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United States Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609
Attention: Jonathan G. Katz, Secretary

Via e-mail: rule-comments@sec.gov, chairmanoffice@sec.gov

Re: File No. S7-19-04, Securities and Exchange Commission Release Nos. 33-8407 and 34-49566 the Proposed Rules

Ladies and Gentlemen:

My firm works with a number of companies that have gone public in what could be called the traditional manner, through the filing of registration statements on Form SB-2 or Form 10-SB, as well as through reverse mergers with public shell companies. In addition, my firm works with a number of companies who are required to file annual and periodic reports under Section 12g of the 1934 Act.

I have the following comments and recommendations based upon my experience with the issues raised with reference to this and other small company matters:

History and each endeavor by man must balance the diabolical with the divine. There exists a common thread, when left unattended that can corrupt, alter and irrevocably stain the fabric of humanity in ways that are often discouraging and depressing. Nowhere is this thread of temptation greater than in the lure of financial gain. Are we to assume the worst then in all who dabble in such an area, for those whose profession is marked by integrity and trust? No indeed. The fulcrum can not swing now in a direction that disenfranchises the majority for the weaknesses of the few. Financial fraud and the magnitude of greed within which recent American companies shave experienced are more barometer readings than industry wide evaluations. In looking forward to the positive change that comes through recognition and admission of poor practices and bad behavior, this paper recognizes that the value of the economy we enjoy and its connectivity to the engine of our nation's strength is much too valuable a resource to dismiss as murky bath water.

The purpose of this paper is rather extensive in that it seeks to shape an opinion of which the reader may ascertain the climate for fraud and the arenas that can cultivate such poor behavior. In so many ways it also a paper that exposes the activity of fraud and its irresponsibility are not inerrant characteristics of small business owners, OTCBB traders, or even internet day traders. Fraud exists in all areas of the industry and must be understood with this perspective in order to create positive and holistic change.

This paper will cover the following issues in detail:

- Introduction and overview of fraud
- Absurdity of Big Boy Fraud vs. OTCBB Fraud
- Impact of fraud on small business by way of the OTCBB

- The successful story of public companies vs. private companies in staying solvent in today's litigious and paranoid culture of "gotcha"
- Focusing on the positive: the many benefits of corporate America

Introduction and Overview to Fraud

Fraud: How should we respond?

In response to the alarming scandals and their cumulative effect on the American markets and overall investor confidence, the President announced a 10 point Plan of Corporate Responsibility[1]. The main thrust is that investors need access to information that is fairly reported in compliance with existing laws, and information that is accurate and can be relied on for investment decisions. To ensure that corporate responsibility was enforced, the President called on Congress to grant the Administration new powers to institute new criminal penalties for mail and wire fraud, strengthen laws and crackdown on obstruction of justice, and give new power to the SEC to freeze improper payments to corporate executives when a company is under investigation.

In line with this thinking, the President created the Corporate Fraud Task Force (including US Attorneys, The FBI and SEC) to oversee the investigation and prosecution of financial fraud, accounting fraud and other corporate criminal activity, and to provide enhanced coordination of investigations.

Later in the same month, the President signed the Sarbanes-OxleyAct of 2002. This Act;

- Created a new accounting oversight board to police the practices of the accounting profession
- Strengthened auditor independence rules
- Increased the accountability of officers and directors of companies
- Enhanced the timeliness and quality of financial reports of public companies, and
- Barred insiders from selling their stock during blackout periods when workers were unable to change their retirement plans.

Since these improvements were implemented, there has been a marked increase in the detection and prosecution of corporate fraud, but too late to save the billions of dollars these incidences of fraud have cost investors and our economy.

Microcap Fraud

Microcap[2] securities provide legitimate opportunities for small and new businesses to raise capital. Unfortunately, they also give the unscrupulous greater license to prey on innocent investors. The reason is straightforward: information about smaller companies is much more difficult to find and obtain than information about larger companies. Public information is perhaps the most important ingredient to making

[1] The full text can be viewed on the White Hose website; www.whitehoouse.gov/infocus/corporateresponsibility/index2.htm,
[2] The term "microcap stock" applies to companies with low or "micro" capitalizations, meaning the total value of the company's stock. Microcap companies typically have limited assets.

an informed investment decision. You can't do that if you don't have this information. Additionally, because most microcap companies have no operating or earnings history, there is usually no analyst or press scrutiny of the stock. The end result is that there is an absence of unbiased information in the marketplace. And, when reliable information is scarce, the potential for fraud increases. Many of the microcap companies that don't file reports with the SEC are legitimate businesses with real products or services. But the lack of reliable, readily available information about some microcap companies can open the door to fraud. It's easier for fraudsters to manipulate a stock when there's little or no information available about the company.

Recent news reports have noted that microcap fraud bilks investors out of approximately $2 billion per year. [3]With microcap fraud on the rise, securities regulators and law enforcement agencies are taking steps to combat microcap fraud. Criminal prosecutions have increased and securities regulators are taking measures to close loopholes in the law that are exploited by fraudsters. Microcap fraud depends on spreading false information. The North American Securities Administrators Association believes that microcap fraud is a problem of market conduct. Investors must take a more active role in protecting themselves from fraud.

> "People spend more time choosing a computer than they spend researching Internet investments," said Nancy M. Smith, Director of the SEC's Office of Investor Education and Assistance. "Investors can take their own preemptive strikes against Internet fraud simply by checking out investments before they buy."

The SEC has a four-pronged approach to tackling microcap fraud: enforcement, inspections, investor education and regulation. If the regulatory bodies do their job and investors protect themselves and follow the advice of the SEC when investing in microcap Stocks on the OTCBB, both investors and smaller companies wishing to go public can benefit from trading on the OTCBB. To find out what recommendations the SEC has for protecting oneself against microcap fraud go to www.sec.gov.

Fraud: Who are the bad guys?

The proverbial bully on the playground eventually attracts attention. While understanding when and who the bad guy's are or who the next investor victim will be are impossible to predict, there are general signs that any astute investor should recognize. Pressure tactics, scare tactics, or methods of asking for cash that appear inconsistent are obvious signs that some level of fraud is or could take place. Orders that are taken over the phone with little protection or personal information required prior to transacting a trade or again opportunities for further homework and a glimpse into the few "bad apples".

There are several types of fraudulent schemes which have been used by fraudsters, but pump and dump and illegal touting seem to be the most popular. The SEC has become increasingly vigilant and proactive in its fight against microcap fraud, conducting nationwide sweeps targeted at preventing microcap fraud.

As a result of the First "sweep", it was announced in September 1998 that the SEC had filed 13 enforcement actions against 41 defendants across the country that defrauded investors of approximately $ 25 million. Most of the cases involved "pump and dump" schemes and manipulated the stock price of microcap companies with false and misleading information about the financial conditions, business relationships and future stock price of those companies.[4]

In a continuation of the nationwide sweep, 4 further enforcement actions were files against another 13 defendants in February of 1999. The fraudsters in this case received cash payments for their illegal touting as well as 2.7 million stocks, which were intended to be sold once the price was pumped up.[5]

[3] http://www.fool.com/specials/2000/sp000223fraud5.htm
[4] SEC Release 98-92
[5] SEC Release 99-24

Again in August of 1999, the SEC announced the filing of 26 enforcement action against 82 defendants who profited by more than $12 million in their second nationwide sweep.[6]

On May 12 1999, the SEC announced 14 enforcement actions against 26 individuals and companies for using the Internet to defraud innocent investors and potential investors, stopping the some of alleged frauds before potential investors lost money.[7]

With the forth Nationwide sweep in September 2000, the SEC had lodged 15 enforcement actions against 33 individuals and companies who used pump and dump manipulations to pump up the market capitalization by $1.7 billion and reap illegal profits of more than $10 million.[8]

Finally, in the fifth nationwide sweep of microcap fraud, 11 enforcement actions were instituted against 23 companies and individuals who used the Internet to defraud investors by pumping up the market capitalization of the stocks involved by $300 million and realized $2.5 million in proceeds.[9]

Fraud in any form or amount is unacceptable, and we must strive for its eradication in the investment and trading institutions. Looking at the cold facts however, shows that the fraud committed by companies trading on the richer exchanges is far more damaging to investors and investor confidence than the fraud which goes on in the realm of the OTCBB. Even if we accept the figure of $2 billion dollars a year for Microcap Fraud, this amount pales in comparison to the dollar cost of the fraud committed on NASDAQ, NYSE and AMEX, where detection of the fraud is not as easy for investors to spot or protect themselves from.

In summary, it is a mirage, a distortion of the truth that the majority of fraud takes place in the small markets. The fact is that fraud in corporate America is rampant not in the small business sector promulgated by companies on trading on the OTCBB but the vast majority and financial impact that the toll takes on investors happens in Fortune 1,000-land among companies touted by bulge bracket firms with market caps in the billions.

<u>**Investor and Shareholder Protection**</u>[10]

In order to understand where the ability to deceive and foster fraud can begin, it is important to recognize and understand the value of your company's investor and ultimate company owner, the shareholder.

It is a myth that shareholders can do little to mitigate their risk other than diversifying their portfolio among several industry market segments and companies when investing in a publicly traded company. In fact, shareholders can insist upon changes in the senior management of the company, demand that enhanced corporate governance methods be instituted to protect the shareholders, and terminate their equity participation.

It is important for investors to realize the difference between securities fraud and simple bad luck. Most investment losses are the result of market forces, trends, and factors that have nothing to do with securities fraud.[11] Stockbrokers are not omniscient, and most investment losses are honest mistakes or are out of the control of the stockbroker. If a shareholder is certain that they have lost money as a result of foul play on the

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[6] SEC Release 99-90
[7] SEC Release 99-49
[8] SEC Release 2000-124
[9] SEC Release 2001-24
[10] *Investor and Shareholder Protection*, white paper. www.pubcowhitepapers.com
[11] http://www.securitieslaw.com/

part of the stockbroker or the issuing company, this is then called fraud. Investors should be well informed about the avenues they can take after establishing that fraud has taken place.

Investors often do not realize that securities fraud has taken place, and they do not realize what happened or how it happened. Stockbrokers have a duty to care for and be loyal to their customers. Brokers must use due care and diligence when dealing with their customers, and the interest of the customer should always come first. There are certain warnings that exist for investors to watch for[12]:

- Inconsistency between the broker's verbal statements and the performance of the investments
- Misrepresentations by the broker, or important information about an investment which the broker did not disclose particularly regarding risk
- Frequent and excessive trading in the account, including in and out trading
- Trading in high risk, speculative or unsuitable investments
- Trading in securities and strategies that the customer cannot understand
- Trades which the customer did not previously authorize
- Trading in low value securities or obscure companies on foreign exchanges, or private investments
- Failure of the broker or his supervisor to be responsive to complaints
- Repeated promises by a broker to make up for losses through various devices
- The loss of funds or value in the account which the customer cannot understand and the broker cannot reasonably explain.

All of these warning signs indicate securities fraud, and if an investor has experienced any of them, he/she should proceed with caution in regards to his/her plan of action.

Fraud from without

It has been suggested that foreign companies that cross-list in the United States have will have a higher degree of protection for their shareholders. Cross-listing subjects foreign companies to the standards of both their native country and the U.S. GAAP requirements. "This increases the expected cost to managers of extracting private benefits and commits the firm to protecting the minority shareholder's interests. There are clear predictions about the relation between subsequent equity issues, shareholder protection and cross-listings: 1) Equity issues increase following all cross-listings, regardless of shareholder protection. 2) The increase should be larger for cross-listings from countries with weak protection. 3) Equity issues following cross-listings in the U.S. will tend to be in the U.S. for firms from countries with strong protection and outside the U.S. for firms from countries with weak protection." [13]

In an effort to prevent securities fraud from happening in the first place, certain companies offer plans that are similar to insurance for investments. Securities Investor Protection Corporation protects investors by helping individuals whose money, stocks, and other securities are stolen by a broker or put at risk when a brokerage fails for other reasons. Cash and securities, such as stocks and bonds, are held by a customer at a financially troubled brokerage firm are protected by SIPC.[14] If an investor or shareholder is not secure in his/her investments, he/she may go to SIPC to seek advice and to inquire about insuring his/her assets.

A closer look: Coreco

[12] *Warning signs adopted from* http://www.securitieslaw.com/faq.html.

[13] http://papers.nber.org/papers/W8164

[14] http://www.sipc.org/brochure.html

Coreco is a company that specializes in the design, development, manufacturing, and marketing of hardware and software for high-performance computer vision applications. In 2002, Coreco instituted a new shareholder protection plan that "provides the board of directors and shareholders with sufficient time to evaluate a take-over bid and, if appropriate, to pursue alternatives with a view to maximizing shareholder value. It should ensure that all shareholders are treated fairly in any transaction involving a change in control and that all shareholders have an equal opportunity to participate in the benefits of a take-over bid."[15]

When a shareholder invests money in a company, there is always a risk that they will lose that money. It is important for shareholders to be informed about the stock that they are buying. It might also benefit the investor to consider investor protection insurance if the block size warrants.

How did we get here? Why and when did fraud become an issue?

It came as a shock to many investors when the reports of major fraud began to surface in the late 90's and into 2000. How could respected and successful companies trading on Exchanges with stringent reporting and regulations standards have committed fraud on such a scale? It is in fact trite to say that this fraud has been costly to the companies, investors and the economy, but more importantly, it has damaged the reputation of the American Financial Markets.

Fraud has always existed at various levels in every sector of business. The prevailing notion however, that fraud is more prevalent and more costly in smaller companies such as those that trade on the OTCBB *(Over the Counter Bulletin Board)*, is not borne out by the evidence. In fact, the bigger, better known corporations who trade on the more prestigious exchanges, are not immune from or above the fray. To the contrary, I submit that we can all learn a valuable lesson from the corporate scandals of the most recent past. Even those most respected companies who are listed on the NASDAQ *(National Association of Securities Dealers Automated Quotation Exchange)*, AMEX *(American Exchange)* and NYSE *(New York Stock Exchange),* and who are regulated by more the stringent reporting requirements of those exchanges, are susceptible to the commission of and have committed fraud. It follows that the due to the value of the respective companies, the difference between the fraud committed in connection with companies whose shares are traded on the OTCBB and fraud committed by the companies traded on the NASDAQ, AMEX and NYSE, is the financial impact.

This is not to imply that there had not been some justification for an adverse perception in an area like the OTCBB. This position however ignores the positive changes set in motion by the appointment of the Garten Committee (named after its chair, Dean of the Yale School of Management, Jeffery Garten). It also overlooks changes and proposals which were made to protect investors in the late 90's and early in the new decade (and which are on going). More information on the historical position of the OTCBB and the regulatory changes which have been implemented as well as those suggested by the NASD, can be found in the white paper **OTCBB a Great 20F Destination**[16].

Absurdity of Big Boy Fraud vs. OTCBB Fraud

The OTCBB is a quotation medium for subscribing members, not an issuer listing service, and should not be confused with The NASDAQ Stock Market. OTCBB securities are traded by a community of Market Makers that enter quotes and trade reports through a highly sophisticated, closed computer network, which is accessed through NASDAQ Workstation II™. The OTCBB is unlike The NASDAQ Stock Market in that it:

[15] http://www.imaging.com/Web/news.nsf/0/59CBEA2AA00BF66885256BBA004E8BFC?opendocument

[16] This paper is available at http://www.pubcowhitepapers.com/whitepapers/focus.php?id=13ef54f2207945.

- does not impose listing standards;
- does not provide automated trade executions;
- does not maintain relationships with quoted issuers
- does not have the same obligations for Market Makers
- does not have minimum quantitative listing requirements
- does not have listing and maintenance fees to issuers

Like NASDAQ, OTCBB does have real-time electronic quotes for domestic issues and minimum listing processing time (3 days for OTCBB, 6 to 8 weeks for NASDAQ). Also, like NASDAQ, OTCBB has requirements to maintain quotation or listing. On January 4, 1999, the SEC approved the OTCBB Eligibility Rule. Securities not quoted on the OTCBB as of that date have been required to report their current financial information to the SEC, banking, or insurance regulators in order to meet eligibility requirements. Non-reporting companies whose securities were already quoted on the OTCBB were granted a grace period to comply with the new requirements. Since July 199 those companies began being phased in and as of June 22, 2000, current financial information about all domestic companies that are quoted on the OTCBB are now publicly available.

The significance of defining regulatory differences between the OTCBB and Big Boys such as NASDAQ and NYSE is important in realizing that though there appear to be more stringent laws governing trading and accounting practices for companies who trade on NASDAQ, etc. it can be assumed that there are less fraudulent cases reported concerning these companies as opposed to less analyzed OTCBB companies. On the contrary, SEC findings have reported more companies who trade on NASDAQ and NYSE to be involved or indicted in fraud cases than those companies who trade on the OTCBB. Moreover, the absurd content of these allegations toward CEO's and CFO's of NASDAQ, etc. traded companies and the ramifications of their crimes far outweighs those of most OTCBB companies who have been involved in similar charges.

In reference to Appendix B, the outlandish nature and expense of the fraudulent cases that indicted NASDAQ or NYSE companies made up almost 95% of all of the listed cases, totaling billions of dollars in loss to major players on these exchanges. A more in depth analysis of some of these companies reveals that not only are the allegations of greater proportions (i.e. forged contracts, embezzlement, creation of fake transactions, unqualified media listings, etc.) but the sums of money on the line are of equal or greater proportions. To qualify this point, a case study below reveals how much the characteristics of a NASDAQ traded company fraud case, Quintus, differs in nature from Unify (an OTCBB company) and Legato (a private company).

Quintus:

The Commission brought fraud charges against former Quintus CEO Alan K. Anderson, 40, of Walnut Creek, Calif. Quintus was a Dublin, Calif. based developer of customer relationship management software. According to the complaint, from December 1999 through October 2000 Anderson personally forged contracts, e-mails, purchase orders, letters, and an audit confirmation in order to boost Quintus' financial results. Anderson created three fake transactions that ranged in value from $2 million to $7 million, for a total of $13.7 million in nonexistent sales. In addition, Anderson caused Quintus to recognize improperly $3 million in revenue on a barter transaction, which was contingent on Quintus' agreement to purchase $4 million of product from its customer. In each case, Anderson caused Quintus to recognize revenue in violation of generally accepted accounting principles (GAAP).

In one instance, Anderson altered a $1.5 million purchase order to make it appear that the customer had actually ordered $6 million worth of Quintus products and services. In another, Anderson forged a contract and a purchase letter to make it appear that the a reseller had agreed to pay Quintus $7 million up-front, rather than the truth-that the reseller would pay Quintus only if the reseller was able to sell Quintus product to end users.

As a result of Anderson's fraud, Quintus overstated its revenue in three fiscal quarters in amounts ranging from 37% to 60% per quarter. In February 2001, NASDAQ delisted Quintus' stock, and the company is now being liquidated through bankruptcy proceedings.

The complaint charges Anderson with violations of the antifraud provisions of the federal securities laws and with lying to Quintus' outside auditors. The complaint also seeks an injunction against future violations, disgorgement of bonuses Anderson received based on the company's fraudulent financial performance, monetary penalties and an order barring Anderson from serving as an officer or director of any publicly traded company.

In addition, the U.S. Attorney's Office for the Northern District of California today announced that it has charged Anderson with one count of securities fraud, based on the fraud at Quintus.

Unify:

The Commission brought fraud charges against former Unify CEO Gholamreza (Reza) Mikailli, 49, of Saratoga, Calif., and former CFO Gary L. Pado, 38, of Sacramento, Calif. Sacramento based Unify develops and sells database management software. The complaint alleges that from May 1999 through May 2000, Mikailli and Pado caused Unify to recognize revenue fraudulently on transactions that they knew were subject to contingencies (including rights of return or cancellation), or involved barter transactions. Under GAAP, it was improper for Unify to recognize revenue on contingent transactions so long as the contingencies existed and, thus, could nullify or impair the sale. Also under GAAP, it was improper for Unify to recognize revenue on barter transactions because Unify's revenue was contingent on Unify's performance of its obligation to the customer.

In several instances Mikailli and Pado engaged in "roundtripping," by causing Unify to provide funds its customers needed to buy Unify products, with no reasonable expectation that the customers would ever repay the funds. In some instances, Unify made an investment in another company, which then used most or all of the invested funds to purchase Unify product. In others, Unify contracted for services from other companies through so-called Funded Development Agreements. However, the companies provided no such services, and simply used funds from Unify to buy Unify product.

As a result of the fraud, Unify overstated its revenue over four fiscal quarters in amounts ranging from 61% to 150% per quarter. During the course of the fraud, Mikailli sold all of his shares of Unify stock and received gross proceeds of approximately $8.2 million. Mikailli illegally failed to file any reports with the Commission during this period disclosing his stock sales.

The complaint charges Mikailli and Pado with violating the antifraud, corporate reporting and bookkeeping provisions of the federal securities laws and with lying to Unify's outside auditors. It also charges Mikailli with insider trading and failing to file required reports relating to sales of shares by insiders. The complaint seeks injunctions, monetary penalties and officer and director bars against Mikailli and Pado. In addition, the complaint seeks disgorgement from Mikailli of all amounts he received as a result of the fraud, including losses avoided by his stock sales, sales commissions he received on fraudulent transactions, and bonuses.

Also named in the complaint was Unify, for violations of the corporate reporting and bookkeeping provisions of the federal securities laws. The complaint seeks a permanent injunction against future violations.

In addition, the U.S. Attorney's Office for the Northern District of California today announced that it has charged Mikailli and Pado with criminal securities fraud, based on the fraud at Unify.

Legato:

The Commission brought fraud charges against former Legato executive vice president of worldwide sales David Malmstedt, 46, of Manhattan Beach, Calif., and former vice president of North American sales Mark Huetteman, 39, of Hinsdale, Illinois. Legato, based in Mountain View, Calif., develops and sells software for managing the data storage functions of computer networks. The complaint alleges that from May 1999 through December 2000, Malmstedt and Huetteman caused Legato fraudulently to record millions of dollars in revenue on orders that were contingent on resellers' ability to sell the product to an end customer, or on customers' rights of exchange, return or cancellation. As a result of the fraud, Legato overstated its revenue over three fiscal quarters in amounts ranging from 6% to 20% per quarter.

In one instance, Malmstedt and Huetteman caused Legato to recognize revenue on a $7 million purchase order that was contingent on further successful negotiations between the parties. Pursuant to this arrangement, if the negotiations broke down, the customer had the right to cancel the purchase order. The cancellation right was set forth in a separate side letter, drafted by Huetteman, which stated in part: "This contingency may not be expressly stated in the order letter, because of the impact on revenue recognition. However, you have my assurance that in the event that we can not [sic] reach terms we will not hold you to the commitment to pay referenced in the order letter."

The complaint charges Malmstedt and Huetteman with violating the antifraud, corporate reporting and bookkeeping provisions of the federal securities laws, and seeks injunctions, disgorgement of losses avoided on sales of Legato stock by Malmstedt and Huetteman during the course of the fraud, and monetary penalties.

In a related matter, the Commission issued an order instituting and simultaneously settling cease-and-desist proceedings against Legato and its former CFO, Steven Wise, 47, of Mountain View, Calif. Legato and Wise consented to the issuance of the Commission order without admitting or denying any of its findings. The order found that Legato violated the corporate reporting, bookkeeping and internal controls provisions of the federal securities laws. In addition, the order found that Wise caused Legato's violations of these provisions, and that Wise knowingly failed to implement adequate internal accounting controls at the company. The order requires Legato and Wise to cease and desist from future violations of these provisions.

The Impact of Fraud on the Small Business

A recent Federal Reserve Report on the Availability of Small Business Credit illustrates the importance of the role played by small business in the economy. Over 20 million business entities filed tax returns in 1994, the vast majority of these being small businesses. Small businesses employ more than half of the private work force and are responsible for approximately 50 percent of all sales and private gross domestic product, often in firms on the leading edge of technology. The number of small businesses nationwide has grown at a brisk 5 percent pace in recent years. [17]

[17] Remarks by Governor Edward M. Gramlich. *Small business access to capital and credit.* Federal Reserve System Research Conference on Business Access to Capital and Credit, Arlington, Virginia. March 8, 1999

These numbers have come about because of a positive environment for small business in the past few years. Traditional lenders have eased standards and accommodated rising loan demand with attractive lending terms for creditworthy borrowers. This has made it easier and faster for small businesses to borrow. Increasingly, larger banks with active small business lending operations are applying consumer credit techniques to loans for very small firms. In addition, community-based lending initiatives have generated many new programs to attract investors and financing to small enterprises in local communities.

Public and Private Sector Finance

Small firms need and use credit. Nearly three-fifths of all small businesses surveyed in the Federal Reserve's 1993 National Survey of Small Business Finances used some form of credit. While a large share of this credit is private, the public sector plays a role as well, through programs that mitigate small business lending risks.

Bank call reports indicate that from 1994 to 1998, there was a steady increase in commercial bank lending to small business, from $294 billion worth of small business loans in 1994 to $370 billion in 1998 (nearly 6 percent annual growth). This growth in overall commercial bank lending suggests a rising business loan demand and a willingness of banks to accommodate that demand. Small businesses that meet periodically with Federal Reserve Bank officials to discuss conditions in the twelve districts have been consistently upbeat about credit conditions.

One factor in this growth is competition. The competition for business credits among banks and nonbanks has been intense in recent years and has resulted in aggressive marketing strategies, product innovation, and a wider range of services offered to small firms. Another factor involved changes in the Community Reinvestment Act regulations, which now require larger financial institutions to collect and report data on loans made to small businesses and small farms. As shown in the morning session of this conference, these data have provided useful new information about small business loan market penetration

Bank Consolidation
Recent mergers and acquisitions, involving many of the nation's largest and most geographically diverse banking institutions, have had a sizeable impact on the industry. This consolidation has fueled a debate about the impact on small businesses. Many small business owners fear that small community banks that are acquired by large regional or national banks may no longer have officials that are knowledgeable about their circumstances and responsive to their needs. Business owners also fear that large financial institutions will have more profitable investment opportunities than the small business loan portfolios found in the banks they acquire. Small business owners are also concerned that if they lose their local banking offices, they will have less access to banking services and loans.

But empirical evidence concerning the effects of bank consolidations on small business gives only weak confirmation to these fears. Researchers have found that large banks do maintain lower ratios of small business loans to assets than do small banks. Yet when small banks buy other small banks, the new entities tend to be more active small business lenders than the banks that were purchased.

A study of the new CRA data, reported in the September 1998 Federal Reserve Bulletin, also offers some important information about lending to small business. While locally based commercial banks and thrift institutions play a role in the small business credit market, so do out-of-market providers. Overall, the new CRA data reveal that out-of-market lenders are numerous in both urban and rural banking markets and they generally outnumber in-market institutions.

Bank and Non-Bank Competition for Small Business Credit
There has been a decline in the commercial banks' share of overall lending. The reason for the decline involves technological changes in communications and information storage that have enabled an increasing number of large firms to gain direct access to capital markets. These same technological changes have facilitated competition from non-bank sources, such as thrifts, savings banks, credit unions, finance companies, insurance companies, mortgage companies, leasing companies, and the like.

Whatever the reasons for the overall trend in commercial bank lending, it has raised questions about the future role of commercial banks in providing credit to small businesses. Banks are believed to have a comparative advantage in lending to small businesses largely due to their ability to assess and monitor the operation of enterprises in their local communities.

This factor particularly affects small business access to credit in rural areas. Small banks experience a great deal of competition for deposits from money market mutual funds and other deposit taking institutions. Rural banks today report that many of them are faced with static or declining deposit bases, a traditional source of low-cost funds. Many rural bankers are seeing a large transfer of wealth as farms and businesses are liquidated upon the death of the owners. In many cases, the funds on deposit at a local bank move with the new owners. And these heirs frequently live and work in metropolitan communities located far from their original homes. As they lose these low-cost, lendable funds, many rural banks are finding it more difficult to serve the credit needs of their customers.

Secondary Markets
Another important development in overall credit markets has been the rapid growth of secondary loan markets. Residential mortgages, credit card receivables, and automobile loans can and are easily bundled and sold in the secondary market. Securitization enables lenders to improve their return on capital, achieve liquidity, and achieve balance sheet diversity. And borrowers whose loans are eligible for securitization typically enjoy lower financing costs. But apart from some successes found in SBA loan pools, small business loans are in general not easily securitized. Highly diverse small business

loans are not easily grouped into large homogeneous pools that credit agencies and investors can efficiently analyze. Underwriting standards tend to vary among originators. Until underwriting standards and documentation for these loans become more uniform and information for estimating the risk of loss more available, markets for securitized small business loans will remain small.

Other Impediments Faced by Small Firms Seeking Access to Credit
There are still other impediments to the small business credit process. All businesses face the cost of regulation and various legal constraints. Small businesses typically have not reached a size or complexity to warrant functional specialization and often must chart an independent course through the rules and regulations that apply to them -- a costly and potentially burdensome proposition.

Lending to small businesses is generally riskier and more costly than lending to large firms. Small businesses are very susceptible to swings in the economy and have a much higher failure rate than larger operations. And, historically lenders have had difficulty determining the creditworthiness of small business loan applicants. Small businesses are extremely diverse and range from small corner grocery stores to high tech data base managers and software providers. This heterogeneity, together with widely varying uses of the borrowed funds, has made it difficult to develop general standards for assessing small business loan applications and has made evaluating such loans relatively expensive.

Small business owners must contend with lenders with varying underwriting standards, varying appetites for risk, and varying expected rates of return for loans they may approve. The vagaries of local economies may also influence the likelihood that a small firm gets approved for credit. The reason for denial may bear no relationship to the financial condition of the business, the level of reserves, or other financial characteristics of the business itself, but be based only on the conditions present in the local economy.

While small firms are faced with many impediments in gaining access to credit, new technologies, such as credit scoring, offer the promise of breaking down some of those barriers. Credit scoring increases the consistency, speed, and often the accuracy of credit evaluations. It also lowers the cost of gathering relevant information. Moreover, credit scoring uses automated systems and loan decisions can be rendered in minutes or hours rather than in days and weeks. However, bank regulators must continue to ensure that the bank's credit scoring models are accurate and nondiscriminatory.

The Importance of Small Business

Small businesses have a tremendous economic impact on the country and economy. According to the U.S. Small Business Administration, small businesses represent more than 99.7% of all employers, generate 60 to 80% of net new jobs annually, and pay 44.5% of the total U.S. private payroll. The following chart illustrates this point.

Small Business Statistics by Employment Size of Firms	
Employment Size	**Number of Firms**
Firms with 0-4 Employees	3,396,732
Firms with 5-9 Employees	1,021,210
Firms with 10-19 Employees	617,087
Firms with 20-99 Employees	515,977
Firms with over 100 Employees	122,310

Small businesses which become publicly traded entities have an increased chance of becoming successful thereby being able to generate more jobs and revenue in the way of taxes for the local, state and national economy. Surely it is the dream of those who start small business that they become successful and ultimately go public, securing the financial future of the founders.

Prevention Plan for Small Business

Considering the potential losses, it behooves small-business owners to make the prevention of fraud a priority in their businesses. Though no business owner wants to feel it employs unscrupulous people, sometimes temptation or personal financial pressures can push even the hardest working, most trusted employee into perpetrating fraud.

The first step in preventing employee fraud is letting employees know you're watching for it. "Perception of detection is a very powerful deterrent," says John Gill, a certified fraud examiner and general council and director of self-study publications for the ACFE. Through its report findings and the experiences of its members, the ACFE has honed in on effective methods for deterring occupational fraud and abuse. Here, Gill shares some of the most useful approaches, which are also detailed in its book How to Prevent Small Business Fraud. Some methods seem commonsense, but when taken into consideration with other preventive measures, they help fortify a business against fraudulent activity.

- **First and foremost, hire the right employees.** Conduct background checks for people handling inventory and money. Check past employment, criminal convictions, references, and education and certifications. Also, conduct drug screening since often, according to Gill, employees will steal from a business to support an addiction. Remember, however, to always get the written consent of candidates before doing research since many federal and state laws govern the gathering of such information.
- **Maintain strong internal controls.** Have checks and balances in place, suggests Gill. "For example, you don't want a signatory on the bank account balancing the check book," he says. "If I can write checks on the account and I reconcile the bank book, I'm free to manipulate the check register."
- **Make sure expenditures are approved.** For every expense, have a manager and someone in accounting approve it. The supervisor will ensure that the expenses are valid, while accounting will run the math.
- **Monitor cash situations.** In a retail situation, Gill suggests having security cameras monitor activity at registers and storage areas where inventory is kept. "People are less likely to do it if someone is watching them," he says.
- **Conduct surprise audits.** Catching an employee off guard could be your best bet in discovering fraud. "The key is that an employee generally doesn't know what's coming and won't have the time to change the records to hide the fraud," says Gill. Additionally, auditors have sampling and computer data analysis techniques that help uncover fraud. Using these techniques, auditors can quickly examine, say, the payment of 1,000 invoices in detail, including invoice numbers, to whom payments were made, and when payments were made, and quickly determine those that are suspicious. "We've seen cases where somebody creates a phony company, submits invoices to accounting and accounting sends payment to a P.O. Box," says Gill. In one case, Gill recalls, an employee who set up a fraudulent business through which he submitted preprinted, consecutive numbered invoices to his employer every few months. When the auditors examined the invoices, particularly the invoice numbers, it seemed funny to them that the business submitting the invoices didn't have other clients or was having an extremely slow year since each consecutive invoice was sent to

the company. A surprise audit also can uncover duplicate invoice amounts and duplicate invoice numbers, both of which can be red flags for possible wrongdoing.

- **Establish a third-party hotline service.** According to Gill, the number one method for catching occupational fraud is getting tips from employees. Because most employees are reluctant to report suspicious activity, using a third-party hotline offers a level of anonymity that an in-house hotline might not provide, making employees more likely to blow the whistle on fraudulent activity. An outside company is staffed 24 hours a day and provides information to the business immediately.
- **Create a fraud policy.** "Don't create anything complicated," says Gill. Simply inform employees during employee orientation, training programs, memorandums, or other communication that fraud is not tolerated and let employees know what to do if they suspect fraud. Also, be sure to inform employees of the actions the company will take if it suspects or determines fraud has been committed.
- **Enforce mandatory vacations.** "Our research has shown that if employees don't take vacation, it can be a red flag," says Gill. "They're afraid to go on vacation because someone is going to find out that something is not right." Requiring employees to take time off can aid in the prevention of some frauds.

The Importance of the OTCBB to Small Business

The advantages to being a publicly traded company are[18]:

- **Increased access to capital**. Selling stock or issuing debt securities such as bonds can raise capital, and the funds that are raised can be used for growth and expansion, marketing and development, among others.
- **Liquidity**. A public company has a greater opportunity to sell shares of stock to investors, and liquidity can provide investors or owners an exit strategy, portfolio diversity, and flexibility of asset allocation.
- **Higher valuation.** Public companies generally have higher valuations than their private competitors.
- **Employee compensation.** **S**tock and stock option plans create strong incentives for employees to complete their tasks in an efficient and reliable manner. Further, employees who have a stake in the company are more likely to have a greater sense of loyalty and pride in the company.
  - **Prestige.** Publicity is a built-in benefit to going public, and this exposure often leads to improved recognition among consumers and stronger business operations.

The successful story of public companies vs. private companies in staying solvent in today's litigious and paranoid culture of "gotcha"

For decades, the United States has been widely viewed as having the best approach to corporate governance in the world. But the scandals of the past year – Enron, Worldcom, Global Crossing, Tyco, Imclone and others – have shaken public confidence in the integrity of U.S. financial markets.

These events have to led to renewed attention to the system of governance and a consideration of whether particular improvements are needed in order to restore public confidence in U.S. markets.

Simply put, the only difference between a public and private company is that public companies sell stock to the public. Private companies don't. Because public companies sell to the public, they must also make their accounting and financial information available to the public: shareholders can then stay updated, and investors can then research and study the company. For a private company, the information is harder to obtain and not subject to the same scrutiny that public companies face.

But to conclude that because companies who report their filing and shareholder information are more apt to fraud or cases of unethical professional conduct is an illogical leap of faith.

Leveling the Public v. Private Playing Field: Legislation

The Sarbanes-Oxley Act, the most sweeping accounting and corporate governance reform legislation in nearly 70 years, was enacted in response to high profile corporate and accounting scandals and frauds. Although most of Sarbanes-Oxley directly affects only public companies, private companies are not immune from its requirements. Some provisions of Sarbanes-Oxley directly apply to private companies, including:

- penalties for taking action against "whistleblowers."
- penalties for destroying, covering up or falsifying documents to impede, obstruct or influence a federal investigation.
- requirements for ERISA plan administrators to notify participants and beneficiaries of certain blackout periods during which their ability to direct or diversify account assets or obtain loans or distributions from the plan is suspended or restricted.
- extension of the statute of limitations for securities fraud lawsuits. (The
- antifraud rules of federal securities laws apply to any offering of securities, even if private.)
- prevention of the discharge in bankruptcy of debts from violations of securities laws.
- the creation of new fraud crimes and increases in fraud penalties.

Most of Sarbanes-Oxley applies only to "public companies" and their audit committees, auditors and attorneys. However, a private company will be subject to all of Sarbanes-Oxley's provisions upon filing a registration statement. Also, a private company acquired by a public company will indirectly become subject to the Act. Sarbanes-Oxley is thereby indirectly creating "best practices" for all companies, both public and private. For example, lenders may scrutinize the makeup of the board or audit committee of a private company or its internal controls when arranging a credit facility.

Similarly, venture capitalists and other investors are performing increased due diligence in response to the Act such as reviewing loans to insiders, auditor independence and codes of ethics. Potential merger partners are adding related items to their standard due diligence, such as whether the target's policies and procedures will mesh with those of the acquiror backing up financial statements or officer certifications.

Sarbanes-Oxley bans public companies from extending credit to executive officers and directors. At the time of filing a registration statement, a private company cannot have any loans to executive officers or directors, no matter how small or whatever the purpose. If a private company employee becomes an executive officer or director of a public company in a merger, the same concerns arise. Investors in private companies that have an IPO or merger exit strategy must be aware that such personal loans must be unwound or paid off before the company goes public or is acquired by a public company.

Other Sarbanes-Oxley requirements affecting public companies that private companies may want to consider adopting include:

- establishing a code of ethics.
- obtaining stockholder approval of option plans and amendments.
- restricting non-audit services performed by auditors consistent with new restrictions on public company auditors.
- having the audit committee pre-approved non-audit services by the auditors having an independent board committee approve insider transactions.[19]

A closer look: Pereira v. Cogan

Every state has general rules regarding the fiduciary duties which directors owe to the company as well as its shareholders. These duties include the duty of due care and the duty of loyalty. The duty of due care requires a director, in good faith and in a manner that the director believes to be in the best interest of the company and its shareholders, to reasonably investigate each transaction as an ordinarily prudent person would under similar circumstances. The duty of loyalty requires a director to place the company's and its shareholders' interests before his or her own personal interests. If a director violates these duties, he or she may be held liable for any damage caused by the violation.

In *Pereira v. Cogan*, 00 Civ. 619 (2003), the Southern District of New York, applying Delaware law, held that a private company's directors violated their duties of loyalty and due care because they rubber-stamped certain transactions benefiting the controlling shareholder without conducting adequate due diligence investigations. In *Pereira*, a Chapter 7 trustee initiated an action against the controlling shareholder and Chief Executive Officer of the company, and certain of the company's officers and directors, for alleged self-dealing and breach of fiduciary duty. The plaintiff claimed that the directors breached their fiduciary duty of due care by failing to carry out their duties in the best interests of the company and by subordinating that duty to the personal interest of the controlling shareholder.

The court stated:

"Given the lack of public accountability present in a closely held private company, it is arguable that such officers and directors owe a greater duty to

[19] http://www.sandw.com/print/pdf/Private_companies_cannot_ignore_SOXA-MHT.pdf

the company and its shareholders to keep a sharp eye on the controlling shareholder. At the very least, they must uphold the same standard of care as required of officers and directors of public companies or private companies that are not so dominated by a founder/controlling shareholder. They cannot turn a blind eye when the controlling shareholder goes awry, nor can they simply assume that all is right with the corporation without any exercise of diligence to ensure that that is the case."

As *Pereira* seems to indicate, private companies may now also be held to a higher standard of review especially in light of the fact that there is no public accountability. Since it is plausible that the courts may find that directors of private companies have similar duties as directors of public companies, it is important for private companies to understand how courts are now defining independence and the duties imposed on the public company's directors.[20]

Spotlight on the catalog industry[21]

It is important to note the long term successfulness of the public market in comparison to the private by examing a few of the industries that have been adversely impacted by the lack of performance associated with private company derailings.

A consultant for the catalog industry was recently quoted in the following news article; *"The New Trend: Catalogers Turning Private";* while the public market is certainly "not as richly priced as it was in the '80s and '90s, it's still better than private money." This is especially true regarding company valuations. Privately held catalog companies have been selling on average for four to six times pretax cash flow, he says. In comparison, public companies have been priced at 12-20 times after-tax earnings.

Much of this has to do with the prestige and credibility associated with being a public company. Because publicly traded companies are required to publish quarterly information about finances, prospective investors, clients, and employees can easily access the data. "This is particularly valuable when competing against private companies," Silverman says.

Summary

While overall market assumptions are a difficult gamble, there does exist substantial evidence that the long-term benefits of the public company (despite recent setbacks through fraud) are far more advantageous than private company VC's. As the legislation and oversight of all companies continues to be scrutinized, private companies can expect to see more headlines in their own sphere of influence as those previously seeking to avoid SEC compliance and filing reports, may be faced with few alternatives of the competition continues for those who own the market share.

Focusing on the positive: the many benefits of corporate America

[20] http://www.hansonbridgett.com/newsletters/CorpGovernance/CorpGov_PrivComp.html

[21] The New Trend: Catalogers Turning Private, Mark Del Franco

Industry Case Statements

The successfulness of OTCBB companies in the creation of jobs, fueling the engine of the Small Business mindset, and providing a place of public entry for many investors and shareholders remains the heartbeat and strength of an economy recently dealt several severe body blows. But despite war, recession and political elections, the public company power and its ability to grow and foster greater economic muscle, remain the attraction over time to the relative obscurity and uncertainness sometimes associated with private company development.

This section looks at two additional industry segments that have been both exceptions and models to the idea that through public trading and good fortune, a platform for jobs, economic stability, tax benefits and prolonged American market dominance will be our reality.

Homeland Defense Industry

While images of anti-terrorism and national defense immediately enter your mind, it is important to remember that the many advances in technology that help to defend our country are also repurposed into the technology that will help secure your home, car, and personal belongings in the near future.

Overview

The results of this dynamically changing industry are significant public market expansion, increased availability of government funding for new technology development, as well as a steady stream of venture capital funding. While the larger defense contractors such as Lockheed Martin, General Dynamics, and Northrop Grumman have seen tremendous market expansion and merger activity, companies in the middle market are benefiting from the market expansion despite a lagging economy and the highest levels of M&A activity in several years.

- Companies that comprise the Homeland Defense Industry serve the vast needs of the military, as well as the varied needs of the government and private sector relating to law enforcement, surveillance, border control and public security. Examples of this newly defined industry's broad reach include, among others:

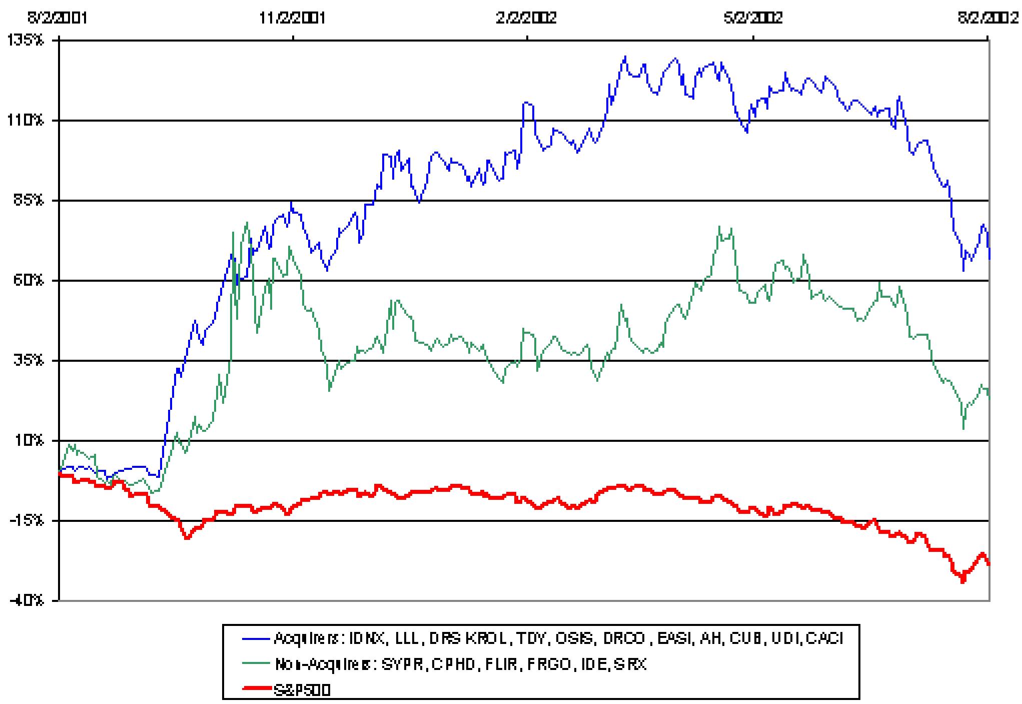
Most public security companies are experiencing the following:

- Unprecedented expansion in the amount of capital earmarked for products and services utilized by Federal, State and Local law enforcement agencies
- Federal agencies are not only sponsoring new R&D efforts for updated technologies, but they have become active in finding companies to perform such activities
- A marked rise in the Military and intelligence communities' interest in products and services that benefit human assets in the field, including soldiers and intelligence personnel

- An overall attitude across all organizations to utilize, whenever possible, U.S. based products and service providers with long-standing relationships and officially documented sales channels

Public Company trends

Companies of all sizes serving our Nation's varied defense needs have benefited from several positive market trends in comparison with the rest of the public markets over the past twelve months including strong stock growth and market cap expansion for those already public, as well as the viability of an IPO to finance growth.



Small to mid-cap public companies have seen stock prices increase by 52 percent on average in the past year and have experienced an aggregate market cap expansion of over $4.5 billion. Although the large cap companies have experienced a significantly larger dollar expansion in market cap, on a percentage basis, middle market players have topped their larger peers by almost 4 times.

Perhaps the most interesting statistic that has emerged over the past twelve months is the difference in growth between the small-to-mid cap companies that have been acquisitive and those that have relied on organic growth. Those companies that have shown acquisition activity over the past year are currently outpacing their non-acquiring counterparts by approximately 2.5 times as detailed in the following chart.
There have also been several successful IPO's during the past year that are homeland defense related. These new entrants have either maintained stability or shown immediate growth during an abysmal period in the public markets. In aggregate, over $1.8 billion in new market capitalization has been created.

Computer Industry: Information Technology

While the term information technology (IT) might not have a sexy, technological ring to it, IT services continues to be big business, even in troubled economic times. The implosion of the dot-com frenzy, a slumping economy, and the September 11 terrorist attacks may have shifted the balance of power in the IT world, but companies worldwide continue to pour money into the necessary technology that underpins our daily operations. Armed with buzzwords like "fast companies" and "new digital economy," pundits were quick to proclaim the death of the traditional IT company -- enormous, sprawling firms such as International Business Machines (IBM), Electronic Data Systems (EDS), and Computer Sciences -- with long histories of handling technological heavy lifting such as data processing for banks and government agencies. Hundreds of upstart providers quickly capitalized on the growing demand for IT services, expanding rapidly in an attempt to secure their slice of what appeared to be an ever-expanding pie. As the economy has weakened, however, and the speculative bubble has burst, the companies hardest hit have been those same upstarts.

The "dinosaurs" of IT services may have actually benefited from the economic turmoil. The contracting economy has forced many businesses to cut costs wherever possible, accelerating the trend towards outsourcing some or all IT functions (which is often more cost-effective than internally managing IT assets). Giants such as IBM and EDS quickly pounced on this opportunity with their traditional strengths in outsourcing, which includes installing, managing, and servicing entire networks. The September 11 terrorist attacks have also colored the IT landscape, as companies become increasingly conscious of security issues. While much of the focus has been on hardware providers of facial recognition and other security systems, IT firms that primarily serve the federal government and armed forces have also garnered a share of the spotlight. Companies such as Science Applications International Corporation (SAIC), Computer Sciences (which acquired Dyncorp in 2003), and CACI International (which have quietly been providing IT services to the federal government for decades) stand to benefit from not only an increased exposure, but also from planned budget increases for homeland security and technology infrastructure improvements. In fact, one of the most active sectors in a largely stagnant IPO market has been the IT services arena, primarily those companies focused on government agencies. Lending an ironic twist to the IPO market that once focused on the fast, faster, fastest mantra, firms such as Anteon, SRA International, and ManTech have recently entered the fray after years of steady profitability as private corporations. While economic and political climates may alter the flow of IT spending, companies will continue to spend money to install and maintain the hardware and software nearly every business depends upon. IT spending will also continue to grow as technology becomes increasingly pervasive. As long as computers exist, so too will companies devoted to servicing them.

Summary

While recent media exposure and software challenges have tainted the market of IT and its sister industry, software development; the industry as a whole remains markedly solid and profitable into the balance of 04. By its very ingenuity and ability to morph and adjust to the increasing speed of hardware components and customer demands, the IT industry has had an impact akin to medical CPR on many sectors of unemployment and business renewal. By forging more and more competitive alliances, streamlining production costs, and continually shrinking the R&D side of product development, the world of Information Technology in the American public marketplace deserves the attention and gratitude of countless cottage and subindustries that thrive on its advances and are buoyed along by its emerging technological improvements.

Sincerely,

Stephen Brock