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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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 C. Campos
Commissioner Annette L. Nazareth
Ms. Nancy M. Morris

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EXECUTIVE SUMMARY[1]

Background

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:[2]

- 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

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[1] This report has been approved by the Committee and reflects the views of a majority of its members. It does not necessarily reflect any position or regulatory agenda of the Commission or its staff.

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 USC 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.

[2] 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 specified 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.

Our chartering documents[3] 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, Parts VII, VIII and IX of this report contain separate statements submitted by Mark Jensen, Kurt Schacht and John B. Veihmeyer that describe briefly their reasons for disagreeing with specific recommendations of the majority of our voting members.

[3] 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" consisting 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 at several meetings. We agreed at our final meeting on April 20, 2006 to submit to the Commission the 32 recommendations discussed in this report.[4]

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";

[4] The 32 recommendations are listed by category in Appendix D. This number does not include two recommendations, which the Committee adopted on August 10, 2005 and submitted to the Commission in a separate report dated August 18, 2005 (included as Appendix D of this report and discussed therein). The Commission acted favorably upon these two recommendations in September 2005. See Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports, SEC Release No. 33-8617 (Sept. 22, 2005); Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Reports of Companies that are Not Accelerated Filers, SEC Release No. 33-8618 (Sept. 22, 2005).

recommendations related to internal control over financial reporting are discussed under the caption "Part III. Internal Control Over Financial Reporting"; capital formation, corporate governance and disclosure recommendations are discussed under the caption "Part IV. Capital Formation, Corporate Governance and Disclosure"; and accounting standards recommendations are discussed under the caption "Part V. Accounting Standards."

Before addressing our recommendations, the Committee wishes to emphasize that each of our members fully embraces the concepts of good governance and transparency. We believe our recommendations are designed to further these goals while establishing cost effective methods of achieving them.

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. The recommendation reads as follows:

- Establish a new system of scaled or proportional securities regulation for smaller public companies using the following six determinants to define a "smaller public company":

  - the total market capitalization of the company;
  - a measurement metric that facilitates scaling of regulation;
  - a measurement metric that is self-calibrating;
  - a standardized measurement and methodology for computing market capitalization;
  - a date for determining total market capitalization; and
  - clear and firm transition rules, i.e., small to large and large to small.

  Develop specific scaled or proportional regulation for companies under the system if they qualify as "microcap companies" because their equity market capitalization places them in the lowest 1% of total U.S. equity market capitalization or as "smallcap companies" because their equity market capitalization places them in the next lowest 1% to 5% of total U.S. equity market capitalization, with the result that all companies comprising the lowest 6% would be considered for scaled or proportional regulation.[5]

Under this recommendation, microcap companies would consist of companies whose outstanding 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 outstanding 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 the number of U.S. public companies, as shown in the table below:[6]

Table 1: Recommendation on Scaled or Proportional Regulation for Smaller Public Companies[7]

	Market Capitalization Cutoff	Percentage of Total U.S. Equity Market Capitalization	Percentage of All U.S. Public Companies
Microcap Companies	<$128.2 million	1%	52.6%
Smallcap Companies	$128.2-$787.1 million	5%	25.9%
Smaller Public Companies	<$787.1 million	6%	78.5%
Larger Public Companies	>$787.1 million	94%	21.5%

We believe that the Commission should establish this scaled 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

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[5] Mr. Schacht abstained from voting on this recommendation. All other members present voted in favor of this recommendation.

[6] This table presents information on the Committee's first primary recommendation on scaled or proportional securities regulation. It is not intended to present direct information on the number or percentage of companies that would be affected by the Committee's second and third primary recommendations, which relate to Section 404 of the Sarbanes-Oxley Act. Information on the impact of those recommendations is presented in Table 2 below and in Part III, where those recommendations are discussed in detail.

[7] Source: SEC Office of Economic Analysis, Background Statistics: Market Capitalization & Revenue of Public Companies, Table 2 (Apr. 6, 2006) (included as Appendix E). The universe of publicly traded equity securities and their governance is explained in Appendix F.

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

Our other primary recommendations are listed below. Included in the list is a parenthetical reference to the location in this report where the recommendation is discussed in detail:[8]

- Unless and until a framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs, provide exemptive relief from the Section 404 requirements of the Sarbanes-Oxley Act[9] to microcap companies with less than $125 million in annual revenue, and to smallcap companies with less than $10 million in product revenue,[10] that have or add 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 (the "Exchange Act");[11] 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 disclosure of the code in connection of the company's obligations under Item 406(c) relating to the disclosure of codes 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, 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, apply CEO and CFO certifications to such disclosures and have their management report on any known material weaknesses. (Recommendation III.P.1).[12]

- Unless and until a framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs, provide exemptive relief from external auditor involvement in the Section 404 process to the following companies, subject to their compliance with the same corporate governance standards as detailed in the recommendation immediately above:

    - Smallcap companies with less than $250 million in annual revenues but greater than $10 million in annual product revenue; and

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[8] 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. For example, 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.
[9] 15 USC 7262.
[10] As discussed in Part III of this report, we contemplate that the revenue limits contained in our internal control recommendations would be periodically and automatically adjusted by reference to an established benchmark such as the Consumer Price Index or the GDP Price Deflator.
[11] 15 USC 78a et seq.
[12] Messrs. Jensen, Schacht and Veihmeyer dissented from this recommendation. The reasons for their dissents are contained in Parts VII, VIII and IX of this report. All other members present voted in favor of this recommendation.

  - Microcap companies with between $125 and $250 million in annual revenue. [13] (Recommendation III.P.2).[14]

- While we believe that the current 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 Recommendation III.P.2 above, we also believe that if the Commission reaches a public policy conclusion that an audit requirement is required, we recommend that changes 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 microcap and smallcap companies (Recommendation IV.P.2).

- Allow all reporting companies listed on a national securities exchange, NASDAQ or the OTC Bulletin Board 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).

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[13] Under Recommendations III.P.1 and III.P.2, approximately 95%, or $16,046 billion, of the total U.S. equity market capitalization of $16,891 billion, would remain fully subject to Section 404. Companies accounting for the remaining 5%, or $845 billion, would be eligible for relief unless and until an appropriate framework for assessing internal control over financial reporting for such companies has been developed. In addition, the following table presents information on the number and percentage of public companies eligible for relief under these two recommendations:

Table 2: Public Companies Eligible for Relief Under Recommendations III.P.1 and III.P.2 Unless and Until Appropriate Framework is Developed

	1	2	3	4	5
	Number of Companies in Category	**Category as Percentage of Public Companies**	**Percentage of Public Companies Eligible for Recommen-dation III.P.1 Relief**	**Percentage of Public Companies Eligible for Recommen-dation III.P.2 Relief**	**Percentage of Public Companies Eligible for Recommendations III.P.1 & III.P.2 Relief (Col. 3 + Col. 4)**
Microcap Companies	4,958	52.6%	49.6%	1.6%	51.2%
Smallcap Companies	2,444	25.9%	6.7%	12.2%	18.9%
Smaller Public Companies	7,402	78.5%	56.3%	13.8%	70.1%
Larger Public Companies	2,026	21.5%	0.0%	0.0%	0.0%
All Public Companies	9,428	100.0%	56.3%	13.8%	70.1%

Source: SEC Office of Economic Analysis, Background Statistics: Market Capitalization & Revenue of Public Companies, Tables 1, 2, 27 (Apr. 6, 2006) (included as Appendix E).

[14] Messrs. Jensen, Schacht and Veihmeyer dissented from this recommendation. The reasons for their dissents are contained in Parts VII, VIII and IX of this report. All other members present voted in favor of this recommendation.

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

- Adopt a new private offering exemption from the registration requirements of the Securities Act of 1933 (the "Securities Act")[15] 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 the 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 importance (i.e., the secondary recommendation that we would most like to see adopted is listed first, etc.).

[15] 15 USC 77a et seq.

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.[16] At the same time, Chairman Donaldson announced his intent 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.[17] The Committee's membership was completed on March 7, 2005, with members drawn from a wide range of professions, backgrounds and experiences.[18] 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.[19]

Committee Activities

We held our organizational meeting on April 12, 2005 in Washington, D.C., where Chairman Donaldson swore in and addressed our members.[20] Also at that meeting, we adopted our by-laws,[21] proposed a Committee Agenda to be published for public comment, and reviewed a subcommittee structure and Master Schedule prepared by our Co-Chairs. This and all of our subsequent meetings were

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[16] 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 G).
[17] Advisory Committee on Smaller Public Companies, SEC Release No. 33-8514 (Dec. 21, 2004) [69 FR 76498] (included as Appendix A).
[18] SEC Chairman Donaldson Announces Members of Advisory Committee on Smaller Public Companies, SEC Press Release No. 2005-30 (Mar. 7, 2005) (included as Appendix H). This press release describes the diverse backgrounds of the Committee members.
[19] See Committee Charter (included as Appendix B).
[20] The Record of Proceedings of this and subsequent meetings of the Committee are available on the SEC's 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. 12 & 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)).
[21] The Committee By-Laws are included as Appendix I.

open to the public and conducted in accordance with the requirements of the Federal Advisory Committee Act.[22] 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.[23] We adopted our Committee Agenda at the June 16 meeting in New York.[24] 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."[25] We held additional meetings on October 24 and 25 and December 14, 2005 and February 21, April 12 and April 20, 2006 to consider and vote on recommendations and drafts of our final report to the Commission. All were face-to-face meetings held at the SEC's headquarters in Washington, except the April 12 meeting, which was a conference telephone call meeting. SEC Chairman Christopher Cox, who had succeeded Chairman

[22] 5 USC–App. 1 et seq.

[23] Appendix J contains a list of witnesses who testified before the Committee.

[24] The Committee Agenda is included as Appendix K.

[25] 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 C. 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."

Donaldson on August 3, 2005, addressed us at the October 24 meeting in Washington. No witnesses testified at these additional meetings.

The Committee, through the Commission, published three releases in the Federal Register formally seeking public comment on issues it was considering. On April 29, 2005, we published a release seeking comments on our proposed Committee Agenda,[26] in response to which we received 193 written submissions. On August 5, 2005, we published 29 questions on which we sought public input, to which we received 266 responses.[27] Finally, on March 3, 2006, we published an exposure draft of our final report in the Federal Register,[28] which generated [190] 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 [649] written statements in response to Federal Register releases.[29] All of the submissions made to the Committee will be archived and available to the public through the SEC's public reference room.

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

[26] Summary of Proposed Committee Agenda of Advisory Committee on Smaller Public Companies, SEC Release No. 33-8571, (Apr. 29, 2005) [70 FR 22378].
[27] See Request for Public Input by Advisory Committee on Smaller Public Companies, SEC Release No. 33-8599 (Aug. 5, 2005) [70 FR 45446].
[28] Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies, SEC Release No. 33-8666 (Mar. 3, 2006) [71 FR 11090].
[29] All of the written submissions made to the Committee are available in the SEC's Public Reference Room in File No. 265-23 and on the SEC's Committee Web page at http://www.sec.gov/rules/other/265-23.shtml. To avoid duplicative material in

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 company 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.[30] We voted to 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.[31] We believe that, over the years, some of the original principles underlying our securities laws, including proportionality, have been underemphasized, 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;**

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footnotes, citations to the written submissions made to the Committee in this Final Report do not reference the Public Reference Room or repeat the Public Reference Room file number.

[30] See Record of Proceedings 62-103 (Aug. 10, 2005).

[31] 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.

- **a standardized measurement and methodology for computing market capitalization;**
- **a date for determining total market capitalization; and**
- **clear and firm transition rules, i.e., small to large and large to small.**

Develop specific scaled or proportional regulation for companies under the system if they qualify as "microcap companies" because their equity market capitalization places them in the lowest 1% of total U.S. equity market capitalization or as "smallcap companies" because their equity market capitalization places them in the next lowest 1% to 5% of total U.S. equity market capitalization, with the result that all companies comprising the lowest 6% would be considered for scaled or proportional regulation.[32]

This new system would replace the SEC's current scaling system for "small business issuers" eligible to use Regulation S-B[33] as well as the current scaling system based on "non-accelerated filer" status,[34] but would provide eligibility for scaled regulation for companies based on their size relative to larger companies.[35]

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[36]) would qualify as microcap companies. Companies whose common stock

[32] Mr. Schacht abstained from voting on this recommendation. All other members present voted in favor of this recommendation.
[33] Regulation S-B can be found at 17 CFR 228.
[34] "Non-accelerated filers" are public companies that do not qualify as "accelerated filers" under the SEC's definition of the latter term in 17 CFR 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 requirements of Sarbanes-Oxley Act Section 404.
[35] 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 with the categories of companies established in the securities offering reform initiatives.
[36] SEC Office of Economic Analysis, Background Statistics: Market Capitalization & Revenue of Public Companies (Apr. 6, 2006) (included as Appendix E). Data was derived from Center for Research in Security Prices (CRSP) for 9,428 New York

(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.[37] 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 them in the future. As discussed below, we are recommending that the SEC provide certain relief under Sarbanes-Oxley Act Section 404 to certain smaller public companies.[38] 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.[39]

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.[40] 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

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

[37] Id.

[38] See discussion in Part III below.

[39] See discussion in Part IV below.

[40] We recognize that, if the Commission determines to implement our recommendation, it may want to examine the distinguishing characteristics of the group of "smaller public companies" to which it intends to provide specific regulatory relief. We have done this in developing our recommendations set out in "Part III. Internal Control Over Financial Reporting." A comment letter recently sent to the Commission also went through this exercise in making recommendations with respect to application of Section 404 of the Sarbanes-Oxley Act to smaller public companies. See Letter from BDO Seidman, LLP, at 2-

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, we considered the SEC's recent adoption of rules reforming the securities offering process.[41] 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."

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.[42] 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 previous fiscal year, with the ranges published by the SEC for the most recent recalculation date.[43] The determination would then be used to by companies to determine their

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3 (Oct. 31, 2005) (on file in SEC Public Reference Room File No. S7-06-03), available at http://www.sec.gov/rules/proposed/s70603/bdoseidman103105.pdf.

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

[42] 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.

[43] 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.

status for the next fiscal year. This is what we mean when we say that the measurement metric for determining smaller 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-known seasoned issuer eligibility and ineligibility.

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 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.[44] We are aware that the

[44] The Commission would, of course, need to prescribe a standardized methodology for computing market capitalization.

SEC historically has used public float as a measurement in analogous regulatory contexts.[45] However, we recommend that the SEC use equity capitalization, rather than public float, to determine eligibility for smaller public company status for several reasons. First, we believe that equity market capitalization better measures total financial exposure to investors (including affiliates, some of whom may not have adequate access to information) 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.[46] 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 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.

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[45] For example, a public float test is used to determine a company's eligibility to use Forms SB-2, F-3 and S-3 and non-accelerated filer status.

[46] 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].

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)[47] 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.[48] The Exchange Act originally was enacted to regulate post-distribution <u>trading</u> 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.[49] Since all securities other than exchange-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."[50] 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

[47] 15 USC 77c(b).
[48] Louis Loss & Joel Seligman, <u>Fundamentals of Securities Regulation</u> 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.
[49] Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (adding Section 12(g), among other provisions, to the Exchange Act).
[50] S. Rep. No. 88-379, at 19 (1963).

public interest to be served."[51] Accordingly, Congress chose to limit coverage to companies with a class of equity security held of record by at least 500 persons and assets above $1 million.[52] Over time, the standard set by Congress at 500 equity holders of record and $1 million in 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 asset level several times; it now stands at $10 million.[53]

In 1992, the Commission adopted Regulation S-B,[54] a major initiative that allows companies qualifying as "small business issuers" (currently, companies with revenues and a public float of less than $25 million[55]) 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.[56] Non-accelerated filers are fundamentally public companies with a public float below $75 million, and large accelerated filers are public companies with a public float of $700 million or more.[57]

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

[51] Id.
[52] 15 USC 78l(g).
[53] 17 CFR 240.12g5-1.
[54] 17 CFR 228.10 et seq.
[55] 17 CFR 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.
[56] See Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Report, SEC Release No. 33-8128 (Sept. 16, 2002) [67 FR 58480].

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 regulations 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;
- an unfriendly legal and enforcement atmosphere that diminishes the use and acceptance of professional judgment because of fears of second-guessing by regulators and the plaintiff's bar;[58]
- 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 placed less 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

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[57] 17 CFR 240.12b-2. Both accelerated filers and large accelerated filers must also have been reporting for at least 12 months, have filed at least one annual report and not be eligible to use Forms 10-KSB and 10-QSB.

[58] See Conference Panelists Discuss Earnings Guidance and Accounting Issues, SEC Today (Feb. 14, 2006), at 2 (quoting Teresa Iannaconi as stating that while she believes the PCAOB is sincere in its attempt to bring greater efficiency to the audit

disproportionate fixed costs of Section 404 compliance, these companies have been disproportionately subject to the burdens associated with Section 404 compliance. Moreover, the benefits of documenting,[59] 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, to facilitate 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 their ability to compete.

This last factor is particularly problematic in light of the crucial role smaller public companies play in job creation and economic growth. In addition, we are increasingly participating in a global economy and (1) the much higher costs for Sarbanes-Oxley compliance in general, and Section 404 compliance in particular, (2) the loss of foreign issuers who are either not listing in the U.S. or are departing from U.S. markets and (3) domestic issuers who are going dark or private could pose significant competitive risks to U.S. companies and markets.[60]

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process, accounting firms are not ready to step back, because they have all received deficiency letters, none of which say that the auditors should be doing less rather than more).

[59] 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]. See note 58 infra.

[60] See William J. Carney, The Costs of Being Public After Sarbanes-Oxley: The Irony of 'Going Private,' Emory Law and Economics Research Paper No. 05-4 at 1 (Feb. 2005), available at SSRN: http://ssrn.com/abstract=672761 ("In an economically rational world we don't want to prevent all fraud, because that would be too expensive. Instead, the goal should be to keep on spending on fraud prevention until the returns on a dollar invested in prevention are no more than a dollar. There is an 'Optimal Amount of Fraud.'"); Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 Yale L. J. 1521, 1587-91 (2005); Joseph A. Grundfest, Fixing 404 (2005) (unpublished manuscript, on file in SEC Public Reference Room File No. 265-23) ("While there is substantial debate over the costs and benefits of Section 404 as implemented by PCAOB Statement No. 2, there is far greater consensus that these rules are not cost effective. Put another way, regardless of whether Section 404's social benefits exceed its social costs, a very large portion of Section 404's benefits can be generated while imposing substantially lower costs on the economy. Consistent with this view, the current head of the PCAOB states 'It is . . . clear to us that the first round of internal control audits cost too much."); Henry N. Butler & Larry E. Ribstein, The Sarbanes-Oxley Debacle: How to Fix It and What We've Learned (Mar. 13, 2006) (paper prepared for American Enterprise Institute Liability Project), available at http://www.aei.org/docLib/20060308_ButlerRibsteinSOXDraft313.pdf. Moreover, Congress, in the form of Securities Act Section 2(b), has mandated that whenever the SEC engages in rulemaking it is required to consider in addition to the protection of investors, whether the action will promote efficiency, competition and

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.[61] 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, the experience of most of our members, the most recent Financial Executives International Study[62] 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 debate, they essentially derive from a few fundamental ideas: the primary objective of internal control over financial reporting 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.

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capital formation. See Peter J. Wallison, Buried Treasure: A Court Rediscovers A Congressional Mandate the SEC Has Ignored, AEI Online (Oct. 2005) available at http://www.aei.org/publications/pubID.23310/pub_detail.asp. See also infra notes 87 through 90 and accompanying text.

[61] 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.

[62] FEI reports that based upon a recent poll of 274 public companies, Section 404 compliance costs declined approximately 16.3% in Year 2 following implementation as compared to Year 1, which they note is roughly half of the decrease anticipated. See Financial Executives International, FEI Survey on Sarbanes-Oxley Section 404 Implementation (Mar. 2006). An earlier report by CRA International indicated that Section 404 implementation costs for smaller companies were expected to decline an average of 39% in the second year of implementation. See infra note 87.

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

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.[63] In addition, on June 17, 2004 the Commission issued an order approving Auditing Standard No. 2 of the Public Company Accounting Oversight Board ("PCAOB"), entitled An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements (AS2), which established the requirements that apply to an independent auditor when performing an audit of a company's internal control over financial reporting.[64] 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 procedures, including the broad distribution of the framework for public comment.[65] The Commission release adopting the rules implementing Section 404 and AS2 both specifically identify the internal control framework published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) (the COSO Framework) as suitable for

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

such purposes, and indeed, the COSO Framework has emerged as the only internal control framework available in the U.S. and the framework used by virtually all U.S. companies.[66]

As noted above, 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."[67] 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.[68]

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[65] See Exchange Act Rules 13a-15(c) and 15d-15(c), 17 CFR 240.13a-15(c) and 240.15d-15(c).

[66] 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. COSO published the COSO Framework, formally titled "Internal Control–Integrated Framework, in 1992 and supplemented it in 1994. The COSO Framework is available at http://www.coso.org/publications/executive_summary_integrated_framework.htm. 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. 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 30, 73.

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

[68] Several comment letters submitted to COSO in respect of the guidance are illustrative, including the following: Letter from 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 from Institute of Management Accountants to COSO (Oct. 24, 2005) ("The 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 from Deloitte & Touche LLP to COSO (Dec. 30, 2005) ("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 from 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

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)[69] 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.[70]

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.[71] Additionally, due in part to the continuing evaluation of the impact of the Section 404 requirements on smaller public companies by this Committee, on September 22, 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.[72]

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 that the auditor's attestation "shall not be the subject of a separate engagement."[73] Moreover, the Senate Committee Report that accompanied Section 404 to the Senate floor included the following language:

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control process by management, and in the cost to audit internal controls by companies' auditing firms."); Letter from 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.

[69] The term "accelerated filer" is defined in Rule 12b-2, 17 CFR 240.12b-2, under the Exchange Act, 15 USC 78a et seq.

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

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

[72] SEC Release No. 33-8618 (Sept. 22, 2005) [70 FR 56825].

[73] 15 USC 7262.

> 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.[74]

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.[75] 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.[76] 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.[77] 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 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

[74] S. Rep. No. 107-205, at 31 (2002).
[75] 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.
[76] Pub. Law No. 95-213, tit. I (1977).
[77] 15 USC 78m(b)(2)(B).

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.[78] The speech was adopted by the Commission as an official agency interpretation and policy statement, and retains that status to this day.[79] 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 are also are relevant to today's Section 404 environment. We urge the Commission to republish and re-emphasize the Williams statement and make it the framework 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 controls over financial reporting 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.

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

[78] 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 L).
[79] 17 CFR 241 (citing id.).

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 has been the absence of any clear definition or guide as to what constitutes adequate internal controls for smaller companies. This problem has been compounded by the different requirements in Section 404 for management and for their external auditors.[80] 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 (attest to) 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 as 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 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

[80] 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.

for management as to what constitutes adequate internal controls for smaller companies.[81] 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."[82] This results in audits that are not risk-based and, in particular, involve extensive testing of information technology (IT) controls. The result is an extensive focus by auditors on detailed processes, a number of which create little or no risk to the integrity of the financial statements.

Finally, the Sarbanes-Oxley Act created the PCAOB to monitor the performance of the external auditors. The creation of this regulatory watchdog, the introduction of PCAOB inspectors and the subsequent issuance of AS2 have altered auditor behavior and, we believe, have diminished the exercise of professional judgment.[83]

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[81] Many believe that 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. Many observers acknowledge the need to scale for smaller public companies, but because of the challenges involved, have avoided attempting to scale despite such need.

[82] 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.

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

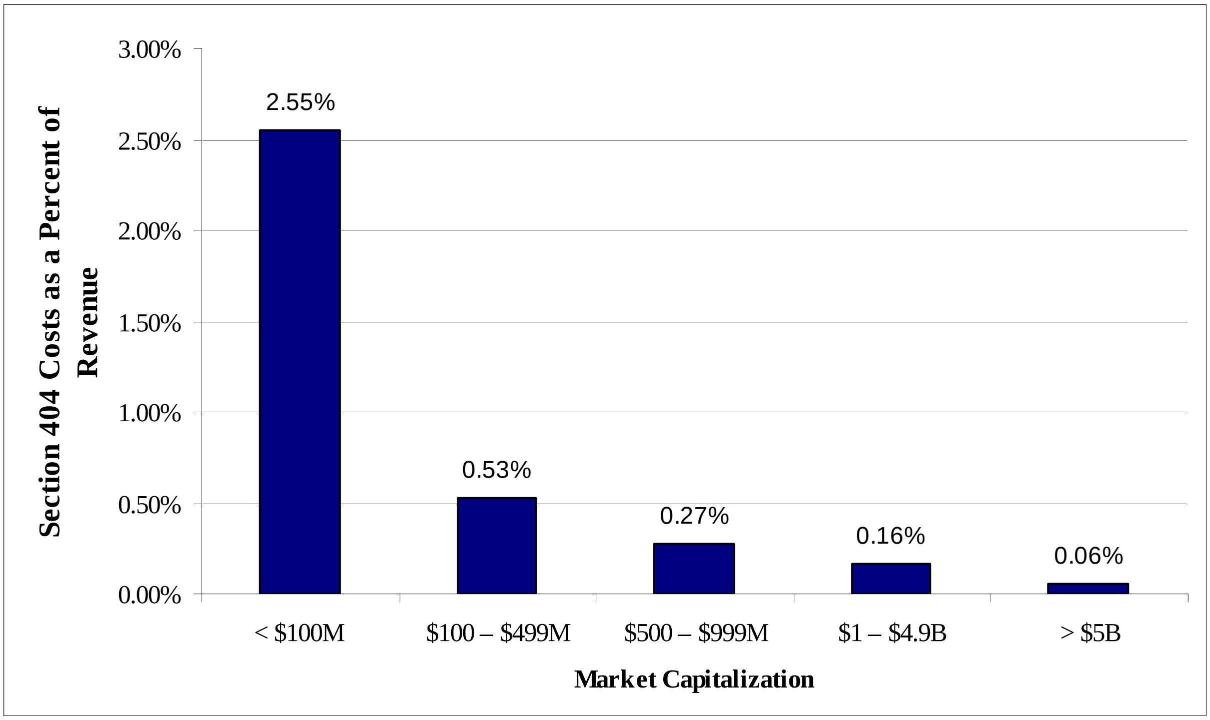
Disproportionate Impact: The Smaller You Are, The Larger the Hit

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.[84]

But beyond the aggregate costs involved with Section 404 compliance, costs in relation to revenue 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 expected 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:[85]

[84] 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.

[85] This table is based on data from the Financial Executives International study and estimates of the Section 404 working group of the American Electronics Association. We note that companies with a market capitalization of less than $75 million generally did not have to comply with Section 404 in 2004. Many expect that compliance costs for the smallest companies in the chart will consequently be much higher when such companies are required to comply.

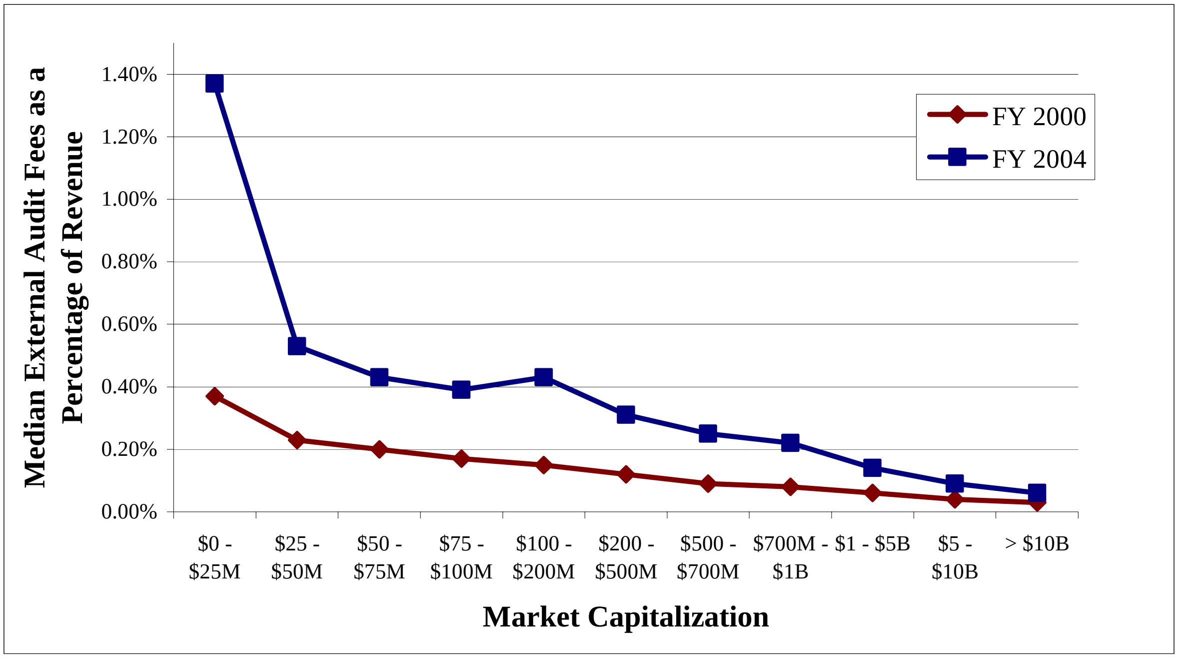


Source: American Electronics Association (AeA) Report entitled *Sarbanes-Oxley Section 404, The 'Section' of Unintended Consequences and Its Impact on Small Business* (Feb. 2005).

We also note that external auditor fees have overall been increasing, 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.[86] 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.[87]

[86] Source: SEC Office of Economic Analysis, Background Statistics: Market Capitalization & Revenue of Public Companies (Apr. 6, 2006) (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.

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



Many commentators, including 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 (i.e., that total Section 404 implementation costs are three to four times external audit fees) 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.[88] 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 oversees financial reporting.[89] 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 be involved in all material transactions and directly involved in financial reporting.[90] Smaller companies, by their nature, need to be 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 requires frequent changes in process and more frequent job changes inside the company, which limits

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[88] See American Institute of Certified Public Accountants, Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention (2005), available at http://www.aicpa.org/audcommctr/download/achilles_heel.pdf.

[89] 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." COSO Framework at 56.

[90] 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

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. Many believe that in a smaller company these 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.[91] 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.[92] 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.

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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.

[91] Id.

[92] See Exchange Act §13(b)(2)(B), 15 USC 78m(b)(2)(B)(codifying part of Foreign Corrupt Practices Act of 1977, §102, Pub. L. No. 95-213).

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 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.[93]

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 limits 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.

With respect to our Recommendations III.P.1 and III.P.2, we also note that in Release 2004-008 the PCAOB determined that certain provisions in its Auditing Standard No. 2 (AS2) were relevant to situations in which an auditor is engaged solely to audit a company's financial statements. In that rulemaking, the PCAOB amended certain of its interim internal control standards to conform, where applicable, to AS2. The new standard significantly increased the auditors' responsibility to communicate internal control weaknesses discovered by them to management when engaged solely to audit a company's financial statements. This increased responsibility coupled with the requirement that

[93] The COSO Framework (at p. 31) 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."

management disclose such information is seen by us as significantly strengthening the focus on internal controls by management.

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.

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 costs for Section 404 implementation were underestimated so dramatically (millions of dollars per year, versus $91,000), the pain and loss 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, more costly legal and audit fees, and increased fees for independent advisors to the committees, a new and sometimes 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 unless and until an appropriate framework is developed, 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.[94]

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, the following developments should be carefully monitored:

- Some companies are either going dark or going private or considering doing so;[95]

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[94] 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). Butler and Ribstein have recently advocated a similar proposal. See supra note 60.

[95] 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. See William J. Carney, The Costs of Being Public After Sarbanes-Oxley: The Irony of 'Going Private,' Emory Law and Economics Research Paper No. 05-4 at 1 (February 2005) available at SSRN: http://ssrn.com/abstract=672761; Joseph N. DiStefano, Some Public Firms See Benefit in Going Private, Phil. Inq., Jan. 21, 2006 (reporting on a discussion at the 11th Annual Wharton Private Equity Conference), available at http://www.philly.com/mld/inquirer/business/13676241.htm. 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

- The London Exchange's Alternative Investment Market (AIM) for smaller public companies is gaining momentum;[96]
- Foreign new listings in the United States during 2005 dropped considerably from the previous year;[97]
- 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.[98]

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 unless and

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costs associated with being a reporting company under the Exchange 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 Exchange 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.

[96] See G. Karmin and A. Luchetti, New York Loses Edge in Snagging Foreign Listings, Wall St. J., Jan. 26, 2006, at C1, and Stephen Taub, VCs Look For Payday in London, CFO.com, Feb. 3, 2006, available at http://www.cfo.com/article.cfm/5487545/c_5486496?f=TodayInFinance_Inside. See also Letter from John P. O'Shea to Committee (June 16, 2005), available at 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). The momentum of AIM is also reflected in a program presented at the American Bar Association Business Law Section's Spring Meeting in Tampa, Florida on April 6, 2006 entitled "Going Public Try-Outs: TSX Venture Exchange and London AIM as Farm Teams for U.S. Public Market Big Leagues." All program speakers were from Canada and the United Kingdom, and they described in detail both the AIM market in London and the TSX Venture Exchange in Canada and the benefits these markets provide to issuers, particularly those with a market capitalization of less than $125 million. A CD of this program is available from the ABA Business Law Section at http://www.abanet.org/buslaw/home.shtml and written materials from the program have been placed in the SEC's Public Reference Room.

[97] See Patrick Hosking, Cull of U.S. Investors Set a Worrying Precedent, Times Online, Feb. 2, 2006. available at http://business.timesonline.co.uk/article/0,,13129-2020817,00.html. In addition, we urge the Commission to study the detailed report on Sarbanes-Oxley set forth in Sally Chan, Parveen Gupta and Tim Leech, Sarbanes-Oxley: A Practical Guide to Implementation Challenges and Global Response (2006).

[98] Record of Proceedings 100 (Oct. 14, 2005) (testimony of Gerald I. White). See also Rebecca Buckman, Tougher Venture: IPO Obstacles Hinder Start-ups, Wall St. J., Jan. 25, 2006, at C1 (stating that "[l]ast year, 41 start-ups backed by venture-capital investors became publicly traded U.S. companies, down from 67 in 2004 and 250 in the boom year of 1999" and that "[o]verall IPO's of U.S. companies also declined last year, but not as sharply, to 215, from 237 in 2004").

until an appropriate framework for assessing their internal control is developed, 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 unless and until an appropriate framework for assessing their internal control is developed, 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 understand 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 material financial fraud. Therefore, our recommendations provide that a smallcap company whose annual product 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 such companies is developed that recognizes their characteristics and needs, provide exemptive relief from Section 404 requirements to microcap companies with less than $125 million in annual revenue, and to smallcap companies with less than $10 million in annual product revenue,[99] that have or add 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 disclosure of the code in connection of the company's obligations under Item 406(c) relating to the disclosure of codes 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, apply

[99] As discussed below, we contemplate that the revenue limits contained in our internal control recommendations would be periodically and automatically adjusted by reference to an established benchmark such as the Consumer Price Index or the GDP Price Deflator.

CEO and CFO certifications to such disclosures and have their management report on any known material weaknesses.[100]

This 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 unless and until an appropriate framework for assessing their internal control over financial reporting is developed, conditioned upon their compliance with the enhanced corporate governance provisions described above.[101] We envision that full Section 404 relief would be effective immediately for these companies. The following federal securities law requirements would remain applicable to all companies that would qualify for 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;[102]

[100] Messrs. Jensen, Schacht and Veihmeyer dissented from this recommendation. The reasons for their dissents are contained in Parts VII, VIII and IX of this report. All other members present voted in favor of this recommendation.

[101] The approach adopted by the Committee has been raised as a possibility by various parties. See, e.g., Letter from Ernst & Young LLP to SEC, at 16 (Apr. 4, 2005) (Ernst & Young said, with a number of reservations, including the lack of sufficient information and longer term experience with 404: "Should the level of costs necessary to do the job right be determined to be unacceptable in relation to the benefits provided to investors in smaller public companies, the SEC could then consider using its exemptive authority to provide alternatives, including annual reporting by management on the issuer's internal controls over financial reporting with no auditor attestations or with less frequent auditor attestations (for example, auditor attestations every other year) or even complete elimination of annual reporting by management on the issuer's internal controls over financial reporting.") (on file in SEC Public Reference Room File No. 4-497), available at http://www.sec.gov/news/press/4-497/eyllp040405.pdf. We note that Mr. Veihmeyer, in his discussion of reasons for dissenting from this recommendation (included in Part IX of this report), states that after further study and experience with Section 404 "it may become evident . . . that an audit of internal control over financial reporting may not be justified for certain very small public companies that evidence certain characteristics."

[102] We expect that the Section 302 certifications of companies receiving exemptive relief from Section 404 (even non-accelerated filers, who are not currently required to include such language) would 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 internal control over financial reporting having been designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements). We acknowledge that in response to our request for public comment on the exposure draft of this Final Report, Lord & Benoit, LLC submitted the results of a study that raises questions concerning the effectiveness of a

- 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.[103]

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 incorporated the requirements of Rule 10A-3 into their respective listing standards. The audit committee

management-only assessment of internal controls. See Letter from Lord & Benoit, LLC to Committee (Mar. 31, 2006), available at http://www.sec.gov/rules/other/265-23/rbenoit8977.pdf.

[103] 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.

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.[104] 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 that employees who work in companies with comprehensive ethics and compliance programs reported

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

fewer observations of misconduct and higher levels of confidence in management's commitment to integrity.[105]

This recommendation provides relief only for microcap companies with less than $125 million in revenue and smallcap companies with less than $10 million in product revenue. In both cases, revenues would be measured on an annual basis. The concept we are trying to convey in providing relief for smallcap companies with less than $10 million in annual product revenue is that full Section 404 compliance is not appropriate for uncomplicated business organizations with much potential but simple current operations from an accounting standpoint. This relief would only apply to companies with market capitalizations above the threshold to be classified as a microcap company (above $128 million for purposes of this report) but no significant product sales.[106] We wish to note that, in accordance with our goal of promoting regulation that is self-calibrating, we believe that these $10 million and $125 million revenue limits, as well as the $250 million revenue limit referenced in Recommendation III.P.2 below, should be adjusted automatically and periodically by reference to a recognized benchmark, such as the Consumer Price Index or the GDP Price Deflator. As with Recommendation II.P.1 above, we leave to the Commission's discretion the frequency with which adjustment would occur, but observe only that it should be timed so as to minimize uncertainty among issuers as to their Section 404 filing requirements.

With regard to the final paragraph of this recommendation, we simply wish for the Commission to make clear, to the extent clarity is lacking, that those smaller public companies qualifying for exemptive relief would 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

[105] KPMG Forensic Integrity Survey 2005-2006.

[106] We would defer to the SEC as to how the term "product revenue" should be defined in implementing this recommendation. We would assume that the SEC would define the term similarly to the way it provides for the disclosure of product and services revenue in Section 5-03 in SEC Regulation S-X, 17 CFR 210.5-03, but exclude license fees, and research and development payments, milestone payments, and other payments received from an unrelated third party before product sales have commenced under the terms of a collaborative contractual agreement to develop a product.

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 such companies is developed that recognizes their characteristics and needs, provide exemptive relief from external auditor involvement in the Section 404 process to the following companies, subject to their compliance with the same corporate governance standards as detailed in the recommendation above:**[107]
>
> - **Smallcap companies with less than $250 million in annual revenues but more than $10 million in annual product revenue; and**
> - **Microcap companies with between $125 and $250 million in annual revenue.**[108]

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:

- 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,[109]

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[107] Messrs. Jensen, Schacht and Veihmeyer dissented from this recommendation. The reasons for their dissents are contained in Parts VII, VIII and IX of this report. All other members present voted in favor of this recommendation.

[108] As discussed in connection with Recommendation III.P.1 above, we contemplate that the revenue limits contained in our internal control recommendations would be periodically and automatically adjusted by reference to an established benchmark such as the Consumer Price Index or the GDP Price Deflator.

[109] The Committee believes that, until the Commission recognizes a new framework for managements of smaller public companies to use is assessing internal control over financial reporting other than the COSO framework discussed above, they should be allowed to use as a framework the Commission's own official agency interpretation and policy statement on internal controls. The Commission's policy statement was adopted by citation at 17 CFR 241 (citing Foreign Corrupt Practices Act of

- 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.

We emphasize that management under either the regime we have recommended for smallcap companies or for microcap companies is not exempt from and, indeed, must establish internal controls that satisfy the FCPA. We envision that the Section 404 external audit of internal control relief would be effective immediately and would be effective until an appropriate framework for assessing internal control over financial reporting is developed for such companies.[110]

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 SEC statement of policy) (included as Appendix L).

[110] 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 USC 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 from 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

Recommendation III.P.3:

> **While we believe that the current 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 Recommendation III.P.2 above, we also believe that if the Commission reaches a public policy conclusion that an audit is required, we recommend that changes 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.[111]**

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,[112] this alternative recommendation should be made effective for fiscal years starting one year after the PCAOB issues

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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 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. These views were supported in a letter to SEC Chairman Christopher Cox from Representative Oxley, one of the original sponsors of the Sarbanes-Oxley Act, and Representative Baker, the current Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. <u>See</u> Letter from Rep. Michael G. Oxley and Rep. Richard H. Baker to SEC Chairman Christopher Cox (Mar. 2, 2006), <u>available at</u> http://www.sec.gov/rules/other/265-23/mgoxley030206.pdf. A different view as to the Commission's authority under Section 36(a) was expressed in a letter from Professor James D. Cox and 19 other law professors, although the professors acknowledged that "[s]pecific disclosure requirements tailored to the unique risks and likely regulatory benefits of smaller public companies are entirely appropriate and consistent with the rulemaking authority the Commission enjoys under Section 3(a) of the Sarbanes-Oxley Act." <u>See</u> Letter from James D. Cox et al. to Committee (Mar. 21, 2006), <u>available at</u> http://www.sec.gov/rules/other/265-23/26523-309.pdf.

[111] Mr. Barry abstained from the vote on this recommendation. Messrs. Jensen, Schlein and Veihmeyer dissented from this recommendation. Mr. Jensen's and Mr. Veihmeyer's reasons for their dissents are set forth in separate statements in Parts VII and IX, respectively, of this report.

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

ASX.[113]

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 efficient for these companies;
- have the standard specify a report that would 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 would more likely engage its auditors to conduct 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:

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

- 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.

Internal Control Over Financial Reporting—Secondary Recommendations

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; also, assess if and when it would be advisable to reevaluate and consider amending AS2.**

Clear guidance does not yet exist for smaller public 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 smaller public 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.

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 (we note that this might require amendments to AS2 and SEC rules).

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;[114] 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.

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,

- state 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;
- 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.

[114] 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.

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[115]) the helpful points made in the PCAOB's May 16 guidance[116] and its November 30, 2005 report,[117] 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";
- control testing is to find material weaknesses, and other testing should be scaled back (i.e., testing is not to find deficiencies and significant deficiencies);
- the financial and internal control audits should be integrated (especially at smaller companies);
- not all restatements should be treated as material weaknesses because accounting complexity not control deficiencies are at the root of many restatements; and

[115] See Conference Panelists Discuss Earnings Guidance and Accounting Issues, SEC Today (Feb. 14, 2006), at 2 (quoting Teresa Iannaconi as stating that while she believes the PCAOB is sincere in its attempt to bring greater efficiency to the audit process, accounting firms are not ready to "step back," because they have all received deficiency letters, none of which say that the auditors should be doing less rather than more).

[116] PCAOB Release No. 2005-009, Policy Statement Regarding Implementation of Auditing Standard No. 2, an Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (May 16, 2005).

[117] PCAOB Release No. 2005-023, Report on the Initial Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (Nov. 30, 2005).

- management's consultation with the external auditor regarding the proper accounting for a transaction should not necessarily lead the auditor to conclude a material weakness exists.

In addition, the Commission could ask the PCAOB to:

- state that materiality for the purposes of assessing a "material weakness" under Section 404 should be determined on an annual rather than quarterly basis;
- 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.

*   *   *   *   *   *   *

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 smaller public companies to comply with Section 404[118] may not generate commensurate benefits, adversely affecting their ability to compete with larger U.S. public companies, U.S. private companies and foreign competitors.[119] 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

[118] In the course of our deliberations, we explored a number of alternatives for producing a better balance of costs and benefits for smaller companies complying with Section 404. At the end of our discussions, two ideas were considered that we believed should be memorialized but that we could not recommend because we did not have an opportunity to fully explore them. One idea is to allow a qualified person other than a company's financial statement auditor to attest to and report on management's assessment of internal control over financial reporting. This could introduce an element of competition into the provision of Section 404 outside attestation and consequently reduce costs. A second idea is to provide for random outside audits of management's assessment, perhaps by the SEC, the company's stock exchange or the company's financial statement auditors on some irregular basis such as by chance or selection by lot. We are aware that implementing either of these ideas may seem inconsistent with the view that the Committee's primary Section 404 recommendations provide for a temporary deferral of full Section 404 compliance "unless and until" development of a suitable framework for assessing internal control for smaller public companies. Both of these ideas seem to contemplate that development of such a framework will not occur until well into the future.

[119] We note that the Canadian Securities Administrators recently announced that they will not proceed with an instrument that would have closely paralleled the requirements of Section 404 and required annual auditor attestation as to the effectiveness of internal control over financial reporting. Instead, the CSA are proposing to expand their existing instrument to require a company's CEO and CFO to certify annually that they have evaluated the effectiveness of such internal control as of the end of the financial year and caused the company to disclose in its MD&A their conclusions based on the evaluation. See Canadian

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.

Securities Administrators, Press Release, Regulators Release Proposals on Harmonized Internal Control Reporting Requirements (Mar. 10, 2006), available at http://www.csa-acvm.ca/html_CSA/news/06_07_internal_control.htm.

PART IV. CAPITAL FORMATION, CORPORATE GOVERNANCE AND DISCLOSURE

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[120] 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,[121] 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

[120] With respect to venture-backed startups, the average time from initial venture financing to initial public offering increased from less than three years in 1998 to more than five and a half years in 2005. Rebecca Buckman, Tougher Venture: IPO Obstacles Hinder Start-ups, Wall St. J., Jan. 25, 2006, at C1.

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

In light of the continued importance 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 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 increasingly 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.[122]

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.

Capital Formation, Corporate Governance and Disclosure—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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[121] 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.

[122] G. Karmin & 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 . . . [b]ut 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."[123] "Small business issuer" is defined as an issuer with both revenues and a public float of less than $25 million.[124] 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, and Regulation S-X, the integrated financial statement system, for larger companies.[125]

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[123] Small Business Initiatives, SEC Release No. 33-6949 (July 30, 1992) [57 FR 36442]. Regulation S-B is codified at 17 CFR 228.10 et seq.

[124] 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 CFR 228.10(a)(1).

[125] Regulation S-K is codified at 17 CFR 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 generally are contained in Item 310 of Regulation S-B, 17 CFR 228.310.

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.[126]

Listed below are 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.

- 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.

[126] 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 Letter from Brad Smith to Committee (May 24, 2005) (on file in SEC Public Reference Room), available at http://www.sec.gov/rules/other/265-23/bsmith2573.htm; Letter from Kathryn Burns to Committee (May 24, 2005), available at http://www.sec.gov/rules/other/265-23/kburns052405.pdf; Letter from David N. Feldman to Committee (May 30, 2005, available at http://www.sec.gov/rules/other/265-23/dnfeldman053005.htm; Letter from Michael T. Williams to Committee (May 30, 2005), available at http://www.sec.gov/rules/other/265-23/mtwilliams6614.pdf; Letter from KPMG to Committee (May 31, 2005), available at http://www.sec.gov/rules/other/265-23/kpmg053105.pdf; Letter from BDO Seidman to Committee (May 31, 2005), available at http://www.sec.gov/rules/other/265-23/bdoseidman053105.pdf; Letter from Stephen M. Brock to Committee (May 31, 2005), available at http://www.sec.gov/rules/other/265-23/smbrock1317.pdf; Letter from Ernst & Young to Committee (May 31, 2005), available at http://www.sec.gov/rules/other/265-23/ey053105.pdf; Letter from Small Business & Entrepreneurship Council to Committee (May 31, 2005), available at http://www.sec.gov/rules/other/265-23/kkerrigan8306.pdf; Letter from Society of Corporate Secretaries & Governance Professionals to Committee (June 7, 2005), available at http://www.sec.gov/rules/other/265-23/sspc-slc-scsgp060705.pdf; Letter from Mark B. Barnes to Committee (August 2, 2005), available at http://www.sec.gov/rules/other/265-23/mbbarnes080205.pdf; and Letter from Gregory C. Yardley, Jean Harris, Stanley Keller, A. John Murphy, and A. Yvonne Walker to Committee (Sept. 12, 2005), available at http://www.sec.gov/rules/other/265-23/gcyadley091205.pdf.

- Regulation S-B provides for more streamlined disclosure for management's discussion and analysis of financial condition and results of operations by requiring only two years of analysis if the company is presenting only two years of financial statements, instead of the three years required of companies that present three years of financial statements, as required under Regulation S-K.[127]
- Regulation S-B does not require smaller companies to provide a tabular disclosure of contractual obligations as larger companies must do under Item 303(a)(5) of Regulation S-K.[128]
- 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.[129]
- 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.[130]

We have numerous reasons for recommending the abandonment of Regulation S-B as a separate, stand alone integrated disclosure system, including the abandonment of separate prescribed forms for small business issuers. 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

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[127] MD&A requirements are found in Item 303 of both Regulation S-K and Regulation S-B, 17 CFR 229.303 & 17 CFR 228.303.
[128] 17 CFR 229.303(a)(5).
[129] 17 CFR 229.305.
[130] Executive compensation disclosure requirements are found in Item 402 of both Regulation S-K and Regulation S-B, 17 CFR 228.402 and 17 CFR 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, SEC Release No. 33-8655 (Jan. 27, 2006) [71 FR 6541]. We recommend that the Commission apply whatever executive

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.[131]

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.[132]

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 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."

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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.

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

[132] See Letter from Brad Smith to Committee (May 24, 2005) available at http://www.sec.gov/rules/other/265-23/bsmith2573.htm); Letter from Kathryn Burns to Committee (May 24, 2005), available at http://www.sec.gov/rules/other/265-23/kburns052405.pdf; Letter from David N. Feldman to Committee (May 30, 2005) available at http://www.sec.gov/rules/other/265-23/dnfeldman053005.htm; Letter from Michael T. Williams to Committee (May 30, 2005), available at http://www.sec.gov/rules/other/265-23/mtwilliams6614.pdf; Letter from KPMG to Committee (May 31, 2005), available at http://www.sec.gov/rules/other/265-23/kpmg053105.pdf; Letter from BDO Seidman to Committee (May 31, 2005), available at http://www.sec.gov/rules/other/265-23/bdoseidman053105.pdf; Letter from Stephen M. Brock to Committee (May 31, 2005), available at http://www.sec.gov/rules/other/265-23/smbrock1317.pdf; Letter from Ernst & Young to Committee (May 31, 2005), available at http://www.sec.gov/rules/other/265-23/ey053105.pdf; Letter from Small Business & Entrepreneurship Council to Committee (May 31, 2005), available at http://www.sec.gov/rules/other/265-23/kkerrigan8306.pdf; Letter from Society of Corporate Secretaries & Governance Professionals to Committee (June 7, 2005), available at http://www.sec.gov/rules/other/265-23/sspc-slc-scsgp060705.pdf; Letter from Mark B. Barnes to Committee (Aug. 2, 2005). available at http://www.sec.gov/rules/other/265-23/mbbarnes080205.pdf; and Letter from Gregory C. Yardley, Jean Harris, Stanley Keller, A. John Murphy, and A. Yvonne Walker to Committee (Sept. 12, 2005), available at http://www.sec.gov/rules/other/265-23/gcyadley091205.pdf.

Recommendation IV.P.2:

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

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 required to file three years of audited income statement and other data and two years of audited balance sheet data under Regulation S-X.[133] We recommend that smaller public companies be required to file

[133] 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.

only <u>two</u> years of audited income statements, cash flows, and changes in stockholders equity but <u>two</u> 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.[134] 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 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.

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

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.[135]
- 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 acquired businesses or pending acquisitions that are included in an Exchange Act registration statement.

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

- 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 on a national securities exchange, NASDAQ or the OTCBB 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 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.[136] 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 exchange or are quoted on NASDAQ. Many smaller public companies are not eligible to use Form S-3 in

[136] Form S-3 can be found at 2 Fed. Sec. L. Rep. (CCH) ¶ 7151. Form S-3 was originally adopted in Revisions of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, SEC Release No. 33- 6383 (Mar. 3, 1982) [47 FR 11380].

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")[137] 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. And, in order to take advantage of the Section 404 exemptive relief we are recommending for microcap companies, all those reporting companies included in the Pink Sheets would need to be current in their SEC periodic reporting obligations. 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,[138] 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 on a national securities exchange, NASDAQ or the OTCBB were permitted to utilize Form S-3 and the associated benefits of incorporation by reference. Further, the smaller public companies that would be

[137] 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.
[138] See Internet Availability of Proxy Materials, SEC Release No. 34-52926 (Dec. 15, 2005) [70 FR 74598].

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 recent Securities Act Reform rules.[139] 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

[139] 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.[140]

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. [141]

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."[142] 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

[140] To prevent issuers from taking advantage of the system by, for instance, becoming current on day one and filing a Form S-3 on day two, the Commission could require that the issuer be current for at least 30 days before filing a Form S-3.

[141] 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.[143] 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.[144]

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.[145]

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[142] 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].

[143] A recent article notes, for instance, that fewer companies are receiving analyst coverage today than at any time 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.

[144] Testimony provided to the Committee indicated that approximately 1,200 of the 3,200 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.

[145] In the course of the Advisory Committee's 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

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;[146]
- 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.[147]

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

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global settlement agreement 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.

[146] 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 School U. Pa., Working Paper No. 10567) (July 8, 2004).

[147] 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.[148]
- 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 more or less for a 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 from the registration requirements of the Securities Act that does not prohibit general solicitation and advertising for transactions with purchasers who do not need all the protections of the Securities Act's registration requirements. Additionally, relax prohibitions against general solicitation and advertising found in Rule 502(c) under the Securities Act to parallel the "test the waters" model of Rule 254 under that Act.**

[148] Section 17(b) of the Securities Act provides: "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.[149] 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 the SEC staff has considered in determining if a general solicitation has occurred are: the number of offerees; their suitability as potential investors; how the offerees were contacted; and whether the offerees have a pre-existing business relationship with the issuer.

Beyond the difficulty of determining if particular contact is impermissible, however, the current ban on general solicitation and advertising 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 is 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

[149] 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[150] to define the term "accredited investors."[151]

[150] 17 CFR 230.501-508.
[151] See Securities Act Rule 501(a) under Regulation D, 17 CFR 230.501(a).

- Natural persons would qualify as eligible purchasers based on (1) wealth or annual income, (2) investment sophistication,[152] (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 persons to qualify as eligible purchasers would be substantially higher than those currently in effect for natural person Accredited Investors.[153] We suggest $2 million in joint net worth or $300,000 in annual income for natural persons and $400,000 for joint annual income.[154]
- 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[155] safe harbor similar to that included in SEC Rule 701.[156] Under such a safe harbor, offers and sales made in compliance with

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[152] 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.

[153] 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).

[154] 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.

[155] 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).[157] 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.

[156] 17 CFR 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.[158] 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.[159]

As a corollary to our recommendation 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, we further recommend that the Commission 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. 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

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[157] 17 CFR 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.

[158] Rule 254, 17 USC 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.

[159] 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.

solicitation similar to that allowed in a Regulation A "test the waters" solicitation.[160] 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.[161] 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.[162] 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).

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

[160] 17 CFR 230.254.
[161] 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.
[162] 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

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,[163] 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.[164] 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 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

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(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), available at http://www.sec.gov/news/speech/speecharchive/1999/spch339.htm.

[163] 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.

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 capital formation, corporate governance and disclosure, we also submit for the Commission's consideration the following secondary recommendations:

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[164] 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.[165]

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.[166] 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.[167] 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,[168] circumvention and manipulation of the

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[165] Although overall this recommendation passed unanimously, Messrs. Schacht and Dennis dissented from 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.

Several persons who submitted comments on the Exposure Draft of this Final Report published for public comment in SEC Release No. 33-8666 (Mar. 3, 2006) [71 FR 11090] urged that the Committee assign a higher priority to this recommendation. We would have been inclined to do so if we had more data on the expected consequences of adopting the recommendation in terms of numbers of companies affected.

[166] 15 USC 78l(b), 78l(g) & 78o(d).

[167] 17 CFR 240.12h-3 & 17 CFR 240.12g-4.

[168] 17 CFR 240.12g5-1.

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 12(g) for U.S. companies to include only securities held by persons identified as holders in the issuing company's stock ledger.[169] 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.[170] 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.[171]

Exchange Act Rules 12g-4 and 12h-3[172] 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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[169] 17 CFR 240.12g5-1.
[170] 15 USC 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 the threshold 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].
[171] Section 13(a) of the Exchange Act requires companies registered with the Commission to file annual and quarterly reports with the SEC.
[172] 17 CFR 240.12g-4 and 240.12h-3.

count all accounts as holders of record.[173] 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.[174] We received other letters in support of rulemaking in this area.[175]

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).[176] This procedure of going dark is contrasted with the going private procedures pursuant to Rule 13e-3.[177] 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.[178] In late 2002, it was estimated that over 84% of securities were held in nominee or street name.[179] The Nelson Law Firm and other proponents of such an amendment to Rule

[173] See Rulemaking Petition of Nelson Law Firm to SEC (July 3, 2003), available at http://www.sec.gov/rules/petitions/petn4-483.htm.
[174] Letter from Nelson Obus to Committee (Apr. 7, 2005), available at http://www.sec.gov/rules/other/265-23/26523-1.pdf.
[175] Letter from James Brodie to Committee (Apr. 12, 2005), available at http://www.sec.gov/rules/other/265-23/jabrodie9204.htm); Letter from Stephen Nelson to Committee (June 8, 2005), available at http://www.sec.gov/rules/other/265-23/sjnelson060805.pdf.
[176] 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.
[177] 17 CFR 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.
[178] 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").
[179] 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, Chairman and CEO of DTCC, commenting on Securities Transaction Settlements, SEC Release No. 33-8398 (Mar. 18, 2004)

12g5-1 believe that the current definition of "held of record" allows a company 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 study should also consider whether a standard other than number of shareholders would be a better determinant of when a company should be required to enter or allowed to exit the SEC disclosure system. After the study is completed, the Commission or Congress can 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.

[69 FR 12922] (on file in SEC Public Reference Room File No. S7-13-04, available at http://www.sec.gov/rules/concept/s71304/s71304-26.pdf. 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.

We also received testimony[180] 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 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.[181] 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,[182] 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.

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[180] 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).

[181] For statistics concerning over-the-counter issuers not required to file reports with the SEC, see Appendices I and J.

[182] 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.

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.

In order to address this concern, 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.[183] Additionally, banks have advised us that

[183] See 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); Letter from Independent Community Bankers of America to Committee (Mar. 31, 2005), 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), available at http://www.sec.gov/rules/other/265-23/ccole040805.pdf; Letter from Kathryn Burns, Vice President and Director of Finance, Monroe Bank to Committee (May 24, 2005), available at http://www.sec.gov/rules/other/265-23/kburns052405.pdf; Letter from Charlotte Bahin, Senior Vice President, America's Community Bankers to Committee (July 19, 2005), available at http://www.sec.gov/rules/other/265-23/acbankers071905.pdf; Letter from Mark A. Schroeder, President and CEO, German American Bancorp to Committee (August 3, 2005), available at http://www.sec.gov/rules/other/265-23/maschroeder080305.pdf; Letter from Charlotte Bahin, Senior Vice President, America's Community Bankers, to Committee (Aug. 9, 2005), available at http://www.sec.gov/rules/other/265-23/cmbahin080905.pdf; Letter from David Bochnowski,

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 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.[184] 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 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

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President and CEO of Northwest Indiana Bancorp to Committee (Aug. 9, 2005), available at http://www.sec.gov/rules/other/265-23/dbochnowski080905.pdf.

[184] NASD Rule 2460 (Payments for Market Making) provides: "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."

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.

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[185] 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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[185] 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,[186] 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 investors in 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 to, among other things, 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 during periods of 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.

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

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

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.[187] 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.[188] 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.[189]

The SEC recently has taken several steps to facilitate electronic delivery of 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 prospectus delivery. The Commission has also recently proposed a rule facilitating the electronic delivery

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[187] 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].

[188] 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.

[189] 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).

of proxy materials. [190] 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."[191] 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.[192]

Recommendation IV.S.9

Shorten the integration safe harbor from six months to 30 days.[193]

The concept of integration, discussed above,[194] has been the subject of intense criticism, almost since its inception, [195] 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

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[190] Id.
[191] 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].
[192] 17 CFR 240.15c2-8.
[193] Although the Committee is recommending a 30-day period, we are flexible in this regard.
[194] See text accompanying note 155.

does not) apply. Though the SEC attempted to introduce more certainty into the determination by introduction of a five-factor test in 1961,[196] as a practical matter the question of integration remains for smaller companies an area fraught with uncertainty–and therefore risk.[197]

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.

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.[198] 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

[195] See Stanley Keller, Basic Securities Act Concepts Revisited, Insights (May 1995).

[196] See, e.g., Perry E. Wallace, Jr., Integration of Securities Offerings: Obstacles to Capital Formation Remain for Small Business, 45 Wash. & Lee L. Rev. 935, 937, 972-975 (1988) (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 their offerings among several different exemptions, thus vitiating the registration process upon which the Securities Act is premised.

[197] 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

[198] 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 CFR 230.405.

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.

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)[199] to the Exchange Act, prohibits public companies from extending personal loans to directors or executive officers.[200] 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

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[199] 15 USC 78m(k).
[199] 17 CFR 230.405.
[200] Pub. L. 107-04, § 402, 166 Stat. 745 (2002).

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.

Recommendation IV.S.11:

> **Increase uniformity and cooperation between federal and state regulatory systems by defining the term "qualified purchaser" 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,[201] 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.[202] Although 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.[203]

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.[204] 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 investors in small businesses, since the securities of many of

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[201] Pub. L. No. 104-290, 110 Stat. 3416 (1996).
[202] Defining the Term "Qualified Purchaser" Under the Securities Act, SEC Release No. 33-8041 (Dec. 19, 2001) [66 FR 66839].
[203] See, e.g., Letter from 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.
[204] Supra note 202, at 4.

these firms 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.

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.[205] 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 Rule 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 simultaneously contemplates a private placement and registered offering,[206] we believe that it is time to clarify or amend the language of the rule appropriately.[207]

[205] 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." 17 CFR 230.152.
[206] See, e.g., SEC No Action Letter, Verticom, Inc. (Feb. 12, 1986).
[207] One further issue, which we did not fully explore and consequently do not make part of our formal recommendation, concerns establishment of a safe harbor from integration for companies that wish to undertake a private placement after they have filed an IPO registration statement and before that registration statement has been declared effective. Issuers sometimes encounter financing difficulties in the midst of the IPO registration process; this is particularly true when the process, either because of market conditions or difficulties in obtaining SEC staff clearance, gets delayed. Under current rules, an issuer's ability to access equity capital privately in such circumstances is extremely limited, and generally requires that it withdraw the public offering registration statement, conduct a private placement limited to qualified institutional buyers (QIBs) and a limited number of large institutional buyers or otherwise structure a private offering that does not run afoul of the SEC's "five-factor" integration test. For companies in urgent need of financing, including smaller companies that lack access to QIBs or large institutional buyers or whose shareholders have preemptive rights to participate in future financings, these restrictive options in many cases mean that equity financing is considerably more expensive or is not a viable option. We suggest that the

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. These areas of concern are:

- Diminished use and acceptance of professional judgment because of fears of being second-guessed by regulators and the plaintiffs bar;
- Complexity of current accounting standards;
- Perception of lack of choice in selection of an audit firm;
- Lack of judgment concerning application of auditor independence rules; and
- Lack of professional education requirements covering SEC reporting matters for auditors of 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 diminished use of professional judgment caused in part by fears of second-guessing by regulators and the plaintiff's bar. This is a very

Commission explore the possibility of establishing a safe harbor from integration that would allow private offerings to take place in this limited context.

serious issue for smaller public companies. Testimony taken by us, as well as written communications we received, strongly supported this view.

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 an approach dictated by their auditors, which the companies believe is caused by their auditors' concerns about regulators questioning their 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.

- 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.[208] 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 protections did not provide adequate protections to reporting companies from abusive private securities litigation.[209]

[208] 17 CFR 230.175, 240.3b-6.
[209] 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:

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 diminished use of professional judgment due to fears of being second-guessed. This is a deep seated problem related to the excessive litigiousness of our society.[210] 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 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

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

companies and public companies.[211]

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.[212] 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.[213]

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.[214] 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 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.

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[210] 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).

[211] 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 ¶ 29 (May 2003) and FASB Staff Position 150-3 (Nov. 2003).

[212] See Letter from Ernst & Young LLP to Committee (May 31, 2005); Letter from American Bankers Association to Committee (Aug. 31, 2005).

[213] See Letter from BDO Seidman, LLP to Committee (May 31, 2005).

[214] See Statement 150, paragraph 29. See also FASB Statement of Financial Accounting Standards No. 123, Share-Based Payment ¶¶ 69, B248 (revised 2004) (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).

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 considered 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 believe that if a two-tiered system of accounting standards existed, many smaller public companies 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.[215] 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.[216]

[215] See , e.g., Letter from Council of Institutional Investors to Committee (Aug. 26, 2005).
[216] 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

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 recent increase in financial statement restatements for previously undetected accounting errors.[217] 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 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

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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 Letter from PricewaterhouseCoopers LLP to Committee (Sept. 2, 2005); Letter from Grace & White, Inc. to Committee (Oct. 6, 2005); Letter from Glass Lewis & Co. to Committee (Sept. 14, 2005). See also responses to Questions 16 and 21 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.

[217] Record of Proceedings 30-31 (Sept. 19, 2005) (testimony of Lynn E. Turner, Managing Director of Research, Glass Lewis & 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. 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 a full

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.[218]
- 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 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.

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

[218] The Accounting Principles Board (APB) was the predecessor entity to the FASB.

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.[219] 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.[220] 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.[221] 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.[222] 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 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

[219] 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)(68 FR 6006).
[220] Those principles are: (1) an auditor cannot function in the role of management; (2) an auditor cannot audit his or her own work; (3) an auditor cannot serve in an advocacy role for his or her client; and (4) an auditor and audit client cannot have a relationship that creates a mutual or conflicting interest. See Preliminary Note to Rule 2-01 of Regulation S-X. 17 CFR 210.2-01. See also 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).
[221] See Preliminary Note to Rule 2-01of Regulation S-X and Item 201(c)(4) of Regulation S-X, 17 CFR 210.2-01(c)(4); Exchange Act Section 10A(g), 15 USC 78j-1(g).

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 believe 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.[223] 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 recommends that the SEC examine its independence rules and consider establishing a rule provision that

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

[223] One witness before the Committee 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).

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.[224]

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 and the FASB, promote competition and reduce the perception of the lack of choice in selecting 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.[225] A large concentration of both large and small

[224] 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).

[225] One witness before the Committee 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, 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). 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 (Dec. 5, 2005) (stating that competition is essential for the proper functioning of any market, and a broader and more competitive market for audit services should be encouraged).

In a July 2003 study, the United States General Accounting Office noted that the preference by investment bankers and institutional investors that public companies use the Big Four to audit their financial statements could have an adverse impact on smaller companies accessing the capital markets, as use of a less well-known accounting firm might create added uncertainty on the part of investors and could possibly lead to delays in accessing new capital. See U.S. Gen. Accounting Office, Public Accounting Firms, Mandated Study on Consolidation and Competition (2003).

public companies is audited by the Big Four audit firms.[226] 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 indicated that they too are capable of serving smaller public companies.[227] 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.[228] More encouragement should be given to audit committees and underwriters to seriously consider engaging a non-Big Four audit firm. We believe that market forces ultimately will determine which firms will audit public companies. We recognize the Commission's, the PCAOB's and the FASB's limited authority to affect concentration in the auditing industry. We also recognize that some of our recommendations concerning internal control

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[226] See United States General Accounting Office, 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).

[227] 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, McGladrey & Pullen LLP, 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.").

[228] One witness before the Committee 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 winning 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, McGladrey & Pullen LLP). 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.").

may increase the concentration of smaller public companies with revenues over $250 million who are audited by the Big Four.[229]

We nevertheless believe that efforts to promote competition in the auditing industry and educate registrants in the choice of selecting audit firms is essential to maintain pricing discipline and to address the perceived lack of competition in the auditing industry. We are therefore recommending that the SEC, the PCAOB promote competition among audit firms and that the FASB further this effort by ensuring that non-Big Four firms are included in committees, public forums, and other venues that would increase the awareness of these firms in the marketplace.[230]

Recommendation V.S.2:

> **Formally encourage the FASB to continue to pursue objectives-based accounting standards.[231] In addition, simplicity and the ease of application should be important considerations when new accounting standards are established.**

[229] See Letter from Crowe Chizek and Company LLC to Committee (Feb. 20, 2006), available at http://www.sec.gov/rules/other/265-23/mhildebrand022006.pdf ("Removing the auditor involvement requirement for Smallcap companies will cause firms other than the Big Four to have very few internal control audit clients . . . This will create a large, unintended competitive advantage to the Big Four and foster further consolidation in the audit profession.") and Letter from McGladrey and Pullen LLP to Committee (Feb. 21, 2006), available at http://www.sec.gov/rules/other/265-23/btravis022106.pdf (supporting the efforts of the Advisory Committee but expressing concern that the Committee's Section 404 recommendations will further concentrate audit services of public companies with the Big 4 audit firms and suggesting that the SEC take further measures to ensure that there is no further audit concentration of audit services in the United States).

[230] 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, McGladrey & Pullen LLP, 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, 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).

[231] 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).

This recommendation is an attempt to deal with the issue of excessive complexity in accounting standards.[232] 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 in today's financial reporting system because of fears of second-guessing by regulators and the plaintiff's bar.[233]
- Development of complex business arrangements and accounting-motivated transactions.[234]
- Constituent concerns about earnings volatility and desire for industry-specific guidance and exceptions.[235]
- 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.[236]

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[232] See Remarks by Robert H. Herz, Chairman, Financial Accounting Standards Board, Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 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 (Dec. 5, 2005); 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 (Dec. 5, 2005).

[233] One witness before the Committee 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 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, McGladrey & Pullen LLP).

[234] 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.

[235] 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).

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.[237]
- Scopes in standards are at times unclear and may contain exceptions.[238]
- The standards have different measurement attributes (such as historical cost versus fair value) and treatment alternatives.[239]
- Rules and bright-line standards provide opportunities for accounting-motivated transactions that are not necessarily driven by economics.[240]
- The standards themselves have become extremely lengthy and difficult to read.[241]

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 Accounting Principles Board (APB), and the Emerging Issues Task Force (EITF).
- Differing views exist on the application of fair value measurement techniques and models.[242]
- Phased projects produce only interim changes.[243]

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[236] 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).

[237] 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.

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

[239] 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).

[240] See Off-Balance Sheet Staff Study.

[241] 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).

[242] 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.

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.[244] 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 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.

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[243] 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.

[244] 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).

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 identified 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 939 U.S. audit firms registered with the PCAOB, we noted that approximately 82% of them audit five or fewer public companies.[245] 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

[245] Daniel L. Goelzer, PCAOB Member and Official Observer to the Committee, provided this information to the Committee in October 2005.

matters.[246] We noted the substantial amount of testimony on this issue.[247] We also noted that the PCAOB and the SEC had issued guidance in May 2005 regarding the implementation of Section 404 and the interaction between an auditor and its client.[248]

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[246] 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.

[247] One witness before the Committee 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, McGladrey & Pullen LLP, 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, 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, Managing Director of Research, Glass Lewis & Co., predicting the costs of Section 404 internal controls to come down after the first year of implementation, and 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). One witness before the Committee 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 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 &

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.

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 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).

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

PART VI. SEPARATE STATEMENT OF CO-CHAIRS

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

PART VII. SEPARATE STATEMENT OF MR. JENSEN

Introduction

I am dissenting to recommendations III.P.1, III.P.2 and III.P.3 contained in the Final Report of the Advisory Committee. Since the time of the original vote on the recommendations, I have become aware that certain investor groups are concerned with the removal of Section 404 of the Sarbanes-Oxley Act of 2002 requirements for a large number of public companies. While no one knows the exact extent of investor opposition, I believe this group is too important to the health of our capital markets to ignore their point of view. Specifically, I believe that providing a permanent exemption for smaller public companies from these requirements may ultimately harm investors of those companies. In addition, I disagree with the adoption of a weakened auditing standard for Section 404 compliance by certain companies.

The fact that the Advisory Committee heard so many different points of view on these critical issues supports the fact that we do not yet have sufficient experience with implementation of Section 404 to know with certainty that a permanent exemption is a better answer, or whether any change in auditing standards is warranted. In light of these factors, my recommendation calls for additional temporary deferrals coupled with a study of key implementation elements and a definitive timetable for resolution.

Dissenting Views and Rationale

I agree with the rationale in the Final Report describing the need to scale securities regulation for smaller companies. As a member of the Advisory Committee I heard testimony from many on the potentially damaging impact of the costs of Section 404 on the growth potential of smaller public companies. Additionally, many parties provided written comment on the disproportionate burden of Section 404 related costs on smaller public companies. The Final Report includes a number of examples and anecdotes on the reasons for this disproportionate burden including constraints caused by limited internal and external resources, lack of guidance tailored to smaller companies and less revenue with which to offset implementation and ongoing compliance costs. I acknowledge that this cost issue necessitates a significant and substantial effort to develop an appropriate application of Auditing Standard No. 2 in the small public company environment.

I am also cognizant of testimony and written comments the Committee received on the significant benefits of Section 404. Many reminded the Advisory Committee of the corporate failures that resulted in Congress enacting the Sarbanes-Oxley Act of 2002. Other investors gave testimony on the benefits of Section 404 both to themselves and to the companies in which they invest and the increased confidence instilled in the investor community as a result of the additional checks and balances required by the Act. A smaller public company, as information provided to the Advisory Committee indicates, is more likely to suffer control deficiencies than a larger company. This fact logically means that investors will consider their investment in smaller public companies a higher risk. It seems, therefore, that smaller public companies could benefit from a process that improves investor confidence in their financial reporting thereby helping them achieve a wider and more diverse investor base. If such benefits for both companies and investors can be derived from Section 404, then it seems to me that eliminating the requirement for these companies is unwarranted. Rather, more effort should be expended to scale the approach to smaller public companies.

The key is to balance the needs of the users of financial statements with the costs to companies in supplying the required information. Balancing what preparers of financial statements can reasonably provide and what users of financial statements can reasonably expect to receive is a basic principle of our financial reporting and regulatory systems. The current debate around Section 404 demonstrates clearly that this required balance does not exist at smaller public companies today. Many smaller public companies have indicated that the solution to this problem is to eliminate their compliance with Section

404. However, simply eliminating the requirement will tip the scales and investors, who will not receive the information and assurances intended to be provided under the Act, will likely believe that the system is out of balance to their detriment. I believe that through additional implementation experience, guidance and tools, Section 404 reporting can become more efficient and cost-effective for smaller public companies.

I disagree with the adoption of an alternative auditing standard. A lesser standard may prove not to be in the interest of the smaller public company as it creates a two tier system. The existence of a two tiered system could reduce investor confidence in the smaller public companies' financial reporting process and would thereby eliminate all of the benefits of Section 404 which, as discussed above, may be an important benefit that could be derived by smaller public companies. I believe that effective Section 404 compliance in the smaller public company will continue to improve investor confidence and I also strongly believe that compliance can be achieved in a cost effective manner.

Further Consideration

Accordingly, in lieu of permanent exemptions, I recommend an additional temporary deferral of the Section 404 reporting for non-accelerated filers that have not yet reported under Section 404, coupled with a definitive action plan led by the SEC as outlined below. This plan includes participation by smaller public companies, the auditing profession and the PCAOB. Given the cost concerns provided to the Advisory Committee on smaller public companies, such an additional temporary deferral could include an optional, temporary suspension of certain of the requirements for smaller public companies that recently implemented the Section 404 requirements and meet the market capitalization and revenue criteria in recommendations III.P.1 and 2. On this latter point, the SEC would have to weigh the implications of this proposal with the likelihood that many of the companies already complying would nonetheless choose to continue to comply.

The steps that I would propose would be subject to a defined timeline and a set of actions to definitively resolve the scope of Section 404 implementation for smaller public companies prior to the 2008 year-end. For example, these actions could include:

- Reconsideration of the end product in the ongoing process to tailor the COSO requirements for smaller businesses. This project has been underway for some time. It is essential that the final document succeed in being truly useful to smaller companies. It is vitally important that the final document be replete with guidance, examples and tools, which permit the efficient implementation and testing of COSO requirements for smaller businesses. A definitive guide for performing management's assessment of internal control effectiveness for smaller public companies would be the single most useful element of this effort.
- The conduct of an SEC-led pilot program for a prescribed number of micro-cap and smaller public companies during 2006 that would serve as a field test and lead to the development of guidance on application of AS2 in that environment for auditors, as well as the development of internal control and Section 404 compliance tools for management of micro-cap and smaller public companies.
- An in-depth study of the companies that have two years of experience in complying with Section 404, perhaps by focusing on the smaller of the complying companies in order to gain an in depth understanding of the costs and benefits. The criticality of reliable, not anecdotal, cost-benefit information is a fundamental predicate to finalizing the important regulatory and public policy decisions that the SEC needs to make.

The basic timeline for this action plan could be: pilot program and study in 2006, develop and field test guidance and rules in 2007, and implement in 2008.

Should this recommendation be adopted, my firm would be willing dedicate resources to participate in any efforts to gather evidence, field test new guidance, or develop tools for management and auditors that will further support this process. We would look forward to working with others in the accounting profession, vendors of technology solutions, and companies in the program and other public and private-sector organizations to achieve success in this endeavor.

It is important to note that this timeline includes only one additional annual deferral of the Section 404 requirements for non-accelerated filers; however, it should also include specific, defined steps during this period, to significantly improve guidance and tools, and increase the cost effectiveness of implementation for smaller public companies.

This recommendation is made with our mutual public interest goals in mind. It reflects my opinion that after only two years of implementation for accelerated filers, market participants and regulators do not have sufficient information to make final decisions regarding the long-term application of these important internal control requirements for smaller public companies. I recommend that a process be developed to gather empirical, field-driven information to resolve this important question, and that an additional deferral be granted until this can be accomplished.

PART VIII. SEPARATE STATEMENT OF MR. SCHACHT

This Separate Statement to the Final Report of The Advisory Committee on Smaller Public Companies (the "Report") is submitted for the purpose of dissenting on several of the primary recommendations of the Advisory Committee. These relate to the work of the sub-committee on Internal Controls Over Financial Reporting (the "Sub-Committee"). As a member of the Sub-Committee and consistent with our dissenting opinion of December 14, 2005, a copy of which is attached, we remain opposed to key portions of the Report.

Observers and committee participants agree that the most substantive recommendations in the Report relate to the application of Section 404 of Sarbanes-Oxley ("Section 404") to smaller public companies. As a Committee, we reviewed several issues impacting smaller public companies. It is clear however, that the impacts of Section 404, particularly the resource demands and costs of implementing 404, have proven to be the most challenging. During our deliberations, the Sub-Committee discussed dozens of ways and options for reducing costs, while maintaining investor protections.

Cost-Benefit Analysis

The Advisory Committee members generally agree that the costs of Sarbanes Oxley ("SOX") are the real issue. While minimization of regulatory costs is always a desirable goal, the Report confirms what we knew coming into this Committee process, that the costs have exceeded all estimates, and have significantly impacted small companies. There have been numerous cost studies and other anecdotal comments on whether these costs are, or will be, coming down in subsequent years. The evidence will only be clear once we have actual data in the coming months. For many companies that have yet to go through the process, the initial costs will be high. But the analysis must not end there. It suggests that whatever the benefits of Section 404 might be, they are surely far outweighed by these more obvious cost figures. The Report states that the benefits are of less certain value and moves on to other matters.

The Advisory Committee, by and large, agrees that internal controls over financial reporting at public companies are important. More specifically, we assert they are an important feature for accurate financial reporting, investor protection, and market integrity. But is there a measurable benefit? It is impossible to measure the value of a financial/accounting fraud avoided. In 2005, there were approximately 1300 restatements and weaknesses in financial reporting revealed and fixed by a Section 404 inspired process, more than double the number in 2004. This dramatic increase will have an inestimable and far-reaching impact on financial reporting reform. Some argue this is a reflection of deferred maintenance on an internal controls process that has been neglected and that SOX represents a renaissance for proper internal control process and environments. Whatever the reason, these are benefits that are significant and certain. Moreover, they are benefits which, we believe, balance the cost of a properly scaled and verified internal control structure.

Section 404 Exemption vs. Improved Section 404 Implementation.

The Sub-Committee set about its work with the focus of adjusting the main cost driver of Section 404, the level to which internal controls need to be documented, verified and tested by management and outside auditors. The original objectives were to reduce the cost burdens but maintain the investor protections associated with Section 404. The Sub-Committee focused on a variety of ways to meet the objectives but narrowed its attention to two. The first is creating a more tailored and cost-efficient internal control structure and verification process for small companies, i.e., reducing the cost and resource drain of Section 404 through better implementation. The second is providing small companies with an exemption from the main requirements of Section 404.

The objectives of cost control and investor protection need not be mutually exclusive. However, the Report's primary recommendations make them so. Our strongest objection is that the Report recommends a flat-out exemption from all auditor 404 involvement in reviewing and confirming internal controls. This is not for just a few, but for what will effectively be more than 70 to 80 percent of the public companies in this country.

One could cite any number of flaws in this approach, but several in particular stand out:

- First, the entire premise of SOX was to bolster investor confidence by requiring meaningful corporate governance and financial reporting reforms. Likewise, maintaining investor protections is a primary tenet of the Committee Charter. Properly designed and functioning internal controls over financial reporting were and are a cornerstone of this legislation. Proper structuring and implementation of 404 requirements are very different from eliminating these completely for a broad segment of U.S. companies. That approach works against the statute's legislative intent and the directive that we heard from both Chairman Donaldson and Chairman Cox.

- Second, it is unclear to many whether the broad exempting recommendations of this subcommittee are even within the commission's legal authority. Comprehensive, sweeping exemptions from Section 404 may not be possible under the current legislation, which specifically excluded Section 404 from the Securities and Exchange Act of 1934. As the full Commission works toward final recommendations, it would be well served to resolve that potential legal uncertainty so as to avoid further litigation delays in addressing Section 404 concerns.

- Third, with regard to Micro Caps as defined, the Report recommends exemptive relief from not only auditor involvement in reviewing internal controls but also exempts the managers of these firms from having to do their own internal assessment of such controls. Essentially, no one has to check the design, implementation and effectiveness of internal controls over financial reporting at these companies. The reason for this complete 404 exemption according to the Report is that there is no specific directions/guidance available to such small company managers to know how to create an appropriate internal control structure. We wonder about two things in this context. First, how have these firms been able to meet the on going legal requirements for maintaining an effective system of internal controls (actually mentioned as part of the recommendation) and more importantly, if such guidance is missing for micro caps, how does it suddenly become clear for managers of small companies above $125 million in market cap? In the event any of these exemptive recommendations are adopted by the SEC, we believe logic dictates that managers in all public firms be required to complete an annual Section 404 assessment of internal controls.

- Fourth and maybe most important, small public companies need checks and balances over financial reporting. This includes the Section 404 checks and balances in our view. The Report indicates that: small cap firms have less need for internal controls; requiring external verification of internal controls is a waste of corporate resources; and, that better corporate governance is a substitute for such verification. It further suggests that investors in these companies don't particularly care about internal control protections and that these companies represent an inconsequential bottom 6% of total U.S. market capitalization, rendering even an Enron-like blowup a minor event. At the same time, the Report characterizes such small companies as a critical link in economic growth and competitiveness and that Section 404 is the regulatory tipping point and barrier to accessing public markets. Parsing through these contrasting views of inconsequential vs. critical seems to suggest incorrectly that venture capital exit strategies are more important to protect than public investors providing risk capital. A number of experts we heard from feel that properly structured and verified internal controls are probably more important for the riskier, smaller firms and that additional corporate governance provisions are in no way a substitute for properly working internal controls. For example, these small firms consistently have more misstatements and restatements of financial information, nearly twice the rate of large firms, according to one report. Alarmingly, these small firms also make up the bulk of accounting fraud cases under review by regulators and the courts (one study puts it at 75 percent of the cases from 1998-2003).

- Finally, we note that as part of each of the recommendations for Section 404 exemption, the Report suggests these companies be reminded of pre-SOX legal requirements to have an effective system of internal controls in place. This legal reminder simply points out how ineffective the rules were pre-SOX and how they are no substitute for having some level of external verification of controls as prescribed by Section 404.

Better Implementation of Section 404 & SOX "LIGHT"

A more balanced approach to fixing the cost concerns of Section 404 is to continue requiring manager assertions and auditor attestation of internal controls, but direct the appropriate regulatory and de facto standard-setting bodies (the Committee of Sponsoring Organizations of the Treadway Commission (COSO), the Public Company Accounting Oversight Board) and the SEC to develop specific guidance for small companies. This approach has been referred to as a "404 Light" or "SOX Light" approach. However, the term has become confusing over the course of the Committee debate.

Much of the outline for this approach appeared in preliminary recommendations of the Sub-Committee. We encourage the Committee to be clear on the options for better implementation and for the Commission to consider a broad range of approaches. These may include: 1) reviewing/refining the existing AS-2 standards; 2) possible development of an alternative auditing standard (the Report references AS-X) that provides for a meaningful, but more cost effective audit; and 3) development of specific directives from COSO and PCAOB on how to "right-size" for small issuers, the control structure, the requirements for managers assessment and the scope of an internal controls audit.

This "Better Implementation" approach appears in the Report, but comes only as a fall-back alternative to the exemptive recommendations. To ensure continued investor confidence in our markets, we support the approach that preserves the investor protection aspects of 404 while lowering costs to implement and verify proper internal controls over financial reporting.

Investors Support Section 404

It is clear that we need to do something for small companies. Investors in these companies, more than anyone, have a significant stake in making sure we balance the regulatory burden with the need to grow and access capital markets. Investors and the economy are ill-served by a system that neglects either.

We heard commentary from several professional investors and institutional managers in support of Section 404 requirements. The weight of such testimony has been questioned since many do not invest directly in micro cap firms. Moreover, the lack of specific individual testimony from micro cap and small cap investors along with the observation that people still invest in these firms without Section 404 protections, both in U.S. and foreign markets, has been suggested as evidence that investors do not care about section 404 protections.

While we encourage more of these small company investors to come forward and participate in the next comment period, we believe the investor base involved in these firms is very fragmented. These companies represent somewhere between 70 and 80 percent of public companies and collectively have millions of individual retail and private shareholders. It is unlikely this group will magically coalesce and speak with a collective voice on this or any other regulatory or financial reporting issue affecting the companies in which they invest. That silence should not be misinterpreted. These are precisely the investors that need the formal and self-regulatory "system" to provide the necessary protections, transparency and honesty that ensures a fair game. It is what continues to make U.S. markets the gold standard.

We appreciate the opportunity to serve on the Advisory Committee and to serve as a representative for investor views. We encourage investors to provide timely commentary to this Report. As with any regulation, it is important to reach the proper balance between cost burden on the issuer and investor protection. We firmly support realignment and better implementation, not elimination of Section 404, as the proper balance.

STATEMENT OF MR. SCHACHT DATED DECEMBER 14, 2005

I appreciate the opportunity to address the entire committee on the work of the 404 subcommittee and want to acknowledge all of my colleagues' hard work. It was a pleasure working with them.

As a committee, we have reviewed several issues affecting smaller public companies. It is clear however, that the impacts of Section 404 of Sarbanes-Oxley, particularly the implementation costs, have proven to be by far the most challenging. While I do not agree with several subcommittee recommendations, Section 404 is one of the key issues to focus on. Solutions to its overly burdensome cost, particularly on small issuers, are not simple.

Notwithstanding that I am the lone dissenting vote on the subcommittee, I do want to acknowledge that this group has examined this topic closely. They fully considered my concerns and those of others who commented on the proper ways to "fix" 404. We discussed dozens of ways and options for reducing costs, while maintaining investor protections.

We all agree that the costs of SOX are the real issue. They have been too high, exceeding all estimates, and they hit small companies much more significantly. There have been numerous cost studies and other anecdotal comments on whether these costs are or will be coming down in subsequent years. I think the evidence will only be clear once we have actual data in the coming months, because this is clearly not yet at a point of equilibrium. For many companies that have yet to go through the process, the initial costs will be high. There is no question about this.

Also, we all agree that internal controls at public companies are important. They are an important feature for accurate financial reporting, investor protection, and market integrity. Some argue that internal controls have been somewhat neglected, and SOX has tried to bring about some assurance that adequate controls are in place and working as desired. How the markets get that assurance -- that is, the level to which these internal controls need to be verified and tested by management and outside auditors -- is the rub.

The subcommittee goal was to reduce the cost burdens but maintain the investor protections associated with Section 404. These need not be mutually exclusive. My concern, and the basis for my dissent, is that the panel's recommendations make them mutually exclusive. We seem to say you can't have meaningful cost reductions unless you eliminate 404, including the investor protections.

Our biggest concern is that the main recommendations give a flat-out exemption from all auditor 404 involvement in reviewing and confirming internal controls. This is not for just a few, but for what will effectively be more than 80 percent of the public companies in this country.

One could cite any number of flaws in this approach, but three in particular stand out:

- First, the entire premise of SOX was to bolster investor confidence by requiring meaningful corporate governance and financial reporting reforms. Properly designed and functioning internal controls over financial reporting were and are a cornerstone of this legislation. Proper structuring and implementation of 404 requirements are very different from eliminating these completely for a broad segment of U.S. companies. That approach works against the statute's legislative intent and the directive that we heard from both Chairman Donaldson and Chairman Cox.

- Second, it is unclear to many whether the broad exemptive recommendations of this subcommittee are even within the commission's legal authority. Comprehensive, sweeping exemptions from Section 404 may not be possible under the current legislation, which specifically excluded Section 404 from the Securities and Exchange Act of 1934. As the full committee works toward final recommendations, it would be well served to resolve that issue, as I expect there will be legal challenges of this authority.

- Finally, and maybe most importantly, small public companies need checks and balances over financial reporting. They consistently have more misstatements and restatements of financial information, nearly twice the rate of large firms, according to one report. Alarmingly, they also make up the bulk of accounting fraud cases under review by regulators and the courts (one study puts it at 75 percent of the cases from 1998-2003).

A more balanced approach to fixing SOX 404 is to continue requiring manager assertions and auditor attestation of internal controls, but direct the appropriate regulatory and defacto standard-setting bodies (the Committee of Sponsoring Organizations of the Treadway Commission (COSO), the Public Company Accounting Oversight Board) and the SEC to develop specific guidance for small companies. These would specifically outline appropriate control structures and the auditing scope for small companies under 404 – a SOX 'light' approach.

Much of the outline for this approach appears in Recommendation 3 of the subcommittee's report. However, it comes only as a fall-back alternative to the exemptive recommendations. To ensure continued investor confidence in our markets, we deserve an approach that preserves the investor protection aspects of 404 while lowering costs to implement and verify proper internal controls over financial reporting.

It is clear that we need to do something for small companies. But giving them a pass on any verification and oversight of internal controls will come back to haunt us.

The subcommittee's recommendations will now attract a fuller public debate on some very important public policy issues. I would offer this challenge to investors and, indeed, all participants in the financial reporting process to get involved in commenting on these recommendations. It is important to reach the proper balance between cost and investor protection. Realignment not elimination of Section 404 is needed to accomplish that.

PART IX. SEPARATE STATEMENT OF MR. VEIHMEYER

Section 404 of Sarbanes-Oxley has contributed significantly to the improvement of financial reporting, oversight of internal controls, and audit quality. The public interest and the capital markets have been well served by this legislation. At the same time, compliance with the provisions of Section 404 has placed important responsibilities on issuers and auditors that are both expensive and time consuming. Clearly, the important goals of Section 404 must be achieved in the most cost-effective and least burdensome manner, to ensure that the costs of Section 404 do not outweigh the benefits. This is particularly challenging with respect to smaller public companies. The Advisory Committee on Smaller Public Companies has worked very hard to determine where to strike the appropriate balance between the benefits to investors and the burdens on issuers. The Final Report of the Advisory Committee is the result of that work. While I respect the Committee's efforts to find the best possible solutions to these difficult problems, I differ with the majority over one fundamental principle. In my judgment, sound public policy dictates that the protections provided by Section 404 should be available to investors in all public companies, regardless of size. Accordingly, our focus at this time should not be on exempting companies from Section 404, but on developing implementation guidance for assessing and auditing internal control over financial reporting for smaller public companies that recognizes the characteristics and needs of those companies. This guidance should be jointly developed by regulators, issuers and the accounting profession and should be field-tested for effectiveness, including appropriate cost analysis, before implementation.

The Final Report provides extensive root-cause analysis of the costs of compliance with Section 404, but fails to address the reality that economies of scale do influence the relative cost of regulatory compliance and professional services, including audits of financial statements. Therefore, there is need for additional steps to be taken to further improve the execution of Section 404 compliance relative to smaller companies, as described below.

I also believe that PCAOB Auditing Standard No. 2 is fundamentally sound and scalable, and it is not prudent to consider amending the Standard at this time. The first year of integrating the financial statement audit with the requirements of Auditing Standard No. 2 was a difficult process due to a number of environmental issues that have been well-documented. Simply stated, the full integration of the financial statement and internal control audit did not occur in year one. However, my firm's experience is that the additional year of experience, coupled with the May 2005 guidance from the SEC and the PCAOB, and the efforts of issuers and auditors to improve their respective approaches, has resulted in further integration of the financial statement and internal control audit and is reducing the total cost of compliance. I believe that issuers and auditors should be allowed the opportunity to introduce incremental effectiveness and efficiency into the compliance process – a migration that will occur naturally as issuers and auditors move forward on the learning curve associated with reporting on internal control over financial reporting.

Because I believe that compliance with the provisions of Section 404 provides needed protection to investors in all public companies, regardless of size, I do not support recommendations III.P.1, III.P.2, and III.P.3 in the Final Report, as each would serve to dilute this protection.

Specifically, Recommendation III.P.3 referencing a standard providing for an audit of the design and implementation of internal control, but not the testing by the auditor of the operating effectiveness, is in my view not advisable. While clear disclosure that a company has not undergone an audit of internal control over financial reporting is understandable to users, those same users cannot be expected to assess the relative gradations of assurance provided by this proposed distinction in reporting on internal control. An alternative providing for an auditor's report only on design and implementation of internal controls, at a time when much attention has been directed toward reporting on the effective operation of internal controls, will result in users' misunderstanding the level of assurance provided by the auditor. It is important to note that a well-designed system of internal control, while vital, does not equate to the generation of reliable financial information in the absence of effective operation of internal control. Accordingly, I believe that Recommendation III.P.3 would serve to widen an already existing expectation gap with respect to audit services at a time when emphasis should be directed toward reducing that gap.

I do not support Recommendations III.P.1 and III.P.2 based on my belief that Section 404 of Sarbanes-Oxley has made and will continue to make significant contributions to improving financial reporting, oversight of internal controls, and audit quality. In my judgment, sound public policy dictates that the protections derived from these contributions should be available to investors in all public companies, regardless of size.

I believe that compliance with the provisions of Section 404 by issuers, and application of the principles of Auditing Standard No. 2 by auditors, represent evolutionary skills that will become more effective and efficient with more experience. As noted above, the effectiveness and cost-efficiencies of Section 404 execution have improved over the first two years. However, additional efficiencies and experience with Auditing Standard No. 2 are not likely to fully address the concerns of certain-sized smaller public companies. Accordingly, I recommend that regulators, issuers and the accounting profession work expeditiously to develop specific guidance, focused on the characteristics of these smaller companies and their internal control structures, which will further improve the execution of Section 404 compliance. I will commit resources of my firm to participate in and support this effort. Additional implementation guidance specifically tailored to the application of internal control concepts in a smaller company environment should, at a minimum, address the following: significance of monitoring controls, risk of management override, lack of segregation of duties, extent and formality of company documentation and assessment, and evaluation of the competency of a smaller company's accounting and financial reporting function. This guidance should address both the assessment to be made by management and the auditor's performance requirements relevant to such assessment, as well as the execution of auditing procedures pursuant to the provisions of Auditing Standard No. 2.

In addition, I believe that field testing the effectiveness of this additional guidance, including appropriate cost analyses, should be performed to facilitate well-informed decisions regarding the reasonable application of the provisions of Section 404 in a smaller public company environment. It may become evident, as a result of field testing and meaningful cost analyses, that an audit of internal control over financial reporting may not be justified for certain very small public companies that evidence certain characteristics. For those smaller public companies, an exemption from the provisions of Section 404 may be warranted, but such an exemption should be considered only after careful analysis of the data derived from the field tests. In short, we simply do not have sufficient implementation guidance, experience, or information available at this time to make a permanent reduction in the protections provided by Section 404.

It is essential that the additional implementation guidance, specifically tailored to the application of internal control concepts in a smaller public company environment, be developed and tested expeditiously, given the importance of this issue to smaller public companies and investors. While this guidance is being developed and field tested, I recommend the continued deferral of the Section 404 requirements for all smaller public companies that have not already been required to implement Section 404. However, I would envision that such deferral would not extend more than a year beyond the current implementation date for non-accelerated filers.

It should be noted that this separate statement focuses solely on the recommendations to which I dissent, and not to any specific statements or opinions contained in the Final Report which are inconsistent with my own views.

The work of the Advisory Committee and our Final Report has raised important issues relative to application of the provisions of Section 404. To address those issues, I propose additional guidance for smaller public companies, and the field testing of that guidance, relative to reporting on internal control over financial reporting as well as the continued deferral for non-accelerated filers for an additional year if these activities cannot be completed within one year. I believe these proposals are consistent with our Charter to further the SEC's investor protection mandate, and to consider whether the costs imposed by the current regulatory system for small companies are proportionate to the benefits, to identify methods of minimizing costs and maximizing benefits, and to facilitate capital formation by smaller companies.

APPENDICES

Index of Appendices