.004%	0.009%	-0.002%	0.010%
Not available	3,485	35.7%	0.11%	0.28%	0.43%	0.22%	0.21%	0.015%	0.030%	-0.017%	0.002%

*Source: Public data includes 48,845 observations on an average of 9,769 companies per year from 2000 to the end of the fiscal year 2004 from AuditAnalytics.com. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted by revenue in each year using data from AuditAnalytics.com. Audit fee is defined as the sum of the variables Audit fee and Audit-Related fee provided by Audit Analytics and does not include other non-audit related fees such as Benefit Plan Related Fees, Tax Related Fees, or other Non-Audit Fees. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 24

Audit Fees as a Percent of Revenue, by Revenue

End of Fiscal Year 2004*

Revenue	Average Number of Companies Per Year	Percent Of Average Number of Companies Per Year	Median Audit Fee/Revenue 2000	2001	2002	2003	2004	Median Yearly Percent Change in Audit Fee/Revenue0 2001	2002	2003	2004
Up to $ 1m	436	4.5%	16.62%	20.20%	18.88%	20.28%	24.66%	2.925%	4.081%	2.951%	1.665%
$ 1m to $ 2m	144	1.5%	3.92%	3.57%	3.19%	3.33%	3.51%	0.100%	0.945%	0.171%	0.003%
$ 2m to $ 5m	203	2.1%	1.60%	1.89%	1.59%	1.83%	1.71%	0.162%	0.224%	0.018%	0.006%
$ 5m to $ 10m	457	4.7%	0.92%	0.80%	0.83%	0.88%	1.03%	-0.043%	0.068%	0.054%	0.034%
$ 10m to $ 20m	561	5.7%	0.46%	0.42%	0.46%	0.51%	0.55%	0.008%	0.052%	0.030%	0.015%
$ 20m to $ 50m	892	9.1%	0.27%	0.27%	0.32%	0.35%	0.43%	0.008%	0.039%	0.020%	0.032%
$ 50m to $100m	657	6.7%	0.18%	0.18%	0.23%	0.28%	0.39%	0.007%	0.028%	0.021%	0.047%
$100m to $250m	791	8.1%	0.12%	0.12%	0.18%	0.20%	0.31%	0.007%	0.031%	0.015%	0.066%
$250m to $500m	576	5.9%	0.08%	0.08%	0.11%	0.13%	0.23%	0.010%	0.017%	0.011%	0.066%
$500m to $1b	497	5.1%	0.05%	0.06%	0.08%	0.10%	0.16%	0.005%	0.012%	0.007%	0.046%
More than $1b	1,071	11.0%	0.03%	0.04%	0.05%	0.05%	0.08%	0.004%	0.007%	0.004%	0.017%
Not available	3,485	35.7%									

*Source: Public data includes 48,845 observations on an average of 9,769 companies per year from 2000 to the end of the fiscal year 2004 from AuditAnalytics.com. Includes companies for which relevant data are available and excludes ADRs. Companies are sorted by revenue in each year using data from AuditAnalytics.com. Audit fee is defined as the sum of the variables Audit fee and Audit-Related fee provided by Audit Analytics and does not include other non-audit related fees such as Benefit Plan Related Fees, Tax Related Fees, or other Non-Audit Fees. This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Table 25
Material Weaknesses, by Revenue
June 2005*

Revenue	Number Of Firms	Number of Firms with Material Weaknesses	Number of Firms without Material Weaknesses	Percent of Firms with Material Weaknesses	Mean Audit Fees (in millions) With Material Weakness	Mean Audit Fees (in millions) Without Material Weakness	Mean Percent Difference	Median Audit Fees (in millions) With Material Weakness	Median Audit Fees (in millions) Without Material Weakness	Median Percent Difference
Up to $ 1m	30	5	25	16.7%	$0.16	$0.34	-52.6%	$0.08	$0.31	-74.6%
$ 1m to $ 2m	13	2	11	15.4%	0.22	0.33	-34.5%	0.22	0.32	-33.0%
$ 2m to $ 5m	13	3	10	23.1%	0.54	0.44	22.6%	0.44	0.37	18.9%
$ 5m to $ 10m	33	4	29	12.1%	0.52	0.44	18.1%	0.61	0.39	58.7%
$ 10m to $ 20m	53	7	46	13.2%	0.60	0.45	34.0%	0.45	0.42	7.9%
$ 20m to $ 50m	183	31	152	16.9%	0.54	0.33	62.3%	0.41	0.25	60.6%
$ 50m to $100m	280	41	239	14.6%	0.85	0.49	72.2%	0.85	0.40	111.6%
$100m to $250m	420	63	357	15.0%	1.26	0.80	57.0%	1.01	0.68	49.3%
$250m to $500m	387	55	332	14.2%	1.58	1.20	31.4%	1.28	1.00	27.8%
$500m to $1b	394	53	341	13.5%	2.09	1.50	39.2%	1.78	1.25	42.1%
More than $1b	935	86	849	9.2%	8.46	5.52	53.1%	4.34	3.16	37.1%
Not available	166	17	149	10.2%	1.51	1.83	-17.1%	0.74	0.60	22.8%
Total	2,907	367	2,540	12.6%						

*Source: Public data includes 2,907 companies from AuditAnalytics.com as of June 30, 2005. Includes companies for which audit fee data are available. Companies are sorted in market capitalization sizes based on revenue provided by AuditAnalytics.com. The original dataset includes a total of 3,088 firms that report on the status of their internal controls. Two firms are excluded because they did not report their status and one observation is repeated. The breakdown of the data is as follows:

Total number of companies reporting on the status of internal controls 3,085

- Number of companies reporting no material weakness 2,687 (87.1%)
- Number of companies reporting a material weakness 398 (12.9%)

Total number of companies reporting on the status of internal controls AND audit fees 2,907

- Number of companies reporting no material weakness AND audit fees 2,540 (87.4%)
- Number of companies reporting a material weakness AND audit fees 367 (12.6%)

This table was compiled by members of the staff of the SEC Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the SEC staff.

Appendix J

Universe of Publicly-Traded Equity Securities and Their Governance

To fully understand how and to whom the Committee's recommendations will be applicable, it is important to understand the universe of publicly-traded equity securities. We start with the following:

Table 1
Distribution of Companies, by Listing Venue
March/June 2005*

Listing Venue	Total Market Capitalization (in billions)	Percent of Companies By Market Capitalization	Average Market Capitalization (in millions)	Median Market Capitalization (in millions)	Number of Companies Listed	Percent of Number of Companies
NYSE	$13,192	75.2%	$5,167.2	$1,041.3	2,553	19.5%
AMEX	370	2.1%	495.6	63.3	747	5.7%
Nasdaq NMS	3,104	17.7%	1,203.0	251.2	2,580	19.7%
Nasdaq Small Cap	38	0.2%	64.5	34.4	593	4.5%
OTC Bulletin Board	187	1.1%	63.4	9.1	2,955	22.6%
Pink Sheets	659	3.8%	179.8	0.05	3,666	28.0%
Total	$17,550				13,094	

*Source: Public data includes 13,094 companies from CRSP for NYSE and AMEX firms as of March 31, 2005 and from NASDAQ for NASDAQ and OTC Bulletin Board firms and from Datastream for Pink Sheets as of June 10, 2005. Includes companies with a total market capitalization of $17,550 billion listed on the NYSE, AMEX, and NASDAQ, and quoted on OTC Bulletin Board and Pink Sheets for which market capitalizations are reported through those sources. This table was compiled by members of the staff of the Office of Economic Analysis and does not necessarily reflect the views of the Commission, the Commissioners, or other members of the staff.

*   *   *

Explanation of Pink Sheet Data

The source of the market capitalization data for Pink Sheets is Datastream. Datastream explains the sources of their data as follows: "Most equity market data derives in the first instance from individual stock markets. Datastream generally obtains this data through intermediary carriers, market specialists, and by direct feed from some stock exchanges." Firms for which market capitalization is missing are deleted. The sample excludes preferred stock, warrants, certificates, limited partnerships and notes. The sample includes domestic and foreign common stock, ADRs, units, and REITS. Multiple classes of common stock issued by the same issuer are aggregated. The sample includes 61 ADRs and GDRs (1.7% of all pink sheet firms) with an aggregate market capitalization of $582 billion (88% of the total market capitalization). Additionally, there are 77 foreign common stock issues (2.1% of the total) with an aggregate market capitalization of $12.2 billion (1.9% of the total) and 278 firms in bankruptcy (7.6% of the total) with an aggregate market capitalization of $1.16 billion (0.2% of the total).

*   *   *

The next step in analyzing this data is to understand the federal securities law and self-regulatory organizations ("SROs") regulation of these securities. First, to trade on a national securities exchange or the Nasdaq NMS or small cap venues, the issuer must register these securities under Sections 12(b) or 12(g) of the Exchange Act. This means that the issuer (and its insiders) are subject to the periodic reporting requirements, the insider trading and recapture provisions and the proxy rules adopted by the SEC under the Exchange Act. Moreover, as a precondition to listing on these exchanges and trading venues, each of the SROs requires that the issuers comply with various governance requirements concerning, among other things, they have a majority of independent directors and independent audit, compensation and nominating committees, etc.

With respect to the OTCBB, however, issuers where equity securities are traded thereon do not have to be registered with the SEC under Sections 12(b) or 12(g) of the Exchange Act but they do have to be subject to the periodic reporting requirements of the Exchange Act. If companies listed on the OTCBB become delinquent in their filings of periodic reports with the SEC, the rules of the OTCBB require delisting.

The Pink Sheets have very little regulation or governance requirements. The issuers whose securities trade on the Pink Sheets do not have to be current in their SEC filings even if such filing requirements are applicable to them. Essentially, the only federal regulatory oversight is Rule 15c2-11 under the Exchange Act which requires broker-dealers to have certain information in their possession before they can initiate quotes in the company's securities. The Committee is recommending that Rule 15c2-11 be amended to provide that the information the broker-dealer has be available to the public, which is not the case now.

The Pink Sheets provide a valuable liquidity venue for shareholders of issuers whose securities who have been delisted because, for example, of a bankruptcy or delinquent SEC filings. Without the Pink Sheets, the equity holders in these companies would have nowhere to trade their stock. While the Pink Sheets are subject to very little government regulation, they do encourage the companies that are traded on their venue to provide public information and they have recently proposed an enhanced disclosure process for companies who wish to take advantage of this process. See their web site: www.pinksheets.com. To learn about the Pink Sheets, see the testimony of Cromwell Coulson, CEO of the Pink Sheets, in our June 16, 2005 New York hearings, and the testimony of Professor Michael Molitor in our August 9, 2005 hearings in Chicago. Moreover, Professor Molitor has submitted to the Committee an article to be published in a forthcoming issue of The Indiana Law Journal, entitled "Will More Sunlight Fade the Pink Sheets."

Appendix K

Witnesses Who Testified Before

SEC Advisory Committee on Smaller Public Companies

June 17, 2005

R. Daniel Blanton, Chief Executive Officer and President, Georgia Bank Financial Corporation (testifying on behalf of American Bankers Association), Augusta, Georgia

William J. Carney, Charles Howard Candler Professor of Law, School of Law, Emory University, Atlanta, Georgia

R. Cromwell Coulson, Chief Executive Officer, Pink Sheets LLC, New York, New York

Gayle Essary, Chief Executive Officer, Investrend Communications, Inc., New York, New York

David N. Feldman, Managing Partner, Feldman Weinstein LLP, New York, New York

Edward S. Knight, Executive Vice President and General Counsel, The Nasdaq Stock Market, Inc., New York, New York

Wayne A. Kolins, National Director of Assurance and Chairman of the Board, BDO Seidman, LLP; Executive Committee Member, Center for Public Company Audit Firms, American Institute of Certified Public Accountants, New York, New York

Bill Loving, Chief Executive Officer and Executive Vice President, Pendleton County Bank, Franklin, West Virginia (testifying on behalf of Independent Community Bankers of America)

John P. O'Shea, President, Westminster Securities Corp., New York, New York

Alan Patricof, Co-Founder, Apax Partners, New York, New York

Michael Taglich, Co-Founder, President, and Chairman, Taglich Brothers, Inc.

Neal L. Wolkoff, Chairman and Chief Executive Officer, American Stock Exchange LLC, New York, New York

August 9, 2005

David Bochnowski, Chairman and Chief Executive Officer, Peoples Bank, Munster, Indiana (testifying on behalf of the America's Community Bankers)

James P. Hickey, Principal, Co-Head of Technology Group, William Blair & Company, Chicago, Illinois

Michael K. Molitor, Law Professor, Thomas M. Cooley Law School, Grand Rapids, Michigan

Donald S. Perkins, former Chair, Jewel Companies Inc., experienced public company director, Chicago, Illinois

Mark Schroeder, Chief Executive Officer, German American Bancorp, Jasper, Indiana

Mark T. Spears, Chief Financial Officer, LKQ Corporation, Chicago, Illinois

Joseph A. Stieven, Financial Analyst, Stifel Nicolaus, St. Louis, Missouri

Bill Travis, Managing Partner, McGladery & Pullen LLP, Minneapolis, Minnesota

September 19, 2005

Chris Ailman, Chief Investment Officer, California State Teachers Retirement System, Sacramento, California

Charles L. Bennett, Senior Vice President, Financial Services Practice Group, Intercom Consulting and Federal Systems, Inc., Berwyn, Pennsylvania

Brian T. Borders, Borders Law Group, Washington, D.C.

Ralph V. De Martino, Member, Cozen O'Connor, Washington, D.C.

Irwin Federman, General Partner, U.S. Venture Partners, Menlo Park, California

Kenneth Hahn, Senior Vice President, Chief Financial Officer, Borland Software Corporation, Cupertino, California

Bill Hambrecht, Founder, Chairman and Chief Executive Officer, W.R. Hambrecht + Co., San Francisco, California

Jon Hickman, Vice President, Equity Research—Technology, MDB Capital Group LLC, Santa Monica, California

Lance Jon Kimmel, SEC Law Firm, Los Angeles, California

Michael McConnell, Managing Director, Shamrock Capital Advisors, Burbank, California

Marc H. Morgenstern, Managing Partner, Kahn Kleinman, LPA, Cleveland, Ohio

Gerald V. Niesar, Partner, Niesar Curls Bartling LLP, San Francisco, California

Donald C. Reinke, Partner, Reed Smith, Oakland, California

Lynn E. Turner, Managing Director of Research, Glass, Lewis & Co., LLC, San Francisco, California

Richard Ueltschy, Executive, Crowe Chizek and Company LLC, Louisville, Kentucky

Ann Y. Walker, Partner, Wilson Sonsini Goodrich & Rosati, Palo Alto, California

September 20, 2005

Larry E. Rittenberg, Chairman, Committee of Sponsoring Organizations of the Treadway Commission (COSO), Madison, Wisconsin

October 14, 2005

Jane Adams, Maverick Capital Ltd., New York, New York

Tom Duncan, Frontier Capital Management Co., Boston, Massachusetts

William Miller, Ohio Public Employees Retirement System, Columbus, Ohio

Thomas A. Russo, Gardner, Russo & Gardner, Lancaster, Pennsylvania

Judith Vale, Neuberger Berman Genesis Fund, New York, New York

Gerald I. White, Grace & White, Inc., New York, New York

Martin J. Whitman, Third Avenue Management, LLC, New York, New York

numbers not an integral part of the statement are inserted into it.

Question 3: May revenues on a tax equivalent adjusted basis be included in selected financial data?

Interpretive Response: Revenues may be included in selected financial data on a tax equivalent basis if the respective captions state which amounts are tax equivalent adjusted and if the corresponding unadjusted amounts are also reported in the selected financial data.

Because of differences among registrants in making the tax equivalency computation, a brief note should describe the extent of recognition of exemption from Federal, state and local taxes and the combined marginal or incremental rate used. Where net operating losses exist, the note should indicate the nature of the tax equivalency adjustment made.

Question 4: May information adjusted to a tax equivalent basis be included in management's discussion and analysis of financial condition and results of operations?

Interpretive Response: One of the purposes of management's discussion and analysis is to enable investors to appraise the extent that earnings have been affected by changes in business activity and accounting principles or methods. Material changes in items of revenue or expense should be analyzed and explained in textual discussion and statistical tables. It may be appropriate to use amounts or to present yields on a tax equivalent basis. If appropriate, the discussion should include a comment on material changes in investment securities positions that affect tax exempt interest income. For example, there might be a comment on a change from investments in tax exempt securities because of the availability of net operating losses to offset taxable income of current and future periods, or a comment on a change in the quality level of the tax exempt investments resulting in increased interest income and risk and a corresponding increase in the tax equivalent adjustment.

Tax equivalent adjusted amounts should be clearly identified and related to the corresponding unadjusted amounts in the financial statements. A descriptive note similar to that suggested to accompany adjusted amounts included in selected financial data should be provided.

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17 CFR Part 241

[Release No. 34-17500]

Foreign Corrupt Practices Act of 1977

AGENCY: Securities and Exchange Commission.

ACTION: Statement of policy.

SUMMARY: The Commission's policy regarding the Foreign Corrupt Practices Act of 1977 is set forth in an address by Chairman Harold M. Williams, entitled "The Accounting Provisions of the Foreign Corrupt Practices Act: An Analysis," which was given before the SEC Developments Conference of the American Institute of Certified Public Accountants.

FOR FURTHER INFORMATION CONTACT: Mark B. Goldfus, Special Counsel to the Chairman, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549, (202) 272-2178.

SUPPLEMENTARY INFORMATION: On January 13, 1981, Chairman Harold M. Williams presented an address, "The Accounting Provisions of the Foreign Corrupt Practices Act: An Analysis," to the SEC Developments Conference of the American Institute of Certified Public Accountants. This address was presented with the concurrence of all members of the Commission and constitutes the Commission's policy regarding the matters discussed therein. Accordingly, 17 CFR Part 241 is amended by adding reference to this statement of policy thereto. The text of Chairman Williams' address follows.

By the Commission.
George A. Fitzsimmons,
Secretary.
January 29, 1981.

TEXT OF CHAIRMAN WILLIAMS' ADDRESS

It is a pleasure to again address the AICPA's SEC Developments Conference. In a departure from my talks of prior years—in which I generally surveyed a broad spectrum of current developments—today I will devote my remarks solely to one major auditing development of recent years: the accounting provisions of the Foreign Corrupt Practices Act of 1977. The Act last month had its third anniversary. The time has come to apply the experience we now have in administering, and complying with, the Act to resolving the issues it has raised.

When viewed from an abstract perspective, the Act's accounting provisions seem merely to codify a basic and uncontroversial management principle: No enterprise of any size can operate successfully without maintaining effective controls over its transactions and the disposition of its assets. Perhaps in part because these provisions were considered truisms, the Act was passed without Congressional dissent.

However, practical experience with new legislation—even a law thought to be noncontroversial—often will reveal unanticipated problems. Newly enacted standards, for example, may be subject to differing constructions or raise compliance difficulties and ambiguities unforeseen by their draftsmen. And, until these problems are resolved by an agency, the courts or the Congress, those who are subject to these laws are often faced, unfortunately, with some disquieting circumstances.

The anxieties created by the Foreign Corrupt Practices Act—among men and women of utmost good faith—have been, in my experience, without equal. This consteration can be attributed, in significant part, to the spectre which some commentators have raised of exposure to Commission enforcement action, and perhaps criminal liability, as a result of technical and insignificant errors in corporate records or weaknesses in corporate internal accounting controls. In fact, some commentators claim that, because of the broad strokes with which the accounting provisions are fashioned, no corporate executive can ever feel fully confident that his corporation is in compliance with the law. And, other commentators have expressed fear that this lack of concrete statutory parameters evidences a meaning to the Act which is far beyond its Congressional intent.

Such uncertainty can have a debilitating effect on the activities of those who seek to comply with the law. My sense is that, as a consequence, many businesses have been very cautious-sometimes overly so—in assuring at least technical compliance with the Act. And, therefore, business resources may have been diverted from more productive uses to overly-burdensome compliance systems which extend beyond the requirements of sound management or the policies embodied in the Act. The public, of course, is not well served by such reactions.

The Commission is sensitive to these concerns and considerations. The goal is to allow a business, acting in good faith, to comply with the Act's accounting provisions in an innovative and cost-effective way and with a better sense of its legal responsibilities. I have conferred, accordingly, with my colleagues before presenting these remarks, and they have authorized me to advise you that these remarks

constitute a statement of the Commission's policy.

I will begin with a summary of the Commission's analysis.

—Recordkeeping. The Act's recordkeeping provision requires that a company maintain records which reasonably and fairly reflect the transactions and dispositions of the company's assets. This provision is intimately related to the requirement for a system of internal accounting controls, and we believe that records which are not relevant to accomplishing the objectives specified in the statute for the system of internal controls are not within the purview of the recordkeeping provision. Moreover, inadvertent recordkeeping mistakes will not give rise to Commission enforcement proceedings; nor could a company be enjoined for a falsification of which its management, broadly defined, was not aware and reasonably should not have known.

—Internal accounting controls system. The Act does not mandate any particular kind of internal controls system. The test is whether a system, taken as a whole, reasonably meets the statute's specified objectives. "Reasonableness," a familiar legal concept, depends on an evaluation of all the facts and circumstances.

—Deference. Private sector decisions implementing these statutory objectives are business decisions. And, reasonable business decisions should be afforded deference. This means that the issuer need not always select the best or the most effective control measure. However, the one selected must be reasonable under all the circumstances.

—State of mind. The accounting provisions principal objective is to reach knowing or reckless conduct. Moreover, we would expect that the courts will issue injunctions only when there is a reasonable likelihood that the misconduct would be repeated. In the context of the accounting provisions, that showing is not likely to be possible when the conduct in question is inadvertent.

—Status of subsidiaries. The issuer's responsibility for the compliance of its subsidiaries varies according to the issuer's control of the subsidiary. The Commission has established percentage of ownership tests to afford guidance in this area.

—Enforcement policy. These views reflect Commission policy and practice in implementing and enforcing the accounting provisions and are consistent with the cases brought by the Commission over the last three years. During this period, the Commission has addressed these areas prudently and with common sense. Similarly, the Commission has not sought out violations of the accounting provisions for their own sake; indeed, we have not chosen to bring a single case under these provisions that did not also involve other violations of law. The Commission, instead, places its greatest emphasis on encouraging an environment in which the private sector can meet its responsibilities in complying with the Act meaningfully and creatively. In that connection, the Commission has adopted enforcement policies in furtherance of this policy that I will discuss in a few moments.

I will now amplify on each of these thoughts.

Purposes of the Act

At the outset of this analysis, it is worthwhile to consider briefly the events which led to the Foreign Corrupt Practices Act—not because the abuses which led to its enactment were representative of the entire business community, but rather to put the Act in the proper context. As most will recall, during the mid-1970s the existence of a pattern of questionable payments to foreign government officers by prominent American corporations became public knowledge. These disclosures—often in bold headlines—shook faith and trust in the integrity of our corporate sector. This reaction became part of a rising tide of public skepticism and served further to undermine the traditional American consensus that business conducts itself and reasonably pursues its own economic interests in a manner consistent with the standards and expectations of the larger society. In this climate, Congress felt compelled to act. And, after nearly three years of hearings and debate, the Foreign Corrupt Practices Act became law.

New Section 13(b)(2) of the Securities Exchange Act of 1934 is a product of this legislative process. It establishes two interrelated accounting requirements: First, public companies are required to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions" of their assets. Second, corporations are also required to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that certain specified objectives are attained. In essence, these objectives are that assets be safeguarded from unauthorized use, that corporate transactions conform to managerial authorizations, and that records be accurate.

Some commentators have argued that the Act's title is a misnomer. Clearly, Congress went further than determining whether the payments which gave the new law its name were ethically and commercially justifiable. It also chose to consider the corporate accounting and control deficiencies which had been breeding grounds for these practices. And, by doing so, it addressed the far more serious issues raised by these disclosures.

As the Commission's 1976 report to Congress on questionable payments stated:

> The most devastating disclosure that we have uncovered in our recent experience with illegal or questionable payments has been the fact that, and the extent to which, some companies have falsified entries in their own books and records.

These payment and falsifications were not only previously unknown to public investors and independent auditors, but many were also unknown to the payor's board and, in numerous examples, even to its senior management. In some of these instances, internal controls existed, but they were shown to be ineffective or easily subverted. Unauthorized payments and related falsifications of corporate records seemed to evidence—indeed, were fostered by—a lack of adequate accounting records and controls. Consequently, in the legislation which ultimately emerged from Congress, prohibiting questionable payments and mandating control and recordkeeping were inexorably interconnected.

In enacting these accounting provisions, Congress did not change the government's role with respect to accounting or auditing matters—nor was the Commission authorized to prescribe corporate records such as it may for such regulated entities as broker-dealers and investment companies. Instead, Congress determined that the federal interest in corporate recordkeeping is satisfied if it assures that corporate transactions are recorded—in the words of the Act's Conference Report—"in conformity with accepted methods of recording economic events." Such procedures, the Conference Report declared, "should effectively prevent off-the-books slush funds and payments of bribes." Meaningful accounting controls, the Committee added, "provide reasonable assurances, among other things, that transactions are recorded as necessary to maintain accountability for assets."

Statute or no, these are, of course, inherent obligations of the stewardship

of a public corporation. The standards embodied in the Act's accounting provisions are, in effect, the cardinal principles of managing a business enterprise. Among members of the business community, few would dispute that acceptable management cannot be achieved absent such records and controls.

In that sense, this is hardly the stuff of radical legislation. The Act's accounting provisions endorsed and incorporated accepted private-sector standards; such an approach does not suggest an intent to markedly affect the operations of the great number of companies which already had such procedures in effect.

The primary thrust of the Act's accounting provisions, in short, was to require those public companies which lacked effective internal controls or tolerated unreliable recordkeeping to comply with the standards of their better managed peers. *That* is the context in which these provisions should be construed.

The Act's Accounting Requirements

With this in mind, it is possible to resolve many of the interpretative questions concerning the accounting provisions which commentators and practitioners have raised in recent years. I will now address four of the most important: first, the degree of exactitude in recordkeeping mandated by the Act; second, the deference it affords business decisions concerning internal controls; third, whether a particular state of mind is necessary for a violation to exist; and, finally, liability for compliance by subsidiaries.

Degree of Exactitude

I turn first to the question of whether the Act's text of purpose mandates that business records and controls conform to a standard of absolute exactitude or that a company's control system meet some absolute ideal. The answer is "no." Both of the Act's accounting provisions, it should be noted, are modified by the key term "reasonable." That is, a public company's records must, "in *reasonable* detail, accurately and fairly reflect" disbursements of its assets. And, its internal accounting controls must be "sufficient to provide *reasonable* assurances" that the provision's objectives will be satisfied. In essence, therefore, the Act does provide a *de minimus* exemption, though not in absolute, quantitative terms.

Many persons, however, have not been comfortable with such a fluid legal standard. Indeed, it is the lack of more specific guidelines which, since the Act became law, seems to have generated the greatest concern. Some commentators regard the Act's accounting provisions as excessively vague. And, to resolve this perceived problem, suggestions have been made to qualify these provisions by superimposing a "materiality" test on the requirement that corporate records be accurate and on the scope of the internal controls provision.

Such a test, in fact, was advocated by a number of persons when Congress was deliberating the Act. Despite these suggestions, however, Congress determined not to incorporate such a limitation. It was correct in doing so. Internal accounting controls are not only concerned with misconduct that is material to investors, but also with a great deal of misconduct which is not.

True, materiality is a concept with which managers of public companies, accountants, and lawyers are experienced and feel relatively comfortable. For almost 50 years, it has served as the standard for determining whether, under the federal securities laws, a particular matter must be disclosed to the investing public.

But, materiality, while appropriate as a threshold standard to determine the necessity for disclosure to investors, is totally inadequate as a standard for an internal control system. It is too narrow—and thus too insensitive—an index. For a particular expenditure to be material in the context of a public corporation's financial statements—and therefore in the context of the size of the company—it would need to be, in many instances, in the millions of dollars. Such a threshold, of course, would not be a realistic standard. Procedures designed only to uncover deficiencies in amounts material for financial statement purposes would be useless for internal control purposes. Systems which tolerated omissions or errors of many thousands or even millions of dollars would not represent, by any accepted standard, adequate records and controls. The off-book expenditures, slush funds, and questionable payments that alarmed the public and caused Congress to act, it should be remembered, were in most instances of far lesser magnitude than that which would constitute financial statement materiality.

Reasonableness, rather than materiality, is the appropriate test. Reasonableness, as standard, allows flexibility in responding to particular facts and circumstances. Inherent in this concept is a toleration of deviations from the absolute. One measure of the reasonableness of a system relates to whether the expected benefits from improving it would be significantly greater than the anticipated costs of doing so. Thousands of dollars ordinarily should not be spent conserving hundreds. Further, not every procedure which may be individually cost-justifiable need be implemented; the Act allows a range of reasonable judgments.

The touchstone of this analysis is the judgment of company management. Many managerial requirements are common to all companies. The most obvious illustration of this principle is that every public company needs to establish and maintain records of sufficient accuracy to meet adequately four interrelated objectives: Appropriate reflection of corporate transactions and the disposition of assets; effective administration of other facets of the issuer's internal controls system; preparation of its financial statements in accordance with generally accepted accounting principles; and proper auditing. Thus, for all practical purposes, the adequacy of a company's control system is bounded by the adequacy of its underlying books and records.

In fact, because accurate records are so crucial to these objectives, Congress chose to incorporate a specific recordkeeping requirement into the Act. But, this provision is not an independent and unrestrained mandate to the Commission to establish novel or unprecedented corporate recordkeeping standards; it is, rather, an integral part of Congress' efforts to assure that the business community records transactions and assets in such a way as to maintain adequate control over them. And, this leads to two important conclusions: First, the Act does *not* establish any absolute standard of exactitude for corporate records. And, second, records which are not related to internal or external audits or to the four internal control objectives set forth in the Act are not within the purview of the Act's accounting provisions.

More specific managerial objectives, of course, will vary from company to company. Some companies, by their very nature, have unusual control needs. A company's management requirements may be influenced by such factors as its line of business and prior control problems. A company whose inventory consists of precious metals or jewels would require more sophisticated inventory records and controls than, for example, a dealer in cement. And, in other companies, the frequency with which relatively small losses occur from a common source may require that these losses be considered, in the aggregate, as a significant managerial problem.

Deference

This, in turn, raises questions regarding the extent to which there should be issuer liability for false books and records and the measure of deference the courts and the Commission should afford to management decisions concerning the structure of the company's internal accounting controls. With respect to issuer liability for recordkeeping violations, we will look to the adequacy of the internal control system of the issuer, the involvement of top management in the violation, and the corrective actions taken once the violation was uncovered. If a violation was committed by a low level employee, without the knowledge of top management, with an adequate system of internal control, and with appropriate corrective action taken by the issuer, we do not believe that any action against the company would be called for.

Turning to the controls question, there is an almost infinite variety of control devices which could be utilized in a particular business environment. Thus, considerable deference properly *should* be afforded to the company's reasonable business judgments in this area. The purpose of the internal accounting control provisions, after all, is to assure that a public company adopts accepted methods of recording economic events, safe-guarding assets, and conforming transactions to management's authorization. Importantly, the selection and implementation of particular control procedures, so long as they are reasonable under the circumstances, remain management prerogatives and responsibilities.

In this vein, the law long ago determined that it should avoid interfering in reasonable corporate decisionmaking which entails the exercise of good faith judgment concerning routine matters. High societal costs—including lost innovation and vexatious litigation—would result if courts could substitute their judgments for those of business executives concerning such matters. Provided that the reasonable assurances requirement set forth in the statute is met, the Act's accounting provisions, relating as they do to matters of internal corporate conduct and management, justify such deference to decisions regarding corporate records and control mechanisms; certainly nothing in the Act mandates a different standard of review.

This concept is not a mandate for board—or even most senior management—involvement in the minutia of recording and accounting for every transaction which the company may make. But, it does mean that both management and the board have important roles to play in monitoring and evaluating the adequacy of the company's records and controls systems.

This standard is not satisfied if a company's leadership, while making nominal gestures of compliance, abdicates its responsibilities to foster integrity among those who operate the system. Regardless of how technically sound an issuer's controls are, or how impressive they appear on paper, it is unlikely that control objectives will be met in the absence of a supportive environment. In the last analysis, they key to an adequate "control environment" is an approach on the part of the board and top management which makes clear what is expected, and that conformity to these expectations will be rewarded while breaches will be punished.

State of Mind

Now let us turn to the question of the state of mind needed to violate the Act's accounting provisions. It is, first of all, important to recognize that nothing in the Congressional objectives of the accounting provisions requires that inadvertent recordkeeping inaccuracies be treated as violations of the Act's recordkeeping provision. The Act's principal purpose is to reach knowing or reckless misconduct. It is probable that an injunction will be issued by a court only upon a showing of some likelihood of repetition of misconduct; this remedy would not be expected to be available upon a showing of only past inadvertent conduct. Moreover, depending on the circumstances, intentional circumventions of a company's system of records and of accounting controls by a low-level employee would not always be considered violations of the Act by the issuer. No system of adequate records and controls—no matter how effectively devised or conscientiously applied—could be expected to *prevent* all mistaken and improper transactions and dispositions of assets. Given human nature, regardless of the adequacy of the system, a bookkeeper may still erroneously post entries, an overzealous agent may make unauthorized payments, or an unscrupulous employee may falsify records for his own purposes.

The Act recognizes each of these limitations. Neither its text and legislative history nor its purposes suggest that occasional, inadvertent errors were the kind of problem that Congress sought to remedy in passing the Act. No rational federal interest in punishing insignificant mistakes has been articulated. And, the Act's accounting provisions do not require a company or its senior officials to be the guarantors of all conduct of company employees.

A failure to correct a known falsification—or a falsification that reasonably should be known—or any attempt to cover-up a falsification—is, of course, prohibited. But, this responsibility arises only when the individual in question is in some respect responsible for the records or controls, or otherwise supervises the activity giving rise to the violation. Similarly, there can be no relaxation of the proscription against the creation or maintenance of any fund that is designed to be used for "off-books" payments outside the issuer's system of internal accounting control, or against obstructing or circumventing in any significant respect the issuer's system of internal controls by misstatement to auditors or related means.

The test of a company's control system is not whether occasional failings can occur. Those will happen in the most ideally managed company. But, an adequate system of internal controls means that, when such breaches do arise, they will be isolated rather than systemic, and they will be subject to a reasonable likelihood of being uncovered in a timely manner and then remedied promptly. Barring, of course, the participation or complicity of senior company officials in the deed, when discovery and correction expeditiously follow, no failing in the company's internal accounting system would have existed. To the contrary, routine discovery and correction would evidence its effectiveness.

Subsidiaries

Finally, much concern has been raised about the issuer's liability for compliance with the accounting provisions by its subsidiaries. Where the issuer controls more than 50 percent of the voting securities of the subsidiary, compliance is expected. So, too, would it be expected if there is between 20 percent and 50 percent ownership, subject to some demonstration by the issuer that this does not amount to control. If there is less than 20 percent ownership, we will shoulder the burden to affirmatively demonstrate control.

Responding to Current Developments

While analyses of this sort can diminish the Act's ambiguities, merely making the requirements of the accounting provisions somewhat more concrete should not end our inquiry. The Commission has not ignored meaningful

developments within the private sector itself in the area of corporate accountability. Indeed, it is these developments, rather than the Act, that are the most effective antidotes to the conditions which fostered questionable payments. Let me briefly recount some of these developments:

—Independent directors. The years since the questionable payments disclosures began have witnessed a significant increase in the numbers and responsibilities of directors who are not also part of the company's management. This development is important because independent directors do not face the same short-term performance pressures as do management personnel. They are more likely, therefore, to be sensitive to the negative impact which questionable expediencies have on a company and, indeed, the entire business community. And, independent directors, particularly through the committee system, are playing an increasingly responsible role. The Commission's most recent survey found that 65 percent of directors of public companies are not part of the management of the companies they direct.

—Audit committees. Effective audit committees composed of independent directors are a significant assurance that meaningful internal controls will be established and enforced. In the mid-1970's, few such committees existed. In contrast, the Commission's most recent survey found that 85 percent of public companies now have audit committees, a number that is even higher among major companies.

—Internal auditors. The increasing acceptance of the internal auditor as an important management professional has been yet another major contributor to the quality and credibility of internal accounting control systems. And, while traditionally, internal auditors reported exclusively to more senior management, a recent study indicates that one-third of internal auditors now report directly to the board or the audit committee and that many others have direct access.

—The experience factor. Any new legislation precipitates a learning period among those it affects and a period in which business operations are brought into compliance. In substance, these are a law's start-up costs. During the three years since the enactment of the Foreign Corrupt Practices Act, major efforts have been made by the AICPA and by accounting firms to develop materials and provide guidance to assist managers and directors in establishing, evaluating, and monitoring internal accounting control systems. Many companies have reexamined their internal controls and reevaluated their review programs. It appears that this start-up investment in implementing the Foreign Corrupt Practices Act has been, for most practical purposes, substantially completed; that is, most public companies have now made the adjustments necessary for them to operate within a reasonable reading of the Act.

The Commission's Enforcement Policy

The Commission's overriding policy, in recent years, has been to allow these private-sector initiatives to flower. And, it has administered and enforced the Act's accounting provisions—which share a common accountability purpose with those initiatives—in accordance with this policy.

The genius—and challenge—of these provisions, it should be remembered, is their reliance on private sector decisionmaking—rather than specific federal edicts—to address an area of public concern. The Act's eventual success or failure will, therefore, depend primarily upon business' response. The Commission's obligation, in turn, is to provide a regulatory environment in which the private sector can address these issues meaningfully and creatively. In this regard, we must encourage public companies to develop innovative records and control systems, to modify and improve them as circumstances change, and to correct recordkeeping errors when they occur without a chilling fear of penalty or inference that a violation of the Act is involved.

All new legislation has rough edges that can be polished only by the forces of time and practical experience. To foster the innovative environment which would best effect the Act's purposes, the Commission has addressed these areas through monitoring, constructive criticism, maintaining open lines of communication, and a substantial measure of understanding. The very limited number of enforcement actions which the Commission has undertaken reflect those policies. As I noted earlier, in each of the cases which the Commission has brought under the accounting provisions, these requirements were breached as part of violations of other provisions of the federal securities laws.

Despite these considerations, I recognize, of course, that there is some sentiment that the accounting provisions should be amended. The Commission has not, thus far, taken any position on legislation of that nature. As part of the Commission's own institutional accountability, we would welcome a dialogue with Congress, if it is concerned that our actions or policies do not best serve the public interest or that the reach of the Act should be further clarified.

Conclusion

In conclusion, the Commission is meeting its difficult mandate of administering the accounting provisions of the Foreign Corrupt Practices Act in what we believe is a constructive and pragmatic manner. We have been receptive to—and responsive to—the comments and criticisms of the public, the business community, and the legal and accounting professions. Indeed, we continue to welcome such comments and discussions in light of the private sector's on-going voluntary initiatives in corporate accountability and specifically welcome reactions to this statement of Commission policy. As a consequence, I believe progress has been made—and will continue—in assuring that public companies meet the statutory mandate for accurate records and meaningful internal accounting controls, without inflicting unreasonable costs on the business community and with only minimal federal intrusion upon internal corporate decisionmaking.

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DEPARTMENT OF COMMERCE

Patent and Trademark Office

37 CFR Part 2

Trademark Opposition and Cancellation Proceedings; Compulsory Counterclaims

Correction

In FR Doc. 81-1576, published at page 6934, in the issue of Thursday, January 22, 1981, make the following corrections:

1. On page 6940, second column, § 2.114(b)(2)(i), change the period at the end of the twelfth line to a comma, and lower case the first word of the thirteenth line.

2. On the same page, § 2.114(b)(2)(ii), in the first line in the third column, the word "if" should read "is".

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POSTAL SERVICE

39 CFR Part 111

Second-Class Supplements

AGENCY: Postal Service.

ACTION: Final rule.