U. S. Securities and Exchange Commission

FINAL REPORT OF THE

TWENTY-FOURTH ANNUAL SEC

Government-Business Forum on Small Business Capital Formation

San Francisco, California September 19, 2005

24th Annual SEC Government-Business Forum
on Small Business Capital Formation

FINAL REPORT

November 2005

The SEC hosts the annual Government-Business Forum on Small Business Capital Formation, but does not seek to endorse or modify any of the Forum's recommendations. The recommendations are solely the responsibility of the Forum participants from outside the SEC, who were responsible for developing and prioritizing them. The recommendations do not necessarily reflect the views of the SEC, its Commissioners or any of the SEC's staff members.

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INTRODUCTION

Background

As mandated by the Small Business Investment Incentive Act of 1980, the U.S. Securities and Exchange Commission hosts an annual forum that focuses on the capital formation concerns of small business. Called the "SEC Government-Business Forum on Small Business Capital Formation," this gathering has assembled every year since 1982. A major purpose of the Forum is to provide a platform for small business to highlight perceived impediments in the capital-raising process and address whether they can be reduced. Each Forum seeks to develop recommendations for governmental and private actions to improve the environment for small business capital formation, consistent with other public policy goals, including investor protection. Prior Forums have published numerous recommendations in the areas of securities and financial services regulation, taxation and state and federal assistance, many of which have been implemented.

The Commission hosted the 2005 Forum, the 24th, at the Hyatt at Fisherman's Wharf Hotel, San Francisco, California, on September 19, 2005. The Forum was held in conjunction with a meeting of the SEC Advisory Committee on Smaller Public Companies on September 19 and 20, 2005 at the same location. The Forum's recommendations were presented publicly at a meeting of the Advisory Committee on the morning of September 20, 2005.

Planning and Organization

The SEC's Division of Corporation Finance, through its Office of Small Business Policy, organized a Planning Committee to provide advice and assistance in organizing the 2005 Forum. Consistent with the Forum's statutory mandate, the Planning Committee's membership included representatives of federal and state government agencies as well as business and professional organizations concerned with small business capital formation. The members of the 2005 Forum Planning Committee are listed on pages 5 and 6.

The Planning Committee recommended that this year's Forum be held in conjunction with a fact-finding meeting of the SEC Advisory Committee on Smaller Public Companies in San Francisco in late September. The Planning Committee made this recommendation after concluding that holding the Forum in conjunction with a meeting of the Advisory Committee offered a unique opportunity. This arrangement allowed the Forum's recommendations to be considered by a blue ribbon panel established specifically by the Commission to provide expert guidance on issues historically of deep concern to Forum participants.

Advisory Committee on Smaller Public Companies

The SEC organized its Advisory Committee on Smaller Public Companies in March 2005 to assess the current regulatory system for smaller companies under the

securities laws, including the impact of the Sarbanes-Oxley Act of 2002. The Advisory Committee was asked to make recommendations for changes in the system and submit a final report by April 2006.

The areas of inquiry of the Advisory Committee are:

- 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

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

The Advisory Committee is charged with considering the impact of the Sarbanes-Oxley Act in each of these areas. The Commission has directed the Advisory Committee to conduct its work with a view to protecting investors, considering whether the costs imposed by the current securities regulatory system for smaller public companies are proportionate to the benefits, identifying methods of minimizing costs and maximizing benefits, and facilitating capital formation by smaller companies. The Advisory Committee was also asked to consider providing recommendations to the Commission as to where and how the Commission should draw lines to scale regulatory treatment for companies based on size.

A roster of the 21 members and three official observers of the Advisory Committee is set forth on pages 23 through 25. Additional information on the Advisory Committee, including written statements submitted and presentations made to the Committee, is available on the Advisory Committee's website at http://www.sec.gov/info/smallbus/acspc.shtml.

Participants

The SEC's Office of Small Business Policy worked with members of the Planning Committee to identify participants for the 2005 Forum. Invitations were sent to participants in previous Forums and to members of various business and professional organizations concerned with small business capital formation. The SEC issued two press releases announcing the time, date, place, and Internet webcast address of the Forum.

Approximately 100 participants attended this year's Forum in person, including 18 Advisory Committee members and 20 speakers, moderators and SEC staff. The webcast of the Forum received 375 hits on the day of the Forum, indicating that many individuals participated by listening over the Internet. The webcast archives received another 603 hits by the end of October 2005.

Proceedings

The agenda for the 2005 Forum is reprinted starting at page 8. The two morning roundtable discussions were attended by 18 members of the Advisory Committee and 12 guest roundtable participants. The roundtables were moderated by Alan Beller, the two Co-Chairs of the Advisory Committee, Herbert S. Wander and James C. Thyen, and Marc H. Morgenstern, a long-time participant in past Forums and an active member of the Forum Planning Committee. SEC Commissioner Paul S. Atkins and Gerald J. Laporte, Chief of the SEC's Office of Small Business Policy, also participated in the morning roundtable discussions. Commissioner Atkins also gave a luncheon address.

The afternoon proceedings included five breakout groups designed to elicit and discuss recommendations for governmental and other action to improve the environment for small business capital formation. Three breakout groups discussed smaller public companies, one discussed venture capital and angel investing and another discussed tax issues. Participants chose to participate in a specific type of breakout group based on their area of greatest interest. Each of the five breakout groups was attended by approximately 20 participants, including members of the Advisory Committee.

Each breakout group was moderated by a leader. The breakout group leaders were Charles L. Bennett, Brian T. Borders, Ralph V. DeMartino, Lance J. Kimmel, and Marc H. Morgenstern. The discussions of the break-out groups resulted in three sets of recommendations: (1) a group of recommendations concerned with issues being considered by the Advisory Committee and relating to the requirements of the Sarbanes-Oxley Act; (2) a group of recommendations to the SEC relating to matters not specifically being considered by the Advisory Committee; and (3) a group of recommendations directed to Congress from the tax break-out group.

The five breakout group leaders made a presentation at a public meeting of the Advisory Committee on the morning of Tuesday, September 20, 2005, during which they discussed the Forum's recommendations. Following the presentation, the Advisory Committee heard public testimony from Larry E. Rittenberg, Chairman, Committee of Sponsoring Organizations of the Treadway Commission (COSO). The four subcommittees of the Advisory Committee (Accounting Standards Subcommittee, Capital Formation Subcommittee, Corporate Governance and Disclosure Subcommittee and Internal Control Over Financial Reporting Subcommittee) then discussed their activities before the meeting of the Advisory Committee was adjourned. Many Forum participants stayed to observe the entire Advisory Committee meeting on Tuesday.

Webcast and Transcript

Audio and written records of the proceedings described above, other than the breakout group meetings, are available on the SEC Forum website at http://www.sec.gov/info/smallbus/sbforum.shtml. The archive of the audio webcast of the Forum and Advisory Committee joint meeting is available for listening on the SEC's website under "Webcasts – Other SEC Webcasts" at http://www.connectlive.com/events/secadvisory0905/.

PLANNING COMMITTEE

Chairman:
Gerald J. Laporte
Chief, Office of Small Business Policy
Division of Corporation Finance
U.S. Securities and Exchange Commission

Government/Regulatory Representatives

Anthony G. Barone
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Corporate Finance Committee Chair, North American Securities Administrators Association, Inc.

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Public Company Accounting Oversight Board

Joani Ward
Associate Supervisor
Public Offering Review
Corporate Financing Department
NASD Regulation, Inc.

Denise Kirk-Murray
Community Affairs Officer
Office of the Comptroller of the Currency

Representatives of Business and Professional Organizations

Brian T. Borders
Borders Law Group
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Representing National Venture Capital Association

Giovanni Coratolo
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Erin Fuller
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Representing American Bar Association Business Law Section, Committee on Small Business

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Representing American Bar Association Federal Regulation of Securities Committee, Subcommittee on Small Business Issuers

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Kevin M. O'Neill

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Agenda

Monday, September 19, 2005

8:00 a.m. **Introductory Remarks**
Gerald J. Laporte, Chief, Office of Small Business Policy
SEC Division of Corporation Finance

8:05 a.m. **Opening Remarks**
Alan L. Beller, Director
SEC Division of Corporation Finance

8:15 a.m. **Joint Meeting of Forum and SEC Advisory Committee on Smaller Public Companies**

Moderators:
Alan L. Beller, Director, SEC Division of Corporation Finance
Marc H. Morgenstern, Managing Partner, Kahn Kleinman, Cleveland, OH
James C. Thyen, President and Chief Executive Officer, Kimball International, Inc., Jasper, IN, and Co-Chair of Advisory Committee
Herbert S. Wander, Katten Muchin Zavis Rosenman, Chicago, IL, and Co-Chair of Advisory Committee

Advisory Committee Members

First Roundtable Presenters:

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

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

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

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

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

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

Break

Second Roundtable Presenters:

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

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

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

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

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

Andrew Shapiro, President, Lawndale Capital Management, LLC, Mill Valley, California

12:15 p.m. **Break**

12:30 p.m. **Luncheon**
Speaker: SEC Commissioner Paul S. Atkins

1:45 p.m. **Forum Breakout Group Meetings**
(with participation by members of Advisory Committee)

- **Smaller Public Companies Breakout Group(s)**
- **Venture Capital and Angel Investing Breakout Group**
- **Tax Breakout Group**

3:15 p.m. **Break**

3:30 p.m. **Continuation of Forum Breakout Group Meetings**
(without participation by members of Advisory Committee)

- **Smaller Public Companies Breakout Group(s)**
- **Venture Capital and Angel Investing Breakout Group**
- **Tax Breakout Group**

6:00 p.m. **Networking Cocktail Hour with Members of Advisory Committee**

RECOMMENDATIONS[*]

Set forth below are three sets of recommendations of the 2005 Forum: (1) a group of recommendations concerned with issues being considered by the Advisory Committee and relating to the requirements of the Sarbanes-Oxley Act; (2) a group of recommendations to the SEC relating to matters not specifically being considered by the Advisory Committee; and (3) a group of recommendations directed to Congress from the tax break-out group.

Securities Regulation Recommendations

Introductory Remarks

The five Forum breakout group leaders, Charles L. Bennett, Brian T. Borders, Ralph V. DeMartino, Lance J. Kimmel, and Marc H. Morgenstern, worked together to compile and edit the two lists of securities regulation recommendations of this year's Forum that follow these introductory remarks.

The introductory remarks below are an edited version of the introductory remarks delivered by the breakout group leaders at a meeting of the SEC Advisory Committee on Smaller Public Companies on Tuesday, September 20, 2005, where this year's Forum recommendations were discussed with the Advisory Committee.

This year's Forum participants formulated over 20 recommendations in areas being considered by the Advisory Committee, of which Recommendation Nos. 1 and 2 are the two overwhelming priority recommendations of this year's Forum, namely that: (1) an appropriate definition of smaller public companies reflect several categories of issuers; and (2) that new rules be adopted to legitimize the role of finders in the small business capital formation process.

The consensus among the Forum participants is that significant distinctions should be drawn between different companies based on size and other identifiable economic variables. Substantial additional flexibility should be provided in both the definition and the application of the rules, to reflect the significant differences in the: (1) financial, capital, and human resources available to smaller public companies; (2) costs and benefits of the federal securities laws to smaller issuers; and (3) desirability of having more than one line of demarcation and, therefore, more than one set of rules. Most particularly, "micro-cap companies" should be distinguished from "smaller public companies" which, in turn, should be distinguished from "larger public companies" (*i.e.*, "well-known seasoned issuers").

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Requiring the SEC to conduct the annual Forum represents Congress's acknowledgement of several important facts. First, smaller public companies are genuinely different from larger public companies, and the differences are of kind, rather than simply degree. Smaller public companies have different operating characteristics and capital structures. Chief financial officers of smaller public companies frequently play a more integrated operational role than their larger company brethren and are frequently deeply enmeshed in operations. Because of the limited revenues or profitability of smaller public companies, these issuers are commonly required to disclose the existence of contracts and transactions that are material to them, but which would not be material to their larger competitors. Requiring the disclosure of these material contracts puts the smaller public companies at a competitive disadvantage vis-à-vis their larger public company competitors, because disclosure permits larger competitors to know the strategy and business relationships of their smaller public company competitors. Although there are significant benefits to being public, there are also increasing costs, both legal and operational.

The SEC has demonstrated that it is critical for the nation's capital formation process that smaller public companies continue to believe that entering the public marketplace, with its concomitant financial and disclosure obligations, constitutes a benefit that more than adequately compensates for the associated cost. If private companies continue to reach a different conclusion, and choose strategic sales of their businesses as their exit strategy rather than an initial public offering, or limit their revenue growth to that sustainable only through debt and private equity financing, we anticipate that the domestic economy, job creation, innovation, and the capital marketplace will all be negatively impacted. Both small investors and large institutional investors require a securities marketplace that: (1) consistently replenishes the universe of investment choices by having new entrants; and (2) funds emerging growth companies that are responsible for so much economic vitality.

Finally, because of the clear impact and importance of the Sarbanes-Oxley Act, and the critical nature of the Advisory Committee's work in proposing revisions to Sarbanes-Oxley Act rules, the Forum participants hope that the Advisory Committee and the SEC will each take bold and dramatic action. This is an historically unique opportunity to acknowledge that size does matter. It would be appropriate and helpful to treat smaller public companies differently from larger public companies from both a regulatory and economic perspective. This year's Forum participants encourage the Advisory Committee and the SEC to acknowledge, and more importantly, celebrate those differences.

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Securities Regulation Recommendations in Areas Being Considered by SEC Advisory Committee

The following recommendations are presented in the order of their importance and priority, as established by the five breakout group leaders based upon their respective breakout group discussions.

1. Classification and Definitions of Public Companies

Adopt the following three-tier classification system of public companies:

- **micro-cap companies;**
- **smaller public companies; and**
- **large public companies.**

Rationale: "Micro-cap companies" and "smaller public companies" would be eligible for relief from certain regulatory provisions under the Securities Act of 1933 and/or the Securities Exchange Act of 1934. We urge consideration of *significant* relief, including relief from substantial parts of the internal control requirements under Section 404 of the Sarbanes-Oxley Act for "micro-cap companies" and *scaled* relief for "smaller public companies."

(a) Definition of "Micro-Cap Company"

A *"micro-cap company"* should be defined as a public company having *any* of the following characteristics*:

- **$100 million total market capitalization or less;**
- **$25 million annual revenues or less (the current metric in the definition of "small business issuer"); or**
- **a public float criteria based on standards to be established.**

Rationale: To avoid inconsistencies in the calculation of "public float" from one company to another, "public float" would be defined, for classification purposes only, as "total market capitalization" less the market capitalization of shares held by directors and executive officers. The calculation of a company's "public float" would include ten-percent holders who file a Schedule 13G and founders who are currently neither directors nor executive officers who file a Schedule 13D.

(b) Definition of "Large Public Company"

The definition of a *"large public company"* should be the same as that of either a "well-known seasoned issuer" ("WKSI") or a "large accelerated

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* The foregoing metrics are for reference purposes only. The proposed definition can either use specific dollar criteria or scalable measurement metrics to avoid the problem of having to rewrite dollar-amount definitions periodically.

filer," both of which apply to companies with a public float of $700 million or more.

(c) <u>Definition of "Smaller Public Company"</u>

In order to avoid any gaps in the classification system, a "*smaller public company*" would be defined as a public company that does not meet the definition of "micro-cap company" or "large public company" and, in effect, becomes the default definition to encompass all public companies between the two ends of the spectrum of "micro-cap companies" and "large public companies."

Rationale: We support the use of market capitalization as a good initial criterion for the classification of the size of public companies. We believe that additional criteria are also important for the two smallest categories of public companies to account for different business models and other forces that may be in play for less mature public companies.

We believe that use of a revenue test will allow flexibility in circumstances where a pre-revenue or early-revenue company has a high premium market capitalization because of the perceived desirability of its industry group by the marketplace at a given point in time. For example, market forces are currently valuing small biotech companies with large aggressive market capitalizations, despite the fact that these companies are not expected to generate revenues in the near-term and have limited accounting and legal staff available for a more rigorous compliance regime. Vis-à-vis public companies in other industry groups, the market capitalizations of such small biotech companies are grossly disproportionate to the number of employees they have on staff that are available for financial and accounting functions. In these cases, revenue as opposed to market capitalization more accurately reflects the status of these issuers as younger, emerging, resource-constrained and with limited administrative staff.

We also believe that the use of a public float test is an appropriate and important criterion, as it most closely focuses on the protectible risk at issue – that of the truly independent, third party, public investor. Smaller public companies frequently have a high percentage of shares held by founders, directors and executive officers, the classic insiders who do not need significant SEC protection. We believe that the proposed definition of "public float" – which consciously avoids the less precisely defined terms "affiliate" and "control" – addresses the need to include larger outside investors as part of the protected class, even if they hold more than 10% of a company's issued and outstanding shares and might, for other purposes, be deemed to be an "affiliates."

(d) Exemption from the Definition of Public Company

The concerns of the creeping or inadvertent public company should be addressed under Section 12(g) of the Exchange Act, including providing a definitional exemption that excludes from the calculation the number of shareholder employees who receive options as part of compensatory arrangements.

Rationale: Companies that compensate their employees in part through the granting of options are attempting to conserve cash and retain talent with the promise of a deferred reward. We do not believe it is in the public interest and do not see the protectible interest for such companies, which are otherwise closely held, to expend the capital and resources, or be required to institute the internal controls, that are part of becoming public reporting companies. This is particularly burdensome since they have not received the capital infusion that ordinarily comes from an initial public sale of their securities.

2. Private Placement Broker Dealers

The SEC should embrace the thoughtful, well-reasoned and analytically sound *American Bar Association Report and Recommendations of the Task Force on Private Placement Broker-Dealers* dated June 20, 2005. Addressing the ambiguous standing of "finders," as recommended in this report, has been a high priority recommendation of the Forum for each of the past two years. The ABA report reflects a thoughtful and thorough approach for addressing this issue. It will provide a good starting point for the SEC to assert its leadership on this issue, which necessarily involves the NASD and state regulators.

Rationale: Finders play an important role in introducing small businesses to sources of capital and advising them on the capital infusion transaction. Creation of a limited purpose private placement broker-dealer ("PPBD") and appropriate regulatory regime would eliminate legal uncertainty surrounding participation of legitimate finders in small business capital formation. PPBDs should readily register under a regime that is appropriate to the function they perform and that restricts their activities to those necessary to performing that limited function. Further, witnesses testifying before the Advisory Committee have indicated that other bodies, such as state regulators and self-regulatory organizations, have or are formulating legal and regulatory responses to the activities of finders that place NASD members in jeopardy when they interact with and compensate such persons. These responses have, in some cases, placed finders in the untenable position of facing criminal sanctions for engaging in an activity that, if properly conducted, is generally recognized as fulfilling an important role in small business capital formation.

3. <u>De-Registration or Opting Out of SEC Reporting System.</u>

(a) The SEC should consider modifying the shareholder and asset criteria for the deregistration of a public company under Section 13 of the Exchange Act to: (1) adjust for inflation on the asset side; and (2) shift the focus of ownership from record to beneficial ownership.

Rationale: Micro-cap companies that became subject to Section 12(g) or 15(d) of the Exchange Act before the enactment of the Sarbanes-Oxley Act in July 2002 are the most deeply affected by the disproportionate costs of Sarbanes-Oxley Act compliance. However, the ability of these smallest of public companies to exit the reporting system is often limited. If they are not eligible to file a Form 15 under current criteria, based upon having only a limited number of shareholders of record, they must comply with lengthy and time-consuming going private transaction provisions under Rule 13e-3. The criteria triggering the requirements of a Rule 13e-3 transaction, based upon the number of shareholders, are historically arbitrary. The extensive time and costs involved in a Rule 13e-3 transaction, including the professional costs involved in preparing the SEC filing, the time and effort associated with the regulatory review of the filing, fairness opinions, potential shareholder lawsuits, and the fundamental requirement to obtain the necessary financing for the buy-out of the minority shareholders, often renders a Rule 13e-3 transaction impossible as a financial or practical matter, or both.

Beneficial ownership should be determined based on a current position or non-objecting beneficial shareowner ("NOBO") list.

(b) The SEC should create a "safe harbor opt-out" mechanism for micro-cap companies having fewer than 1,000 beneficial holders and which became subject to Exchange Act reporting obligations before the enactment of the Sarbanes-Oxley Act.

Rationale: Companies meeting these criteria should be automatically eligible to file a Form 15. Additionally, for the 90-day period subsequent to the filing of the Form 15, such companies should have the benefit of transitional relief so that they would not be obligated to comply with any new requirements that otherwise would be applicable to a reporting company because of the Sarbanes-Oxley Act. We believe these companies lack the true characteristics of a public company, yet they have to pay the full compliance costs without an offsetting shareholder benefit.

4. <u>Modifications to Prohibition on General Solicitation</u>

Eliminate the prohibition against general solicitation in offerings exempt under Rule 506 of Regulation D in which sales are restricted to accredited investors.

5. **Deferral of Application of Section 404 of the Sarbanes-Oxley Act to Non-Accelerated Filers**

The requirements of Section 404 of the Sarbanes-Oxley Act for non-accelerated filers should be deferred an additional year. We believe this relief is appropriate for micro-cap companies and smaller public companies, as those terms are defined above in Recommendation No. 1.*

Rationale: Non-accelerated filers currently confront a great deal of uncertainty as to what framework of internal controls will be adopted for smaller public companies by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") and what new definitions of smaller public companies will be adopted by the SEC and how the requirements of Section 404 will be applied to these new classifications of public companies. Because of the extensive lead time, non-accelerated filers should not be placed in a position of adopting frameworks of internal controls (or preparing to do so), or incurring the required expense of such implementation, until a clear regulatory framework is adopted.

6. **Elimination of Independent Auditor Certifications Pursuant to Section 404 of the Sarbanes-Oxley Act for Micro-Cap Companies**

No Section 404 certification should be required of independent auditors of micro-cap companies. Certifications currently required by the CEO and CFO under Sections 302 and 906 of the Sarbanes-Oxley Act should continue to be required.

Rationale: Micro-cap companies generally have not matured to the stage that business models or revenues and profits justify the complexities of internal controls which have been adopted by accelerated filers. In addition, investors in the micro-cap market generally place greater emphasis on the strength of management and management's ability to execute against the business plan. Thus, we are of the opinion that the certifications required of the CEO and the CFO under Section 302 and the potential for penalties which would attach for false certifications under Section 906 should be viewed as sufficient deterrents for managers of this class of issuers.

7. **Single Audit Attestation for Micro-Cap Companies**

A "safe harbor" from Section 404 of the Sarbanes-Oxley Act should be created for micro-cap companies that would permit the use of a single audit standard for Section 404 attestations.

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* On September 21, 2005, the Commission voted to extend for an additional year the compliance date for its Section 404 internal control reporting requirements for companies that are not accelerated filers. Under the new compliance schedule, a company that is not an accelerated filer will begin to be required to comply with the Section 404 requirements for its first fiscal year ending on or after July 15, 2007. SEC Release No. 33-8618, *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies that Are Not Accelerated Filers* (September 22, 2005).

Rationale: The "Single Audit Act" establishes the standards for independent auditors when they audit non-federal entities that receive federal funds either directly or indirectly. The technical rules are laid out in Office of Management and Budget Circular A-133. The circular directs that the auditor conduct the audit in accordance with either generally accepted auditing standards ("GAAS") or generally accepted government auditing standards ("GAGAS"), as appropriate, and opine on the financial statements, as appropriate.

OMB Circular A-133 also requires that the auditor test the internal controls as described in OMB-Circular A-122. The auditor's report on management's responsibility for internal controls is described in the circular. Finally, the auditor is required to report on any material weaknesses in internal controls.

8. Transition Rules for Classification of Public Companies

Transition rules should be adopted for all disclosure purposes, including Regulations S-B, S-K, and S-X, to provide companies with guidance when they transition between market segments, such as between micro-cap and smaller public companies and well-known seasoned issuers. The SEC should also determine the U.S. market capitalization as of calendar year-end and average this figure over a number of years. Similarly, company market capitalization should also be averaged over a number of calendar quarters.

Rationale: The transition rules for graduating up or dropping down to different market classes based on the definition of a public company must be made clear and drafted with sensitivity to avoid subjecting companies to different standards solely due to fluctuations in market value or company market value that may merely reflect short-term market or economic activity, specific to the issuer or generally reflecting broader industry or marketplace issues. Market participants will demand certainty regarding the classification of any particular company and the disclosure standards they are expected to adhere to when reporting. Similarly, companies will not want to be placed in a position where they might be forced to institute costly changes to disclosure and internal control standards if the change in their classification is due to volatility in company market capitalization. Thus, for example, in order to reduce the chances that companies will "bounce" between market classifications, as might be the case if a capitalization based only upon a single point in time is used, we believe that: (1) the calculation of U.S. market capitalization should be averaged over three to five years; and (2) companies should be required to average their market capitalization over four to eight calendar quarters.

We are concerned that companies could migrate between definitional classifications (both up and down) over several years while their actual businesses and operating characteristics may have undergone almost no change. Companies will need time to prepare for and comply with the applicable rules.

9. Clarification of Sarbanes-Oxley Act Loan Prohibitions

The Sarbanes-Oxley Act loan prohibitions should be clarified to avoid their application in the following instances:

> **(a) Cashless exercise provisions in options granted to officers and directors should not constitute a violation of the Sarbanes-Oxley Act loan prohibitions.**
>
> **(b) Advancement of costs in litigation (indemnification) should not be deemed to violate loan prohibitions provided that the recipient is obligated to repay such funds if the outcome of the dispute is such that the governing law and indemnification provisions would not have allowed for indemnification or mandated such repayment.**

10. Delayed Implementation of New Accounting Pronouncements

The effectiveness of new accounting pronouncements should be delayed for both micro-cap and smaller public companies. These two categories of smaller publicly-held companies should always be provided an additional one-year period from the date with which new accounting pronouncements become effective for large public companies to comply.

Rationale: Micro-cap companies and smaller public companies do not have the internal resources and expertise to construe and apply new pronouncements absent substantial guidance. Such a delay in implementation would allow the accounting profession to become better acquainted with the new literature and allow custom and practice to develop, thereby diminishing the burden on the micro-cap and smaller public companies when the pronouncements become effective for them.

11. Guidance on Materiality in a Financial Reporting Context

The SEC staff should provide guidance to issuers and auditors on "materiality" in a financial reporting context.

Rationale: SEC Staff Accounting Bulletin No. 99 is difficult for financial professionals to construe and is being inconsistently applied. SAB 99 is a fair recital of the law of materiality, but it affords little tangible guidance to financial professionals with respect to the practical application of the law. Thus, internal accountants, external auditors and audit committee members often find themselves at odds with respect to the materiality of particular financial items. The circumstances cry out for guidance to make SAB 99 more accessible for non-legal financial professionals. The Forum recommends a question and answer type staff accounting bulletin addressing a host of hypothetical materiality issues.

12. <u>Guidance on Permissible Advice of Independent Certified Public Accountants</u>

Clarification should be widely distributed advising that independent certified public accountants may provide guidance with respect to accounting literature and its application without impairing their independence.

Rationale: The initial guidance provided to the accounting industry by the PCAOB was too narrowly construed. Subsequently, the PCAOB provided further guidance by way of a question and answer release to clarify the extent to which independent public accountants may advise their audited companies. Further clarification needs to be issued because the auditing profession is still acting in a manner that is more reserved than that allowed by the PCAOB guidance. This conservatism has resulted in substantial financial burdens on micro-cap and smaller public companies.

13. <u>Modification of Treatment of Consents and Audits Prepared by Predecessor Auditors</u>

(a) Auditor independence standards should not preclude a predecessor auditor from issuing a consent to the use of a previously issued audit opinion if it was "independent" under the standards that were in effect at the time the opinion was issued merely because it is receiving installment payments with respect to a prior invoice.

(b) A predecessor auditor should also not be precluded from certifying a restatement of previously audited financial statements based upon the new independence guidance if the auditor was independent at the time of the initial certification.

Rationale: In the circumstances addressed above, the independence standards in effect at the time of issuance of the original opinion should be the standards that address any opinion on a restatement or the issuance of a consent. In both cases, the Forum contemplates that there would be special disclosure in the opinion that discloses which standards govern and highlights that the auditor would not be deemed independent under today's standards and the basis in fact and under the literature for those conclusions.

Additional Securities Regulation Recommendations

The Forum break-out groups developed the following additional recommendations, which were not presented to the Advisory Committee on September 20, 2005, due to time considerations. These recommendations are not presented in any order of importance or priority.

14. Regulatory Structure for Private Pools of Accredited Investors

Create a regulatory structure through the use of regulatory authority, including no-action letter relief, allowing private entities to be formed for the purpose of building secure pools of accredited investors to whom pre-qualified pool sponsors can distribute offering documents seeking early-stage capital without violating the prohibition on general solicitation. This approach would be an improved version of the SEC ACE-NET no-action letter but operated by one or more private entities.

15. Exemption of Certain Pooled Investment Vehicles from Investment Adviser Compensation Limits

Create a mechanism for accredited investors to pool funds for investment in non-public operating companies without the compensation limitations of the Investment Advisers Act of 1940.

16. Establishment of Advisory Committee

Establish an advisory committee to address the problems and concerns of small business entities trying to raise $5 million or less in capital.

17. Expansion of Small Business Registration Exemptions

Adopt Securities Regulation Recommendation No. 5 listed in the 2004 Forum Final Report that the SEC should issue a concept release on small business capital formation with a view to improving the utility of small business securities registration exemptions and to increasing the limits for the use of Regulation S-B, Regulation A, Rule 504, Rule 505 and Rule 701.

Tax Recommendations

The Forum tax breakout group developed and prioritized the following recommendations for Congress.

1. **Monetization of Small Businesses' Net Operating Losses**

Currently, Internal Revenue Code Section 1244 allows a preferential write-off of an initial investment in a small business. This benefit only saves *failures* after the fact. What is often needed is an extra infusion of capital to help small businesses *succeed.* We recommend that Congress investigate ways to monetize qualified small businesses' net operating losses ("NOLs"). For example, allow a small business to sell its NOLs to another company. Congress may want to consider thresholds and limits on the dollar amounts of NOLs that could be sold.

2. **Small Business – New Jobs Incentive Act**

Allow a 10% credit for a "qualified investment" in a "qualified small business." The credit would be available to carry forward only. A qualified investment would have a yearly limit for the purchase of an equity investment of no more than $1 million per investor. A qualified small business may include a C corporation, S corporation, LLC or other legal entity structure. In keeping with the desire to promote "patient capital," the investment must be for a period of at least three years, or the credit would be subject to reasonable recapture. In addition, the small business must be in an active trade or business and would not include investment companies or personal service corporations. Further, the credit could be used to offset either the regular tax liability or the alternative minimum tax liability. The credit would reduce the investor's tax basis in the original investment.

3. **Modification of Alternative Minimum Tax**

The alternative minimum tax ("AMT") is an impediment to investment in our country, because it introduces further complexity and reduces rates of returns in small business investing. The preferential rate or treatment of capital gains or investment incentives should not be subject to the AMT.

4. **Tax Simplification**

The current tax code is so burdensome and complex that it has become an impediment to the successful functioning of small business as an engine of economic growth to the overall economy. Over the course of the last 90 years, the Internal Revenue Code and attendant regulations have evolved in such a way that, due to their complexity, they now deter investments in domestic businesses. The environment of a complex tax code has spawned tax shelters. We believe that our system of taxation should be simplified, and this simplification should be designed in light of the global nature of business today.

5. E-Commerce Restriction

Federal and state taxation or restrictions of e-commerce will cripple small businesses' ability to raise capital and increase employment. It will also adversely affect small businesses' product distribution due to increased regulatory compliance and financial burdens. We recommend that Congress prohibit the imposition of any restrictions on e-commerce and ban the states from imposing any state sales, use or telecommunication taxes on e-commerce.

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