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Congress of the United States

House of Representatives

109th Congress

Committee on Small Business

2361 Rayburn House Office Building

Washington, DC 20515-6315

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

Dear Chairman Cox:

We write regarding the Exposure Draft of the Final Report of the Commission's Advisory Committee on Smaller Public Companies (Release Nos. 33-8666; 34-53385; File No. 265-23) and welcome the Commission's continued interest in improving the securities regulatory environment for smaller companies. The Exposure Draft (ED) addresses many of the key issues facing small firms by including recommendations regarding the establishment of a scaled securities regulation system, internal controls over financial reporting, capital formation, and accounting standards. The Advisory Committee has produced a very comprehensive proposal that, if enacted in its entirety, would substantially ease the regulatory compliance burden for small firms.

As we have noted in previous correspondence, the Commission has a well-established history of recognizing the uniqueness of small businesses, and thus providing them size specific regulations. Such instances include small business exemptions from certain registration requirements under the Securities Act and Exchange Act and the establishment of small business issuer disclosure requirements through Regulation S-B. In each instance, the Commission appropriately has sought to balance three competing concerns: investor protection, access to public capital markets, and compliance burden. Due to the enactment of new laws and changes in the capital markets, evidence suggests that this carefully crafted balance has been lost as compliance burden has increased and access to the capital markets has waned.

The Advisory Committee attempts to address this imbalance by making recommendations in four distinct sections. Comments concerning these four main sections are discussed below.

Scaling Securities Regulation for Smaller Companies

At the core of the ED, the Advisory Committee proposes to create a scaled securities regulation system for smaller companies. This system would permit "smaller public companies" comprising the lowest 6 percent of total U.S. equity market capitalization to be considered for scaled or proportional regulation. Within this grouping are "microcap companies," which are defined as those encompassing the lowest 1 percent of total U.S. equity market capitalization and "smallcap companies," which are defined as those comprising the next lowest 1 percent to 5 percent of total U.S. equity market capitalization.

The proposed scaled securities regulation system would enable the Commission to harmonize its approach for providing relief to smaller companies. If such a comprehensive system is implemented, the Commission will greatly enhance the transparency and utility of its size-related regulations, which have grown more complex in recent years.

The Commission currently maintains several standards for providing relief to small companies. Regulation A, pursuant to Section 3(b) of the Securities Act, permits the Commission to exempt small securities offering not exceeding $5 million in any 12-month period from registration. In addition, Regulation A permits companies with fewer than 500 employees and less than $10 million in total assets to be excluded from reporting requirements under the Exchange Act.

Providing further relief to small companies is Regulation S-B, which permits qualified "small business issuers" to choose to file registration statements using simplified small business forms. For the purposes of Regulation S-B, a small business issuer is a United States or Canadian public company that had less than $25 million in revenues in its last fiscal year, and whose outstanding publicly-held stock is worth no more than $25 million. Most recently, the Commission created an additional tiered system for 10-K and 10-Q reporting requirements, in which it deemed "non-accelerated filers" as those companies with a market capitalization of less than $75 million; "accelerated filers" as those with a market capitalization of $75 million or more, but less than $700 million; and "large accelerated filers" as those with a market capitalization of more than $700 million.

The promulgation of these carve-outs, as well as the accompanying definitions, has created a constantly evolving byzantine web of regulation for small companies. Adopting the scaled securities regulation system would provide a holistic framework for the Commission to provide smaller companies with size-related exemption and relief.

Internals Controls Over Financial Reporting

The Advisory Committee proposes to provide a voluntary exemption from Section 404 requirements for microcap companies with less than $125 million in annual revenue and for smallcap companies with less than $10 million in annual product revenue. In addition, the ED proposes voluntary relief from the external auditor requirements of Section 404 for microcap companies with between $125 million and $250 million in annual revenue and for smallcap companies with between $10 million and $250 million in annual product revenue. The "opt-in" approach proposed by the Advisory Committee enables eligible companies to decide whether or not to afford themselves of such exemption or relief.

In the event that the Commission and the PCAOB do not provide timely and definitive guidance and relief to small companies, we believe that these proposals are an appropriate and reasonable manner in which to address the concerns smaller companies face with Section 404. If the Commission chooses to affirm the Advisory Committee's primary recommendations in this area, they should apply until the Commission enacts guidance or rulemakings pertaining to this issue that recognize the unique attributes of small companies and better balance investor protection concerns with the regulatory burden borne by small firms.

The differences between small companies and their larger counterparts are significant and include not only capitalization and product revenues, but also management and organization. As a result, smaller firms' senior management typically fills many roles, including raising capital, marketing new products, and hiring new staff. Sarbanes-Oxley did not recognize these differences and Audit Standard 2 (AS2) did not provide issuers with sufficient clarification. The resulting "one-size-fits-all" approach has often focused attention to immaterial details, rather than on the core financial reporting mechanisms. Large firms were able to readily comply with these requirements because they employee specialized functions that readily absorbed these new responsibilities. In sharp contrast, small firms relied on senior management – oftentimes just one or two individuals – who now have to choose between spending their time on vital business development functions or Section 404 compliance.

The Advisory Committee addresses small companies' primary concern with Section 404 – the high and often disproportionate compliance costs associated with Section 404. Due to the significant fixed costs associated with instituting these new systems, smaller companies must expend a greater percentage of their resources to comply with Section 404, often exceeding 2 percent of annual revenues. By comparison, the largest firms can frequently spend less than 0.25 percent of annual revenues. For small firms, these increased compliance costs can crowd out research activities.

Small companies' investment in research and development activities has been hampered by increased compliance due to Section 404. Reducing these costs would enable small firms to hire research engineers and purchase equipment that could lead to the development of new technologies, or even new industries. Putting capital to more productive uses will yield economic results that will benefit not only shareholders, but also local communities and the U.S. economy more generally.

In addition, concerns have been expressed about the developing trend that has seen foreign issuers increasingly list on non-U.S. exchanges. Foreign exchanges, such as the London Exchange's Alternative Investment Market (AIM), have become a popular destination for many foreign issuers and may portend the foreign listing of domestic issuers in the near future. While this development is due to a confluence of wide-ranging factors, the role of Sarbanes-Oxley generally, and Section 404 specifically, have been cited as key drivers.

Rationalizing small companies' internal controls requirements under Section 404 will permit small companies to have greater access to capital markets. The burden associated with Section 404 could drive smaller public companies to delist from SEC registered exchanges and either go private or trade on the less regulated over-the-counter market. In many regards, this outcome could make it more difficult for small firms to raise capital, potentially limiting the economic growth of these companies.

The Advisory Committee's internal controls recommendations will also provide relief to private companies, for which compliance with Sarbanes-Oxley is not an option, but a requirement. Many of these firms must adhere to the Act's standards if they are to preserve their ability to go public or to be able to merge with a public company. Venture capital-backed companies are often forced to expend scarce resources earlier in the process in order to maintain the future ability of their portfolio companies to go public or to be acquired. Not only does this resource allocation adversely impact innovation and economic growth, but it is also causing smaller firms to reconsider whether the benefits of going public, merging with a public company, or securing venture capital is worth the attendant costs.

In order to afford themselves of this relief, small companies must meet several requirements that will afford investors meaningful protection. Among these are the continued applicability of Section 13(b)(2)B) of the Exchange Act, which requires firms to maintain internal controls for financial reporting. The Advisory Committee further recommends that firms disclose modifications to such internal controls and their impact on a firm's financial statements. Further, the ED continues to require chief executive officer and chief financial officer certifications under Section 302 of Sarbanes-Oxley. This requirement will continue to provide investors with assurance that senior management is actively engaged and properly overseeing the reporting of a company's financial performance.

In addition, small companies must meet corporate governance requirements that include adherence to audit committee standards under Rule 10A-3 of the Exchange Act and adoption of a code of ethics pursuant to Item 406 of Regulation S-K. Given the continued applicability of these safeguards, the Advisory Committee's recommendations for exemption and relief from Section 404 requirements will enable small companies to reduce their compliance costs without undermining public confidence in the capital markets.

Capital Formation, Corporate Governance and Disclosure

The burden of Section 404 requirements for small companies has largely overshadowed other securities regulatory issues that have hampered capital formation for small firms. The ED includes a comprehensive listing of these other issues, several of which warrant comment.

Recommendation IV.P.1 proposes to incorporate Regulation S-B into Regulation S-K and make such alternative regulatory treatment available to all microcap companies. Current regulation permits "small business issuers," generally defined as companies with a market capitalization and annual revenues each below $25 million, to use simplified small business alternative forms for registration under the Securities Act and reporting under the Exchange Act. These market capitalization and revenue thresholds were set when Regulation S-B was adopted in 1992. Since 1992, the economy has changed dramatically – measurable inflation has occurred and the stock market has grown substantially. Given these trends, today's small companies are much larger than the small companies of 1992. As a result, it is appropriate for the SEC to raise these thresholds as the recommendation proposes.

In addition, by incorporating Regulation S-B into Regulation S-K, recommendation IV.P.1 addresses the stigma so often associated with alternative regulatory structures. Doing so will increase the use of this alternative treatment by smaller companies, permitting them to access the capital markets with less burden and cost.

The ED addresses another important issue affecting smaller companies – the lack of quality research on these firms. Quality research and analysis of small firms is essential for these companies to grow stronger. Without such research, investors are unable to readily evaluate companies, leaving small firms with less trading liquidity, lower market capitalization, and a higher cost of financing when compared to those small firms with research coverage. While the Advisory Committee proposes in recommendation IV.P.4 a continuation of current practice at the Commission, we agree that the Commission should continue to search for new means to encourage further analyst coverage.

Recommendation IV.S.3 proposes to form a task force of federal agencies to review and consider ways to lessen duplicative reporting requirements. Unfortunately, the complexity of today's companies and the risks they pose to consumers, investors, and the economy more generally has resulted in growing inefficiencies in the manner in which companies are regulated. The high cost of duplicative regulation is not insignificant; it can cause many firms to forgo hiring new employees and reduce firms' rate of growth. This proposal – as well as any effort that seeks to reduce the regulatory burden on small companies – is to be applauded.

Recommendation IV.S.5 proposes further regulatory relief by calling for the Commission to review alternative approaches to the EDGAR system that would enable smaller companies to make their required filings without undue cost. We concur that the complexity of EDGAR is impairing small companies access to the capital markets and that the Commission should investigate lower cost methods for meeting SEC filings.

With regard to the portion of recommendation IV.S.5 concerning eXtensible Business Reporting Language (XBRL), the Commission should carefully evaluate whether or not the adoption of XBRL will create a new substantial cost for small companies. While XBRL has the potential to increase investor interest and subsequent analysis of small companies, its cost impact on small firms should be carefully evaluated before it is made mandatory. To the extent possible, we urge the Commission to include small companies in its roundtables on the use of interactive data as well as in its voluntary pilot program to file tagged financial reports.

Accounting Standards

While the Advisory Committee makes several proposals for improving accounting standards for small companies, recommendation V.S.1 deserves special recognition. This proposal would require the Commission, the PCAOB, and FASB to jointly endeavor to expand the universe of qualified professional services firms able to perform audit services as required by the Sarbanes-Oxley Act. In addition, V.S.1 seeks to bolster the public perception of existing non-Big Four firms by including them in exclusive committees and forums that would demonstrate their capabilities as well as their acceptance among the audit community.

Although this recommendation is secondary to many proposals, action in this area is key to improving small firms ability to readily comply with the Act irrespective of any changes made as a result of current efforts. The concentration of public company audits among the Big Four demonstrates not only the expertise of these industry stalwarts, but also the stigma associated with using a non-Big Four firm.

Increased competition and market entry by smaller audit firms will provide greater pricing discipline and has the potential to increase quality as well as innovation within the industry. We welcome the Advisory Committee's recommendation in this area and urge the Commission to use this recommendation as a foundation to broaden small firms' access to the professional services required under the Act. By increasing the availability of such expertise, the Commission can ensure that all companies, irrespective of their size, can affordably comply with the Act's requirements.

Conclusion

Although the Commission has extended non-accelerated filers compliance with Section 404 until 2007, this deadline is fast approaching and small firms will have to soon invest substantial additional sums to become fully compliant. Given this reality, we urge the Commission to either act expeditiously and provide small firms with further guidance and relief in this area or to affirm the Advisory Committee's primary recommendations pertaining to internals control over financial reporting.

The Commission is to be lauded for its substantive review and consideration of the securities, financial reporting, and accounting issues affecting small companies. This effort shows great promise to produce a result that will better balance investor protection concerns with the regulatory burden borne by small firms. The pursuit of this elusive equilibrium is a worthwhile goal and a great service to our country's entrepreneurs. We look forward to reviewing your continued work on these matters.

Sincerely,

Hon. Nydia M. Velázquez (NY-12)
Ranking Democratic Member

Hon. John Barrow (GA-12)

Hon. Juanita Millender-McDonald (CA-37)

Hon. Raul Grijalva (AZ-7)

Hon. Ed Case (HI-2)

Hon. Gwen Moore (WI-4)

Hon. Melissa Bean (IL-8)

cc:
The Honorable Paul Atkins, Commissioner
The Honorable Roel Campos, Commissioner
The Honorable Cynthia Glassman, Commissioner
The Honorable Annette Nazareth, Commissioner
Herbert S. Wander, Co-Chair, Advisory Committee on Smaller Public Companies
James C. Thyen, Co-Chair, Advisory Committee on Smaller Public Companies