RECORD OF PROCEEDINGS

SECURITES AND EXCHANGE COMMISSION
ADVISORY COMMITTEE
on
SMALLER PUBLIC COMPANIES

First Day of Meeting

September 19, 2005

8:00 a.m.

The Hyatt at Fisherman's Wharf

555 North Point Street

San Francisco, California

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First Panel of Witnesses

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

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

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

Lynn E. Turner, Professor and Director of The Center for Quality Financial Reporting, Colorado State University, Fort Collins, CO

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

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

Second Panel of Witnesses

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

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

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

Jon Hickman, Vice President, Equity Research- Technology, MDB Capital Group LLC, Santa Monica, CA

Michael J. McConnell, Managing Director, Shamrock Capital Partners, Burbank, CA

Andrew E. Shapiro, President and Portfolio Manager, Lawndale Capital Management, Mill Valley, CA

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P R O C E E D I N G S

The following Members were present in person:

Steven E. Bochner

Richard D. Brounstein

James A. “Drew” Connolly

Alex Davern

Joseph "Leroy" Dennis

Janet Dolan

Richard M. Jaffee

Mark Jensen

Deborah Lambert

Richard Leisner

Robert E. Robotti

Kurt Schacht

Ted Schlein

James C. Thyen

John Veihmeyer

Herbert S. Wander

The following Members were absent:

Patrick C. Barry

Pastora Cafferty

C.R. "Rusty" Cloutier

E. David Coolidge

Scott Royster

The following Official Observers were present:

George Batavick

Daniel L. Goelzer

Jack E. Herstein

The following SEC personnel were present in person:

Commissioner Paul S. Atkins

Alan L. Beller

Gerald J. Laporte

Kevin M. O'Neill

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MR. LAPORTE: If everyone would take their seats, we have a lot to cover this morning.

Well, my name is Gerry Laporte, and I'm the Chief of the Office of Small Business Policy at the SEC, and our office is responsible for supplying support for both the

Forum on Small Business Capital Information and the Advisory Committee on Smaller Public Companies, which are convening together today. Before we get started, we've got a few housekeeping details. First of all, this session is being audio webcast, throughout the world actually, so in order that those people out there in cyberspace can know who's saying what, we ask that everybody state their name before they say anything during this morning's discussions.

Secondly, as most of you know, we have a lunch scheduled at 12:30 today. If you want to have lunch with us, you have to pay the hotel's fee for the lunch. You can do that in the lobby. There will be a cashier there until 10 o'clock to take your -- actually it's 10:30 to take your money for lunch. The cost is $32.50. The SEC had nothing to do with that. Blame the --

MR. WANDER: It would have been more.

MR. LAPORTE: You can blame the Pritzker family from Herb's city of Chicago for the high lunch prices. Also we -- both the lunch and our inability to serve you coffee are due to federal appropriations laws. So if you have any complaints about those things, next time you talk to your congressman, you can tell him or her.

In the booklets that you all got on the Forum, there are lists of breakout groups and places where the breakout groups are going to meet. Those breakout groups are going to meet this afternoon. For the Advisory Committee members later on this afternoon, there are some subcommittee meetings. In front of the chair of each Advisory Committee member is something called a "schedule," and it tells you where you should be when. The breakout groups this afternoon, if they care to do so, will come up with recommendations which can be made to whomever they want. They can make recommendations to the SEC, they can make recommendations to Congress, they can make recommendations to other federal agencies about small business capital formation.

But what we've asked them to do this year is to run their recommendations through the Advisory Committee on Smaller Public Companies, which Alan Beller will explain in a couple minutes. Those recommendations will be presented tomorrow morning at 10:30 in this room. Tomorrow morning -- the Forum really finishes today, and tomorrow morning it's just the Advisory Committee that will be meeting. But the moderators of the breakout groups of the Forum will be presenting recommendations. I think that's at 10:30 tomorrow morning. Yeah, 10:30 a.m. The people who will be the moderators of the breakout groups of the Forum will be presenting the recommendations to the Advisory Committee.

This morning's session, as I mentioned, is a concurrent meeting of the Advisory Committee on Smaller Public Companies of the SEC and the Forum on Small Business Capital Formation. For that reason we have four different people presiding at this morning's session. To my right is Jim Thyen who's the Chairman of -- Chairman and CEO and President, I believe, of Kimball International from Jasper, Indiana; and Herb Wander to my immediate right, Herb is a partner in a prominent Chicago law firm. These gentlemen, their biographies are in the press release, in the copy of the release that's available, that was available when you came in. They are the Co-Chairs named by SEC

Chairman Donaldson to the Advisory Committee on smaller public companies.

To my left are the two people who are here because they have a connection with a Forum on Small Business Capital Formation. To my immediate left is Marc Morgenstern, a prominent corporate, he told me -- if you look on the web, you'll find that it says he's a "veteran deal maker." He's a lawyer from--

MR. MORGENSTERN: That means I'm over 50.

MR. LAPORTE: He's from Cleveland, Ohio, and he has been active in the Forum on Small Business Capital Formation since 1983, which I think is longer than anybody in this room because the first Forum was held in 1982. To his left is Alan Beller who is the Director of the Division of Corporation Finance at the SEC. Alan is here because the Division of Corporation Finance is charged by the Commission with conducting the Forum on Small Business Capital Formation on an annual basis. And now I will introduce Alan and let Alan make some welcoming remarks to you.

One thing I should say before Alan gets up, we're also expecting Commissioner Paul Atkins from the SEC to be here. We've got a chair set aside for him. But he only arrived about 5 o'clock this morning, so he gets an excuse for not being here at 8 o'clock. Alan?

MR. BELLER: Gerry, thanks very much. I'd like to welcome you all here today to an important and, I do think, a somewhat unique event. And all of you who are listening in cyberspace, this is a -- these are concurrent meetings of the SEC government Small Business Forum on Small Business Capital Formation and the SEC's Advisory

Committee on Smaller Public Companies.

The Forum has been meeting with the sponsorship and assistance of the SEC, and particularly the Division of Corporation Finance, since the early '80s. I guess the first Forum was 1982. Congress mandated these Forums in legislation that was adopted in 1980. The Advisory Committee was formed in December 2004 by then Chairman Bill Donaldson of the SEC. Its membership was completed in March of 2005 and it had its first meeting in Washington in April 2005. It subsequently had open meetings and taken testimony in New York, in Chicago, and now today in San Francisco, and it will have three or four additional meetings in, which I think probably the testimony taking function is pretty much over, and the business of the Committee in developing its recommendations to the Commission will begin in earnest.

I think it's important to understand what we're trying to do here today. These two meetings, these two organizations are in no way, and the two meetings are in no way, combined. Both groups have very important separate identities. On the other hand, there's certain parts of what we're going to be doing for the next two days where the activities of the two groups will run concurrently, and we think there are very good reasons for that. The most important example for that is the panel presentations that -- and the sort of roundtable format that we're going to be engaging in for the rest of this morning where we will have groups of presenters making presentations, in effect, concurrently to the Forum and to the Committee. And the four of us up here who are acting as moderators will try to probe some of these presentations, ask some questions in a way that we hope will inform both the Forum and the Committee regarding issues that are important to both of them.

The Forum, it's important to understand that it's separate, it's a -- it's an ongoing body, it's got a continuing agenda, it's got a continuing mandate, as I said, granted originally by the Congress. The Advisory Committee has a defined mission and a finite life span. It's expected to deliver its final recommendations to the Commission in the spring of 2006.

Having emphasized their separateness for a moment, let me now emphasize why we're doing this, which is that there are -- the two groups, the Division believes, are trying to address either the same or overlapping issues, and it seemed desirable to get them together and have these issues addressed concurrently. For the Advisory Committee, I think we think it's important that they interact directly and firsthand with the Forum and have an opportunity to hear firsthand and directly, and that will happen tomorrow morning. The Forum's recommendations will come out of this year's meeting. And we think it's important for the Forum to have an opportunity to interact directly and firsthand with the Committee.

The Forum has been wrestling with issues of capital formation and regulation of small business and smaller companies for over two decades now. Many of the issues have been on the Committee's, the Advisory Committee's agenda since day one, and frankly, we think it's an important opportunity for the Forum to have this ability to, in effect, interact directly and firsthand with the Committee and give it -- give the Committee an indication and a presentation of their issues and concerns. The issues that we're talking about are of keen concern to the Commission. The Commission's been a strong backer and a sponsor of the Forum for nearly 25 years now. It will continue to do so. The Commission enthusiastically supported the creation of the Advisory Committee.

I think many of the members of the Advisory Committee who has met directly with members of the Commission can testify firsthand that they've seen that enthusiasm. I've certainly seen it from every one of them, and that includes our new chairman Christopher Cox. Both he and Annette Nazareth, who is the new Commissioner who replaced Harvey Goldschmidt, have voiced very clear and strong backing for the work of the Committee and their interest in seeing the Committee's recommendations, and for seeing what comes out of today's and tomorrow's concurrent meetings.

One of the Commissioners, Paul Atkins, is with us today, will be with us later this morning as Gerry said. I hope he's getting 40 winks before he joins us. But he will definitely be with us. And finally as an indication of the importance that the Commission accords to the matters that are in front of us today, the Commission at its open meeting on Wednesday has on its agenda, has calendared consideration of two items: one, the further deferral of applicability of internal reporting assessment and auditing requirements under Section 404 of Sarbanes-Oxley; and the second is the filing deadlines for accelerated filers, including smaller accelerated filers, for filing their periodic reports, their quarterly and annual reports.

Both of those matters that are on the agenda parallel recommendations that the Advisory Committee made to the Commission through a letter to Chairman Cox, I think, only about a month ago. And I think it's an indication of the seriousness with which the Commission addresses these issues that they and the staff of the Division of Corporation Finance had been prepared to move so expeditiously. I can pretty well promise you that the Division and the Commission will not move that expeditiously on every recommendation of the Committee, and I think the Forum will probably tell you that from experience, that's right. But they -- the Commission has been committed over the years to taking the Forum's recommendation seriously, it doesn't mean they'll always agree or act, but certainly considers them, and is doing the same things with the recommendations to the Advisory Committee.

Finally, I'd like to thank the people who have made these two important meetings possible. First, the Forum participants without whom we wouldn't have a Forum. We could sponsor and organize an empty room without the enthusiasm and the ongoing support of the participants in the Forum. I don't think all of them have been like Marc and have been doing it for 22 years now, but I know a number of them have been doing it for a number of years, and we're very grateful. We're very grateful for that. I hope by bringing the Forum to the west coast, we have kept the enthusiasm of some of our old friends and developed some interest from some new friends, but we will see how that goes.

I'd like also to thank the members of the Advisory Committee who are gathered around this horseshoe this morning. Both the Forum participants and the members of the Advisory Committee have given up their time and their energy to work with the staff and to work with the Commission on the issues of the appropriate regulation of small business and smaller companies, smaller public companies, and attempting with us to find the right balance of that regulation, including the right balance of costs and benefits that will make it work better. I'd like to thank Commissioner Atkins, and I'll thank him when he's here again, but I'd like to thank him for coming here today and agreeing to speak with us and share his remarks with us at lunch.

Finally, I'd like to thank the staff of the Division of Corporation Finance, in particularly the staff of the Office of Small Business Policy, of which Gerry Laporte is the head, for their efforts in organizing this. Without them, we might have a room full of participants, but we wouldn't have a meeting. And so I'm very grateful to their efforts. That's pretty much what I had to say. Thank you very much. I think we'll move directly into the first panel of presenters. They are -- unless you have theater in the round, you'll always have this problem, of some group is facing away and some group is facing forward. Last year we did it with the moderators facing away; this year I guess we're doing it with the presenters facing away from the audience. We'll figure out which one we like better.

For those of you in the audience and for those of you in cyberspace, let me introduce this panel, the first six folks who will be with us this morning. From my -- and for those of you who are in the room, from my left and from the audience's right, the first is Rick Ueltschy who's an executive of Crowe, Chizek & Company, LLC, in Louisville, Kentucky. Rick is the executive in charge of Crowe Chizek's Financial institution audit group and audit methodology group.

To Rick's left, my right is Lynn Turner, who's the managing director of research at Glass Lewis & Company in Denver, Colorado. Lynn as virtually all of you know, served as the Chief Accountant of the Securities and Exchange Commission from July of 1998 to August of 2001. To my right, Rick's left, is Ken Hahn who's the Senior Vice President and Chief Financial Officer of Borland Software Corporation, Cupertino, California. And in that position, Ken is responsible for financial and administrative operations as well as investor relations activities at Borland.

To Ken's left, my right is Ann Walker who's a partner at Wilson Sonsini Goodrich & Rosati in Palo Alto. Ann specializes in corporate securities law including public offerings, mergers, and acquisitions, and general corporate responsibilities and representation, with a particular emphasis on public company disclosure obligation and SEC regulatory compliance. Next on Ann's left is Gerry Niesar who's a partner at Niesar Curls Bartling, LLP in San Francisco. His work involves general representation of emerging companies, both public and private in a broad spectrum of industries, including a variety of high tech industries and service manufacturing distribution and retail industries.

And finally, to Gerry's left is Don Reinke who's a partner at Reed & Smith in Oakland, California where he is a corporate lawyer in the areas of venture capital finance, public securities offerings, mergers and acquisitions, and other general corporate representation involving both technology, start-up, and emerging growth companies, he also represents venture funds and investment banks. With that, I'm going to get us started. Herb, I'll give you back your microphone. And Gerry, do you have an order of battle?

MR. LAPORTE: Herb, you and Mark, Jim and Alan can share the moderating duties.

MR. WANDER: Well, in the past, we've permitted each of our guests to give a brief introduction to add anything in their background that might be of relevance to the group here and then to make a short presentation, and then members of the Advisory Committee and the Forum will ask some questions of each speaker, and then we may have some general discussion among ourselves, among the panelists. We have allotted about two hours, and so we hope you make your remarks terse so that we can have as much roundtable discussion among us as possible. And why don't we start at my left with Rick please.

MR. UELTSCHY: Thank you. Thanks for the opportunity to speak to the joint meeting, and I will keep my comments terse. I'm just going to speak on a couple of items. First of all, I would like to speak to the recommendation on the size categories that's been brought forward. We agree with the concepts in the size category. In fact, in our comment letter to the SEC in April related to the roundtable, our firm, which principally audits smaller public companies as defined in the regulation, suggested a somewhat similar structure. We would add, or ask that the Committee think about a fourth category explicitly, and while it's not another category of public companies, it's simply exempt for non-public organizations.

We think that's important because of the fact that public companies, which are bearing a certain regulatory burden, are, in fact, competing with non-public companies and they're doing that for capital as well as other items. We think the intersection between when a company leaves one classification, non-public to public or vice versa, is an interesting or very important point in the lives of those companies. And unless the regulation associated with those non-public companies is well thought through, there could be some unintended consequences of changes in the public company sector without considering the impact on non-public companies.

One of the items that could be construed as a small item but illustrative of that, it has to do with the auditor independence rules. Today if a company that is non-public moves forward into an initial public offering, there are certain financial statement requirements for that offering. And those financial statements need to be audited, and the auditor performing that audit needs to comply with the independence rules of the SEC. And as many of you know, there's been a bit of divergence in the independence rules and between the SEC and non-public companies. Several years ago the SEC strengthened the independence rules.

So in the circumstance that I described, we could have a situation where a non-public company, merely going about its business following their auditor independence rules for non-public companies, decides to go public and finds that they have perhaps three years of audits that are of no value in terms of their public offering. And while we don't want to redebate in this Forum the various merits of independence rules, the fact of the matter is that that creates a situation where in order to access the public market, that company may be forced to reaudit up to three years of financial statements, incur meaningful costs in doing that, whereas if they were in -- and, in fact, they would be forced to change auditors because their auditor is not independent, when, in fact, were they to access private equity capital, they would not incur that cost.

Similarly, in kind of an interesting twist of the auditor independence rules, exempt -- there are certain exempt offerings that are available for generally smaller offerings for companies. And again, some of those exempt offerings from time to time will include an audit requirement. Although the offering is exempt, there's no registration, the company does not become public. As you drill through the SEC rules related to auditor requirements for that offering in a non-public setting, once again, the auditor needs to meet public company independence rules. Again, that creates a cost.

There are usually not as many periods involved, but in this case, the cost, again, for the public company -- or the public -- accessing public capital requires that accessing non-public capital would not require. Those are examples of costs and burdens that occur for smaller offerings, and I think, again, we have a situation where the IPO process perhaps for a division of a multi-billion dollar company should be a bit different than perhaps the IPO process for a company trying to raise 20 or $30 million.

The other area that I would just like to just briefly speak on is the issue of audit cost. I was hoping that I could find a way to speak for five minutes without mentioning 404, and that was not possible. But I felt it was very important to, perhaps, bring to the Committee's attention things that we are observing in the market place today. As I mentioned, our firm is -- practices largely, our public practice is in the smaller public company market. We've conducted a significant number of integrated audits under section 404 in that space. And there has been some testimony that this group has heard that says there is an expectation that the year two costs on a 404 audit are likely not to be lower, and I would say that that is completely inconsistent with our experience to date in the small company space.

We are seeing meaningfully lower costs for smaller public companies as defined in the proposal, and there are several reasons for that, we believe. Number one, a fair amount of uncertainty has been removed going into 2004, that no matter what size the company was, no one knew what an internal audit control was, pricing by vendors encompassed the uncertainty associated with that, there was a lack of willingness to provide fixed fee pricing. Secondly, there has been a, what I would call a not quite right-sizing but almost right-sizing supply and demand for resources in addition to the fact that there was a lot of uncertainty in 2004. Eighty percent of the market cap in this company had their audit requirement doubled, and putting in place enough auditors to execute that work was difficult and costly and created no incentive for auditors to provide pricing flexibility.

We're seeing a lot of change there. We are seeing auditors in the smaller company, public company space willing to provide fixed fee quotes in the second year of 404 work for smaller public companies. We are also seeing such auditors willing even to provide fixed fee quotes for companies that have now become accelerated filers and are undertaking their first year of 404. We think that's largely a result of the uncertainty being removed from the marketplace and the stabilization of staffing. We also think that there's been a third -- perhaps a third element at play here, and that is the introduction of competition.

There is one factor working to the advantage of smaller public companies today that did not -- that does not come into play for the largest world-wide companies, and that is simply the factor of choice. We are seeing today many companies at the large -- at the smaller end of the large company classification, as this group's defined it, that are now choosing to look outside the Big Four for their audit services. And they're doing so largely because of an attempt to introduce a bit of market competition into the pricing for the service. The fact of the matter is that the smaller public companies, virtually all of them could be served adequately by more than the Big Four, certainly the eight largest firms are subject to annual review by the PCAOB. And, in fact, many of those smaller public companies could also be effectively be served by the dozens of qualified regional C.P.A. firms.

And what we're seeing in the market place today is companies and audit Committees have come to recognize this, and if you track the auditor change information, you'll see that there are a number of -- there's a fair amount of activity in terms of auditor change, there's real price competition being introduced into that process. And we believe that when we review proxy statements in the spring of 2006 related to 2005 audits, we'll see that for many of the smaller public companies, costs have gone down for outside auditors, and we'll see that there's been a more rigorous application of price competition, through looking at alternative auditors in the smaller public company space. And I guess that will conclude my terse comments, Mr. Chairman.

MR. WANDER: Thank you very much. Are there any questions from the Advisory Committee before we move on? Comments? Marc?

MR. MORGENSTERN: My only question for each witness, having offered your commentary which is very helpful and, since this is the Forum which is a little different than the other advisory panels, out of your comments, are there any specific recommendations that you'd like the Forum to consider?

MR. UELTSCHY: From this -- I specifically would like the SEC, if you will, to consider the acceptance of audits performed under the non-public company audit standards, the independence rules that I mentioned, as acceptable for exempt filings and for IPOs on prior periods, at least as it relates to smaller public companies. And I think that the point I'm making on the fees, while that does not come with a specific recommendation, is that I believe that there is -- I fear that often when we have public policy debates, we sometimes extrapolate the last five minutes out into perpetuity, and I think 2004 was sort of a perfect storm for high costs. And I think we need to -- perhaps if we let the market place work a little bit, we may find that the cost of this regulation in the long run of 404 may not be as great as we think, particularly in the smaller public company arena.

MR. MORGENSTERN: Great. Thank you.

MR. WANDER: Isn't it true that the AICPA has a study under way on private company auditing standards?

MR. UELTSCHY: There is an -- and I'll be stretching my knowledge on the full range of what the AICPA has in play, but there is some work being undertaken as it relates to internal control auditing for smaller public companies, which will tend to move, I think, those particular requirements closer to section 404 requirements.

MR. WANDER: Okay. I know -- oh, George.

MR. BATAVICK: Yes, I'd like to -- this is George Batavick with the FASB. I would like to comment on the efforts of the AICPA as it relates to private company reporting. Myself and another board member plus another assistant director at the FASB is presently working with three individuals at the AICPA. A number of months ago, the AICPA went out with a survey, and they concluded, "they" meaning the AICPA concluded, that private companies really needed differential accounting standards. Where we are at this particular point is that we've agreed to go about this in the following way:

We're trying to first establish what type of attributes or characteristics private companies have that make them different from public companies. If those attributes can be established, then we will look at a process for considering alternate or differential accounting standards. And we have full agreement at this point with the AICPA on that's the way to proceed as opposed to just assuming that private company accounting standards are the way to go. So the process is in its very early stages. I think the FASB over the years has had a history of making some differential decisions relative to private companies, whether it be transition, effective date, etc. That will certainly continue, although we expect our efforts to continue in that particular area and even expand.

But the question on the table is should we go farther? And similar to what the IASB is doing on their small and medium enterprises, but this is a project that probably I would look to see something coming out, some type of direction by the end of the year.

MR. WANDER: Thanks, George. Janet?

MS. DOLAN: Thank you very much for testifying here this morning. I'm the Chairman of the 404 Committee, so I'm sorry you couldn't even get five minutes without 404. I was intrigued by your testimony that you think that the fees will go down significantly. If you would attest to that, I'd feel very good for a lot of small companies but won't hold you to that. But I have a different question which is clearly cost is one factor, but another factor that we have to be very cognizant of in a global capital markets world is the money well spent? You know, is this a wise investment for particularly small companies? And we've heard a lot of the testimony before the 404 Committee in terms of the difference between focusing on tone at the top in small companies and the control environment as opposed to the very detailed transactional focus of 404 as it is right now.

Have you formed any kind of judgment in that area? Can you give us any feedback on behalf of what you've seen with your companies?

MR. UELTSCHY: I think that that's a -- that point is generally true in our experience also, and I think it's important to think about how that might differ in a smaller public company versus a large company. Most of the control problems that were identified in our audits during 2004 were related to financial reporting, difficulties with companies having effective processes in place to evaluate the more complex accounting literature, certain corporate governance matters. But what we found is that in a smaller public company, you tend to have a larger portion of the work devoted to those higher level, tone-at-the-top type matters, because they are simply not the wide range of operational controls to be tested that there are with the largest companies.

If you think of a company with large world-wide operations, you're going to have many divisions and many different types of accounting, process flows, and many, many, many transactional testing of points that take place. In the smaller public companies, you generally have fewer product lines, simpler accounting processes, and fewer transactional controls, but yet you still have to address all of the entity-wide COSO control elements. So we did not find that -- I guess I would say that we did not find that this disproportionate testing of operational controls seemed to exist in the smaller public company setting that we operate in. And we did -- again, and most of the issues, most of the findings with the smaller companies were similar to the larger, which they were financial reporting oriented.

MR. WANDER: Yes.

MR. CONNOLLY: Good morning, sir. I'm Drew Connolly. I am a little bit concerned about the statement being left basically unchallenged, "In year two the cost for small public companies are going to be significantly lower." And I'm wondering if that could be quantified in sort of a general range, because if we take, for example, external calling auditors, attorneys, etc., vendor costs, but rather internal management time, effort, targeted effort and expense to reach this 404 challenge, you may be aware that one of the things we're considering is the possibility of staggered parts of that 404 being applied. I'm wondering if you could quantify what you perceive to be, or what your firm's experience or potentially is if year one is X, what would your flavor be that year two would look like?

MR. UELTSCHY: Let me -- I'll answer that directly. I want to preface it with one comment. Much of the testimony and much of the writing and so forth that we've heard about 404 has been focused on the experiences of the largest companies. Again, if we go back to the SEC Forum and the PCAOB event in May, there's a lot of focus on the largest companies. And if you read much of the discussion, a lot of the cost issue for the largest companies was attributed to scope. The question that was just previous had to do with transactional controls. Our experience is not that that's not what drove costs for smaller companies. What drove cost was a lack of good project management, understanding what this whole thing was about, getting it done timely, coordinating effectively with auditors.

And like many complex activities that are done on a repeated basis, once the company was through with it and the auditors were through with it and they understood what the process was, now there are much better project management activities in place, again, in our direct client base, that will cause the work to be done at the right time by the right people. And those things will permit all of the things that exist in 404 such as reliance on the work of others to be used as effectively as possible. So we think there's real reason to believe that matter that I just described plus the competitive items that I described earlier, that's real reason to believe there will be savings.

I think it's going to be about a third of what year one costs were. You know, it's so hard to say what it would be at any one number, but my feeling is it will be about that. And frankly, I've seen certain circumstances where at the smaller range of the smaller company, say, at the bottom end of the accelerated filer range where multiple smaller regional C.P.A. firms had proposed on the work and market pricing being driven even lower than that.

MR. CONNOLLY: Thank you.

MR. WANDER: Alan?

MR. BELLER: I want to go back to your recommendation to the Forum, and I guess this is partly a question, Rick, for you, but I think it's also partly a question that can be picked up by any of the people on the panel that represent companies that are in the process of going public, the attorneys that are gathered in front of us today. In evaluating the recommendation, I think the Forum has to take into account sort of what is the likeliest cycle for a private company waking up on a Monday morning and saying, "Gee, we ought to be thinking about going public," and that event actually taking place. I think one of the things we saw -- although I wasn't sitting in this chair, I was sitting in your chairs, I think one of the things we saw in 1999 and 2000 was that that cycle was too short to make sense in any conceivable way. Everything we've heard is that that cycle is now longer.

But how would you evaluate your recommendation that there ought to be a relaxation of the audit standards against -- how long should a company be planning to go public? If your answer is three years, I don't understand the recommendation. I assume your answer is less than three years, and, therefore, that's what gives the recommendation some bite. But I guess I'd like to know exactly where -- I know there's not a magic number, I know it's not the same for every company, but what is sort of -- how long does it take these days, and what's the appropriate way to plan for going public?

MR. UELTSCHY: I think that's a largely unanswerable question. There are industry differences, there are -- again, there are size differences. Why is the company going public? Has it been sitting there as a division of a large company? Has it been an entrepreneurial company where they've been perfectly pleased with private capital, but the private capital sources have dried up? Is it that -- there are just so many scenarios within a company that I think trying to peg that is very difficult. I think many, many companies, I think, make the transition from deciding to be private to go public in less than a year, and I don't think that's an unreasonable time frame for a well managed company that thinks about various alternatives. I certainly don't think it's three years. That's a very, very long time in the life of a dynamic company.

MR. WANDER: Yes, Dick.

MR. JAFFEE: Dick Jaffee. I want to come back to the issue of the cost. And regardless of whether it's going to be -- I'd love to see it be a third lower in year two -- I'm somewhat skeptical that that will materialize. But when we started this whole process, we looked at cost/benefit and we looked at percentage of revenues was one metric of smaller publicly traded companies that's devoted to one section of one regulation. And given the SEC's mandate to protect the investor where we see companies devoting one percent of revenues, which in the case of my business would have been 20 percent of profit to compliance with 404, and I can tell you that our people think we get virtually no benefit. So that's a perspective, whether it goes up or down.

And secondly, the idea that there's going to be competition in the market place -- and I have great respect for your firm, I'm from Chicago I know your company. But once a company like mine sort of bites the bullet and moves from a second tier auditing firm to a Big Four company, I think they would be very hesitant to go back. Not that they shouldn't, not that there isn't good reason, you people do a great job, but I think they would be very hesitant because of the focus of the securities laws and why are they changing and why wasn't Pricewaterhouse -- in our case it was Pricewaterhouse. Why weren't they happy with them?

Thirdly, you made reference to the members from 2004 being high water mark and then they're going to go down. I don't have that at my finger tips, but the Foley-Lardner study that we looked at showed a steady progression of 30, 40 percent year over year acceleration, and I would be incredibly pleasantly surprised to see a 30, 40 percent trend line suddenly drop to a 30 to 40 percent reduction. So as I say, I hope you're right, I wish you well. But from what I'm seeing and hearing, it doesn't seem to be the case.

MR. UELTSCHY: Yeah, if I could just briefly comment on that, I think that given the choice to limit yourself to only the Big Four, I think that you will not realize those kind of cost benefits central to the price reductions that I talked about where it was market competition. And I think that there are a lot of forces out there that drive companies once in the public markets to look at a larger public accounting firm. There are risk management processes within the investment banking community that drive individuals -- individual companies toward the use of larger and larger audit firms. But I wouldn't -- I don't know that that's a cost of the regulation as much of a cost and a choice made in terms made of accessing the capital markets. So, you know, I agree that there's significant cost behavior differences between companies that limit themselves to the Big Four and others that use a broader range of C.P.A. firms.

MR. WANDER: We're going to move on because we've got a lot of people to cover. I'm going to ask Lynn to make his remarks next, and then I'm going to switch all the way to the other end, Don, so I don't catch you off guard, and we'll work towards the middle, which is always a good idea, I think. Lynn?

MR. TURNER: Thanks. I'm Lynn Turner, managing director of research at Glass Lewis. Glass Lewis is happy to be able to present today. We are a start-up having started just about two, two and a half years ago. So we would definitely, ourselves, fall within the small business size of company. At the same time, though, we do provide financial proxy research and advice to institutional investors that manage over $8 trillion around the globe, many of those who do invest in small cap companies. We're strong proponents of SOX including SOX 404. We think for the capital markets to work efficiently, since we don't have a merit based system but a disclosure based system that disclosure and transparent financial information is key. And when that information doesn't get out there and isn't in a transparent fashion, then we have the type of events that we had a few years ago, as we've had five other times during the history of the capital markets as well.

And now with 90 million Americans in the market place, it's more important than ever. Keep in mind that the losses on just Enron, understanding it was a big company, but just the losses on Enron itself, were greater than the losses that everyone suffered on Black Tuesday back in 1929. So with the magnitude of money and the number of Americans affected by this it is a very critical and important issue. Perhaps that's why Congress, three times, has taken up the issue of internal controls, debated it, and three times called for action by corporate America on internal controls, the first time 28 years ago when they passed the Foreign Corrupt Practices Act as they found out about the illegal payments and bribes and the collapse of equity funding in Penn Central, followed on in 1991 when it cost the American tax payer half a trillion dollars on the S&L debacle. And then finally in 2002, again, it's interesting to note that Congress did not give an exemption in their original act in 2002 for small business.

One of the questions you asked or supplied to the panel was what was Congress thinking about as they drafted SOX, and was it trying to prevent errors or trying to get to fraud? It is interesting, I remember the first day I was in the Senate banking staff as they started to draft the first section of SOX, and we actually went in and pulled a copy of FDICIA off the bookshelf and started drafting using the language almost verbatim from FDICIA. And it wasn't a notion of you're trying to take care of fraud, or you're trying to fix these other problems; it was more a notion of there was a problem in financial reporting, there was something that systemically wasn't working right in the capital markets. And how do we go about turning around and correcting that and getting it fixed?

And the General Accounting Office had been a strong proponent over the years, led by then comptroller Chuck Bousher, that internal controls, good internal controls translated into good quality financial reporting. It wouldn't necessarily do away with fraud, but if you had those controls in place, it was much more likely that you were going to prevent it than you would if they weren't in place. And the last piece that we layered on as we drafted SOX 404, again, was the notion of an independent auditor, you'll see independence as probably the number one theme of SOX, more independence for the analyst, more independence for the board, more independence for the auditors, and an independent oversight board for the accounting profession as well. So the notion of the independent auditor was added on at that point in time, and that's how we got to SOX 404, to respond to your one question.

It was an attempt to fix what's wrong in the market. Keep in mind in September of '99, the SEC did their first enforcement sweep action involving financial fraud of 68 companies, most of which were small. We see that continued today as recently the SEC did an enforcement action delisting 20 small companies for failure to file timely financial reports having gone out over a year. Huron Consulting noted that over the last five years, 75 percent of the restatements have come from small companies. To date, even though the rule hasn't gone into effect, over 600, or about 600 small companies, those with under 100 million in market cap, have already reported material weakness, many of those who had been certifying and reporting to their investors up to the point in time of that disclosure, that internal controls were okay and appropriate.

And that's the type of thing that SOX 404 was intended, keeping into in mind we've got a disclosure based system, not merit based. It was get that disclosure out to the public as to whether or not you have internal controls, and then let the market work. But what we've had in the past was that disclosure wasn't out there and it hinders the ability of the market then to bring discipline to the market place. We strongly believe the benefits are worth the costs. If you look at the submission that we sent in -- we'd ask that be part of the record -- in just one case alone, in one case the company cited there was 187 million in investor losses from when things went south to when they had to announce their restatement and the problems with controls.

Total audit costs for the small companies, if you look at the charts, a little over 200 million. So one company alone almost made that up. So when you start looking at the magnitude of the companies in some of the charts that are back there, we think that the costs are to become a drop in the bucket compared to the cost to investors. And if the Committee moves forward, we would urge the Committee and request the Committee and the SEC to identify the costs and losses to investors that have come from these companies who have had the material weaknesses and restatements as long as you're out gathering data.

I would come back to some of the questions that were put to Rick here about cost. We've got no skin in the game because we aren't an auditing firm. We seem to be accused of that from time to time. But if you look at the internal control questionnaire that we gave you -- and we put one together, and our staff is a staff of former Big Four auditor firms. They've all been controllers, directors of financial reporting, and the key ones involved were in small companies here. So we put together the type of internal control that we believe you could use to test controls. And when you go through and look at that control questionnaire and you start looking at what it should take to do that on a small company, we're talking, say, a 20 to $40 million size company, any CFO should be able to get that thing filled out literally within a day if they know what's going on within the company.

And an auditor -- and I've done this testing myself in the past -- the auditor should be able to go through that and do that testing in the initial year, the team should be able to get in and out, for the most part if a company has reasonable controls, within a week. If they don't have reasonable controls, then it's all bets are off. And when you look at some of these costs, it's interesting, on some companies we've actually seen the audit fees drop even with SOX 404 cost added in. We've seen some that have exploded without a doubt. So it's very difficult to discuss cost unless you know the particular facts and circumstances of the company.

But when you look at that internal control questionnaire and you look at what it is and what it takes, you start to think about what it would take to wrap up and do that testing. And I actually think Rick is right. When you get it done and you got it done the first year, and people have got an understanding of that control and the companies have invested, many of them for the first time in controls and having the structures that Congress mandated 28 years ago, these costs over time will come down. Will they all come down a third in the first year? You know, your guess would be as good as mine. I would say based upon my experience when I was an auditor out there and an audit partner though, there's no question, you had significant first-year cost whenever you went into audit a company. And it was not unusual that your time would easily drop by a third then when you went onto the second and third years. It's just you get better and smarter at what you do.

So I actually don't doubt what you've heard from Rick here. I do think those costs over time will come down. But it depends upon what this fact pattern is with the company. If someone -- in one of the questions you've cited, five percent to revenues going to test internal controls and you ask about that, and that's a fair question, if that occurred. But the question isn't is that a reasonable cost or not; the question should be why did it take that company and their auditors five percent of revenues to get this job done when you go back and look at internal -- that internal control questionnaire? It just shouldn't have taken that. And there's either a problem in that the company hadn't invested and didn't have controls in place or the auditors didn't manage the process, or most likely a combination of the two, because we all know the truth tends to be in the middle.

So the question isn't is five percent of revenues a realistic number; the question is what was going on at that company that it took them five percent? And did they have a shoe box there that was a disaster? And certainly we have seen some of those examples as we've seen the number of material weaknesses in material statements that are reported. And half of the issues are related to competency of people and half -- and financial systems. And if a company doesn't have competent people and they don't have good systems, then it should be a surprise to no one that we have the type of costs that we have and where they're going. But I do think they'll come down. There's some data in our reply that addresses the disproportionality. And when you look at the auditor costs, they're no more disproportionate for a smaller company than they are for a large company in that regard.

We do think it's time to implement it now. By the time SOX, under current regulations, would have to be implemented for small companies, it's five years out. I've been a CFO, I've been an executive in a company. And if you can't get this done within a five-year time period, ladies and gentlemen, you're not competent to be a financial manager or management of a company regardless of the size. This shouldn't take more than five years to turn around and get done. And it's starting to feel -- there's a well-known analyst by the name of Jack Shujowski, who just last Friday published the question of will this ever be implemented, and is this an intentional effort to try to circumvent an act of Congress?

MR. WANDER: Lynn, we want to move on, so could you finish up so we have some time for questions, please?

MR. TURNER: Yeah, last couple points. The question -- you raised the issue of big GAAP, little GAAP, I would note that at Glass, Lewis, we have implemented the FASB rules for stock option, accounting, and FAS 150 on redeemable things, early implemented. We did not have any trouble with that, not an extraordinary cost to us. It's been easy enough to do and get on. So I'll just say that I think that FASB is doing what they need to do and have gone through good due process and due comment, and that's usually reflected in the final standards that they issue.

MR. WANDER: Let me start with one question because I was fascinated by this Appendix B to the submission that you made, the questionnaire. Has that been endorsed by anybody? COSO? AICPA? Any of the accounting firms? Has it been used, in fact?

MR. TURNER: Since we just put it out last Wednesday, I would doubt it.

MR. WANDER: So we're seeing it for the first time?

MR. TURNER: Right.

MR. WANDER: I guess -- and also do you have an answer sheet?

MR. TURNER: No.

MR. WANDER: An answer sheet. I mean, one of the interesting things I came to, if you can't answer yes, then you have a no. How many nos does it take to make a material weakness or a significant deficiency? And I guess that's where judgment comes in. All right. We have about a little less than ten minutes for questions for Lynn. Let me start with Kurt and then I'll move around.

MR. SCHACHT: Quick question. Is this on? Kurt Schacht from CFA Institute. Good morning, Lynn. A question was raised earlier about another study that was done on cost, I think the Foley and Lardner. Did you take a look at that? And do you have any thoughts on that study?

MR. TURNER: Yeah, I looked at the Foley and Lardner and certainly at the FEI survey as well. When you send out a survey to a CFO, and certainly I participated in a number of those surveys, none of that information is validated and you really don't know what you're getting one way or the other, and you don't know how much time people have spent on it, which is one of the advantages to going directly to the SEC's proxy disclosures, because presumably that's more valid and good numbering. It does show, if you look at the SEC proxy numbers which are in our submission, it does show that the audit fees have gone up, and gone up significantly. I would tell you that's not necessarily in light of what the investor losses were during the last three to four years, that's not necessarily to be unexpected or to be a bad thing.

When you think that during the '90s, companies tried to get the spending on their financial systems to under 1.2 percent of revenue, that's the benchmark that the FEI set out there, and the only way you could do that was not to invest in this area for, you know, some period of time. What we're really seeing now is a catch-up investment. And as we all know, when you have deferred maintenance, it becomes much more expensive in the end than if you maintain as you go along. A lot of the large costs that we're seeing now is this catch-up on investment that wasn't made over a period of ten to 12 years.

MR. WANDER: Drew? Go ahead.

MR. SCHACHT: One quick follow-up. You do a lot of work with investors on the proxy side. Are you hearing one way or another from them whether they care about Sarbanes-Oxley, whether they think it's -- there's a benefit to the protections or whether it's too expensive?

MR. TURNER: It's been an interesting process, because I have gone out and met with a fair number of them and we've talked about 404. And I'd have to say that early on, most investors probably didn't have a good understanding. In fact, some people were asking why should I even be concerned about 404? But as people have gone through the process and as investors have gotten more educated over time and started learning more and more about it and the relationship between problems with controls and problems with restatements and problems with what that could do at the market place, they've gotten smarter, they've done, I think, a pretty good job of assessing which ones are problematic and which ones aren't.

If you look at the study that's part of the submission, you will see the market has recognized the value of 404 and you will see that in general when there's a bad situation, especially when it involves a number of restatements in certain areas, that the market has driven the price down when that announcement was made. So the market is reacting. And I think it will react one way this year, Kurt, and I think it will react another way next year. In the first year, it's been pretty much running with a herd of buffalos, so there's been -- you know, we're getting up over a thousand people that have been reporting these problems with material weaknesses, which is amazing because beforehand almost none were ever reported.

So it's almost like a light switch has come on and now people are really seeing what was behind the scenes. And I think next year, if people still don't have control problems corrected and you get a material weakness next year, I think that the market's going to be much less forgiving than what it was this year. I think with just the mass of them, I think there was some forgiveness, not in all the cases, because some company's severely paid the price, so did investors. But next year I don't think you're going to see that forgiveness out of the market place.

MR. WANDER: Drew and then Alan. Anybody else?

MR. CONNOLLY: Mr. Chairman, I'd like to thank you for inviting this witness to the panel. It certainly shows your willingness to be even-handed. This witness -- Mr. Turner, you've led us to believe that in the drafting of SOX, you and the Senate staff were participating in helping to draft Sarbanes-Oxley; is that correct?

MR. TURNER: Yep.

MR. CONNOLLY: So we all know who to -- we all know who to blame in the room.

Mr. Turner, I just wanted to caution that in that testimony which was voluminous, both the written and the spoken, there were a lot of things that are sort of put together. As I understand it, you and your firm represent large institutional investors, and as you pointed out, you've got a trillion dollars or so at your disposal, or your clients at their disposal. And that goes along with something the chairman said that was in a recent copy of SEC Today where the title is, "Commentators differ on regulatory approach for small public companies." And I quote that the Counsel of Institutional Investors in the Ohio Public Employees' Retirement System as being very much fully supportive of Sarbanes-Oxley as-is, don't meddle with it, it's perfect.

And the thing when reading this and the thing when listening to you that struck me is in terms of microcap companies, the Ohio Public Employees Retirement System is barred from investing in any Bulletin Board stock. And I'm kind of curious as to how many Pink Sheet and Bulletin Board Companies your clients take positions in and, therefore, have an opinion on how they should comply with this law.

MR. TURNER: We actually do provide financial research to a number of funds -- institutional funds, not the public pension funds, but other institutional funds who do invest in small caps. And they have found -- I think they're starting to find that over time, at least in our conversations with them, the benefit to this. Their biggest question is when one of these do emerge, i.e., a material weakness problem emerges and it's not unusual that it's been a company with late filings, it's amazing to see the correlation between a prominent material weakness a restatements statement and a late filing.

And then at that point in time, then those institutions that are into small cap do start asking a lot of questions about what's the ramifications for this, how is this going to work out, and what side of the stock should we be on in this particular one, and then are we going to take a hit? So we do work with a number of small cap investors and they do get concerned when these issues do pop up.

MR. CONNOLLY: Appreciate it.

MR. WANDER: Alan and then Janet.

MR. BELLER: Lynn, I just, for purposes of the Forum, again, want to ask you what Marc asked of Rick earlier. The debate around the table so far, I think, has focused on the Advisory Committee's thinking about Rule 404 and your position, which I'm not sure I congratulate Herb for having brought you to the panel of the Forum. I would have expected her to bring balance views to the Forum and the panel, and I think you provide them, and I think that's wonderful. But is there anything in terms of specific recommendations that the Forum should be thinking about based on your testimony or what you bring to us today?

MR. TURNER: Alan, I would turn around and tell you when the Commission votes on extending this thing or not, it should not be extended. That would be one. The second thing is --

MR. BELLER: Can I just stop you there? Because just for the record, given what you said, I have spoken to the five Commissioners, I am not going to predict what they do on Wednesday, but I will tell you that whatever they do on Wednesday, it is not a prejudgment of some different treatment of anybody under Section 404. I think that if they do vote to defer, it will be because they have concluded that another year to get the formulation right for non-accelerated filers is the appropriate way to go. It's not a signal as to what they expect to do ultimately with respect to accelerated filers.

MR. TURNER: No doubt I would be giving the same question if I was sitting where you're sitting still. At any rate, the other thing is, COSO is working on trying to update their guidance for the internal control stuff. I do think there is a difference, and a very significant difference between the complexity and the type of transactions and the controls you have among different size companies. And there is no question that they're different, as you'll see in the control questionnaire that we put out, between a large company and a small company. We even identify where some of those differences would be.

I would hope and I would -- and my understanding is that the Office of the Chief Accountant is already doing this, but I would certainly help them to do what they could do to get COSO to understand that and reflect it in whatever guidance they finalize and put out. It is not a one size fits all by any means of the imagination, but it shouldn't be that hard. You should be able to go through that questionnaire, complete it in a day as the CFO, and document it and have your systems document it. I think we're just making it much too complex and much too hard, and quite frankly, while I love the accountants, I think this is a case of the green eye shades both on the side of the companies and on the side of the auditors together, working together to, quite frankly, make this a lot more difficult than what it should be. So I think that simplification in a small business needs to be reflected very clearly in whatever is there for the small company.

The second piece of it would go back to the PCAOB, and I think their rules already give you the latitude to do this. But if not, then I would think about it. When you get into a small company, because you may only have three or four accountants there and you don't have a lot of people duplicating, a lot of things that are going on, you have got, perhaps, fewer levels to review, fewer levels to roll up with the information, I -- you've got to recognize that. And I guess in my mind the question becomes, then, what is the level of management testing that needs to be done? Because I think that's one place where we're running up some costs here on the company's side, not necessarily on the auditor's side.

But if management of a company is comfortable because their monitoring controls and their supervision that the controls are working, just how much testing do they need to do and duplicate, then, before the auditors come in? Now, if they don't do much and the auditors come in and find problems, then, you know, they did so at their own risk and it is what it is. But on the other hand, if a company is -- I've seen some very well run, very well controlled small companies, and just given the type of things that they do and systems they have in place, I don't know that I would require them to do as much testing as, perhaps, they might otherwise be asked to do here. And so I think about maybe some Q and A guidance in that area, but that would be -- I do think the PCAOB would give you the flexibility to do that in the current rules, so I wouldn't modify the rules.

MR. BELLER: You think current AS2 provides enough to do that as an interpretive matter.

MR. TURNER: When I go back and look at the Q and A that the PCAOB did this spring time, I think yeah, it -- if I read what's in the Q and A, the Q and A tends to probably give me that latitude. And so -- and I think that would help out small companies immensely in this area. So that would be there. On the auditor independence rules that Rick brought up, there is a difference between being a private company and being a public company. When I went through that process, we probably spent about a year and a half -- back to your question, Alan -- getting ready for it, and I thought that was a pretty reasonable time frame. And it seemed to work okay at that point in time, and that's back in the '97 time frame before the market went crazy.

MR. WANDER: I'm going to ask Janet for one last question and then move on to Don.

MS. DOLAN: Well, I had two, but --

MR. WANDER: Quick ones. Quick answers.

MR. CONNOLLY: Terse, terse.

MS. DOLAN: Terse. Okay. I think I'll -- my first one was I was going to ask you, and I think you perhaps partially answered it, I'm just going to give you the opportunity. None of us on the Commission are here to be in an either/or world; either we have 404 just as it is or not at all. I think we have many financial crises where we can just regulate our way out of it, and then we realize we can't. We can improve the environment, but we can't prevent future problems. So then our question is how do we calibrate? All we're trying to do is calibrate the application of 404 to small companies. And I would say that I think many of the -- much of the testimony that we've gotten from small companies that spent three, four, and five percent of revenue is not because they didn't have controls, but they were doing exactly what I think you just said, they were testing. And because of the more than remote standard, because of the "could" standard, they were testing a lot of things that they just didn't think added any value.

So one, I want to say that you're one of the architects, and as you look back at what was developed, there's been a lot of testimony that the impact on small companies was really significant. Is there anything else you would have done differently or that you would suggest we do different as we calibrate the 404 for small companies? You know, you are an expert, you're in the best position to help us do what we need to do, which is let's calibrate it so it really is of value. Are there any other things you would recommend we do?

MR. TURNER: No, not really. I'd take -- go back and look at that internal control questionnaire. We spent some time to try to come up with what we thought would be a reasonable approach, and I think it's reflected in that. And I think that would then get reflected in just how long. And there's no way when you do that and use that type of questionnaire in the process, which is, again I think, clearly within the confines of the PCAOB rules, that it's going to take you much more than a week to get in and get it out of here on any particular party's part.

Alan, I would just note one thing, Chairman Cox did say today that 14 months was extraordinarily a long period of time of implementation in the hedge fund rules, and given five years, I'd be interested in what his views on what is beyond --

MR. WANDER: Janet, do you have a second question?

MS. DOLAN: I do have a second question. Yes. I'm the head of an American manufacturing company, and so when I talk about outsourcing, I know the impact it has on the industry. And one of my -- one of the concerns we have is ensuring that our capital markets remain globally competitive. And you're advising customers that are investing abroad, and any one of us that's watched the capital dollars going abroad, they don't have 404 or anything like it in any of these markets. Are you seeing that 404 is a competitive advantage for American companies, or are you seeing that it can, in fact, if we don't calibrate the costs to American companies for our idea of reasonable regulation, that over time this could become a deterrent to investment in U.S. companies?

MR. TURNER: You know, I've had discussions with CFOs of, like, Deutsche Bank and Siemen's and Phillip's, especially as it relates to the FASB rules and financial reporting over there versus the set cost disadvantage versus them or whatever. And in all three of those cases, the CFOs noted that having good transparent financial reporting and having good controls also allowed them to just manage the company a lot better, a lot better than what they had before that. And so I think in the long run the way this will work out is good controls will go with good business and good management. And I don't think it creates a disadvantage regardless of where you're at here versus there.

And when you look at the statistics that we gave you, you will see that the change in the number of foreign companies listing on the U.S. stock exchanges is no different than the number of U.S. companies listing. And in fact, during the time period, the New York Stock Exchange foreign listings went up when their U.S. listings went down. And if you look at the M & A activity, the M & A activity here and over in Europe really hasn't varied that much. What does impact that is other factors like the economy, and what's going on with the economy. And things within a particular industry and a particular country have much greater influence than whether or not SOX 404 is going to make you competitive or not.

But I do think -- and this goes back to my days of running a business, an international business, good controls go with good business. You've got to have good controls, you've got to have systems so that you can get the data, so that you can manage on a proactive, timely basis. If you don't have that, you're just not going to be in the top 25 percent performers, which is where you attract the institutional investors. And keep in mind when you look at the stats, the vast majority of these smaller companies unfortunately don't get followings by analysts. And as you continue to create them as a second class citizen, you're going to make it very clear that you're going to have fewer and fewer people that are going to invest in them. And they're going to have very illiquid markets, just as they do today. Rather than fixing the problem, I think you exacerbate the problem.

MR. WANDER: Okay. I'm going to move on to Don, actually. Talking about international is a good segue into what I hope Don's going to talk about, which is really the AIM market.

MR. REINKE: And I wanted to thank Ms. Dolan. I don't know if it was a staged question, but thank you.

Fortunately or unfortunately, I think I actually managed to weave a reference to 404 into my remarks, but it is definitely not the focus of my presentation. And I think we will catch up on some time because my remarks are extremely brief. So I hope there are at least a few questions, and I don't want to indicate that the brevity of my remarks are any reflection of the interest that I have in this topic.

I was asked actually by Gerald Niesar maybe a month ago to briefly discuss my experience with a recent AIM listing for a very small company client of mine, and it was actually my first experience too, so I don't profess to be an expert in this area. But I have -- it was a client named Enova Systems. It's a California corporation based out of Los Angeles, and it's an Over-the-Counter Bulletin Board company who consummated a $20 million offering in the United Kingdom, netting about 18 million after investment banking fees, legal and accounting fees this past July, on the AIM market which is short for the Alternative Investment Market, it's an adjunct offshoot of the London Stock Exchange.

And by way of background, Nova has been what is sort of a publicly-traded company, I guess you'd say for, perhaps, 20 years, and at one point Pink Sheet, and for the past ten years a reporting issuer under the Exchange Act. And how times have changed because we actually voluntarily registered under Form 10 to become a reporting issuer for help with respect to capital raising and markets and the like. But this is obviously a different time and a different period.

And just by way of background, while the business model for this company has morphed over the years, it was originally a solar electric related projects, its current business focuses primarily in developing and marketing electric hybrid drive train systems for commercial vehicles. While I've been navigating the public securities markets in the United States for probably 15 plus years, I note the AIM listing in the UK, as I mentioned, this summer was my first encounter with the London public market, and actually my first encounter with -- other than pursuant to Reg S in a private offering overseas -- was my first experience in actually having a company effectively do a public offering and become publicly listed in a foreign country.

So I'm most definitely not an expert in AIM listing, but was asked to provide my perspective on the experience in raising money for this process. By way of background, last year of the 326 company listings in London, 279 were on AIM. And of the, I think there were approximately a little over a thousand companies now listed on AIM, and about ten percent of those are actually overseas companies, whether in the United States or other foreign companies outside of the United Kingdom. Rather than -- and here's how the process works, and I was learning as we were going on as well, so it was an education process for me.

Rather than a government agency such as the SEC sort of overseeing the process and whose approval is required to go public, AIM relied upon what's known as a Nomad, and that's short for nominated adviser. And in our case, this was actually a UK investment banker named Invest Tech who was sort of tasked along with the accountants and the lawyers with putting together the prospectus and making sure that the Enova Systems was going to comply with all of the disclosure and procedural and ongoing reporting requirements that are required under an AIM listing. And the process, quite frankly, was extremely rigorous and detailed. I don't want to short-shrift that at all. In fact, my client obviously had both U.S. and UK accountants and lawyers and solicitors.

The prospectus, however, rather than being vetted as I mentioned by a government agency such as the SEC, was ultimately approved by this Nomad, Invest Tech, along with the AIM regulators who, along with the lawyers and the accountants were responsible for ensuring the accuracy and the completeness of the disclosures in the prospectus and it to comply with the AIM listing requirements. The process took approximately three and a half months, so I don't even want to claim that the process was necessarily that much shorter than going public taking an IPO on either NASDAQ, or the New York Stock Exchange or even AMEX. What was interesting that even during this process, just as an adjunct or an aside, we had scheduled our road show about three, four, almost at the beginning of the process and pretty much kept to the timetable, and I'll explain why.

We had very few setbacks at all. The only one that gave me, almost gave me a stroke because it was a small public company and it didn't have the resources to cover the lawyers' and the accountants' fees without the successful raising was that we were literally scheduled to go on the road show in London the very day that the London bombings occurred. Surprisingly, it really set us back about less than a week, but I had a few heart palpitations on my side of the ocean at that time. But what I did find of a difference between the IPOs that I've done in the U.S. and the public registrations was the fact that all of the parties were able to convene and sort of review the prospectus on their own time, because we weren't dealing with an independent third party who we had to, you know, submit a registration statement, wait for the 30 days, get comments, etc.

In that sense, it was a less formal process in that the accountants, the lawyers, and the Nomad, the investment banker would be able to schedule their own time in order to review the prospectus, which was in itself fairly comprehensive. But there was, as I said, fewer formalities at this level, although the level of due diligence from my advantage point, both from the legal and the accounting perspective, were extremely detailed and comprehensive. Surprisingly, though, virtually all of the drafting sessions, when you're a lawyer doing an IPO, you'll sit all day in an all-day drafting session, sometimes several days, and go over the prospectus and continue to redraft the registration statement in preparation for the filing or any of the amendments.

And in our case, we literally did this all by conference call, which I was a little leery of at the beginning, not having met my counterpart, my solicitor in London and not having personally met the investment bankers. Although the company had and the company spent quite a bit of time over in the UK. But it definitely wasn't easy from the legal perspective. As company counsel, we, unlike the process here in the United States where you're all one drafting the prospectus, we were also tasked with actually drafting and doing a legal due diligence report that was as comprehensive as anything I've ever put together for any sort of offering. In fact, when we finished the report, it ended up being close to 150 pages.

And it was a little unusual and unique for U.S. counsel because we were -- they kept telling us it wasn't a legal opinion, and I probably spent the first ten pages of the 150 disclaiming that it was a legal opinion because we were identifying every single agreement that was actually referenced in the prospectus. And the bankers and the UK counsel were relying on our due diligence report for a significant portion of the prospectus. So from our vantage point, we put a lot of time and effort into it, and I can't tell you that it was necessarily any less work that an IPO registration process other than the formalities, which I think reduced our ultimate time because -- somebody asked me, "Well, overall, you only raised 20 million, but it really doesn't make any difference whether you're raising 20, 40, or 60 million in an IPO process, you've got to do the same work."

I still think that -- although this is one example and one example doesn't make a trend, but I'd hazard a guess that our legal and accounting fees, even where we had to duplicate both UK and U.S. auditors and counsel, were somewhere between -- and since I didn't add up all of the fees on the other side, but somewhere between 25 to 40 percent less than an IPO, and probably closer to 40 percent, than it would have been for the very same process if we tried to raise 20 million going through a formal regular IPO registration process. And so what I've been able to discern also is that the ongoing reporting requirements, although I haven't been involved in that because we have UK counsel, they do not appear to be as rigorous. Although all of the information that I have seen is that AIM's been out there now -- in fact, this is, somewhere in 2005 was its tenth anniversary.

They seem to have very few failures on the company side even though they tend to be much more smaller companies. In fact, a lot of them are mineral and mining companies, which I guess the basic counterpart you have on North America perhaps is the Toronto or Vancouver Stock Exchange in terms of the types of companies. And yet my understanding is they've had very few failures and very few financial scandals on the AIM market which has been somewhat surprising even for UK regulators. But I also believe AIM is reflective of a broader trend toward the globalization of financial markets, and I think you will see more U.S. companies, particularly private companies -- we were actually already a public company, and as another aside, it was easier, and perhaps some of my other colleagues will speak to this, if we had the option without spending a significant sum of money to go private here in the U.S. our preference would be to remain a public company on the AIM Exchange and not remain a reporting issuer right now just because of our size. Practicalities and the like are such, and I've looked into the ability and the ease with which public companies are trying to go private. And that's not an option for us. But I think if we had that as an option, the direction of that we'd give serious consideration to. And if for anything else, I think opt to go out, as I said, to go public and outside the U.S., and here is where my only reference, and I'll include it only because it was the last sentence I had, I think 404 is one example of others that we -- we found that even though -- because we've had -- we've been able as a small company so far, we haven't had to implement the 404 process and procedure. It did not seem to be an impediment in any form or fashion for the auditors or for the investment bankers or the investment community in the UK that we were not yet 404 compliant. And again, it would be another, I think, advantage if we had that opportunity to only remain public in the UK. And with that, I'll conclude my remarks.

MR. WANDER: Any questions? Thank you very much, Don.

MR. BOCHNER: I don't know if it's a sign, but I didn't get a microphone and they put me next to Alan. But I'll -- Don, I'm on the Governance and Disclosure Subcommittee of the Advisory Committee. This is Steve Bochner. And I'm interested if you had any thoughts in looking at what your company on the AIM market does from a reporting point of view and your knowledge of the '34 Act here. Are there any recommendations you would have in terms of streamlining that disclosure, SEC disclosure via hardship. I want to put 404 aside for a moment. Are they fine as is? Is 404 the issue? Or are there aspects of reporting that you think are particularly tough on smaller public companies?

MR. REINKE: I think at least on the registration process as an example, and in fact, it's in Ann Walker's letter that was drafted by her and some of her colleagues. And it's been anecdotal to me and I was actually pleasantly surprised to see that others had had the same experience where obviously we have the small business issuer regulatory format here, which I guess is the closest you could compare, perhaps, with the AIM listing requirements versus the London Stock Exchange. And yet, I'd be happy if over here the small business issuer process and procedures and regulatory formats were as easy to navigate.

I actually recommend to most of my clients, "Don't go the SB-2 the SB-1 registration route; stick with the S-1." In my experience in the past year to 18 months with several S-B registrations we had, they actually took longer to accomplish than the regular S-1s. We found that our amendments, like the ones referenced in the letter, were reviewed every time front to back, and brand-new issues kept popping up. And so I've actually avoided that alternative even though the intent, I know, was to make it easier on small business issuers.

MR. CONNOLLY: Very quickly.

MR. WANDER: Yes, very quickly because we have three more witnesses to see.

MR. CONNOLLY: No problem. Sir, after our New York hearing at Columbia Law School, I went down to a firm on Wall Street and literally had a meeting with the director of listings for the AIM market. The first thing the gentleman said was that, "Sarbanes-Oxley is the best thing that ever happened to us." And again, it's my understanding that approximately 95 percent of the volume on the AIM market is, in fact, institutional money as opposed to the retail investor. I'm concerned about how the retail investor who presumably has less ability to fend for himself or be aware for himself and is the mandate by the Commission to essentially protect.

Are you finding that by virtue of advising your client to be on the AIM and simultaneously looking at the SOX compliance or the other securities regulation compliance here in the U.S., that they are having less of an opportunity for transparency or investor protection on the AIM?

MR. REINKE: Unfortunately I'm not sure if I've got any substance to respond to that only because we've only been listed since the end of July. And so we haven't had much of experience to get feedback.

MR. WANDER: Okay. I'm going to move on. Ken, please.

MR. HAHN: Just to start with a brief question. I think I know this but want to confirm that I'm the only chief financial officer on either of these panels today.

MR. WANDER: We've had some in the past.

MR. HAHN: I'm wondering if that should concern me.

MR. WANDER: Not at all.

MR. HAHN: In any event, two points on my background that might provide some additional context. My previous company to this, which is about three years back now, in the last year of existence was a microcap company. My current company is roughly $300 million that would fit, and based on a valuation, would fit into the definition of small cap. Of that $300 million, roughly 60 percent is international, which has quite an impact, of course, on internal control systems and the complexities. So just for additional context.

MR. WANDER: And what's your market cap?

MR. HAHN: Today just under 600 million.

MR. WANDER: Okay.

MR. HAHN: So we've been above and below over the last two years, the cut-off, which is another complication.

So firstly, thank you very much for the opportunity to speak on this matter. I care very deeply about the subject and do appreciate the opportunity to provide some input. Secondly, the views I'll express are mine, they're not necessarily the views of my company, though I'm sure many people would echo those views. So the basis of my remarks is intended to address the impacts of Sarbanes-Oxley on small and mid-cap companies specifically, and by definition the impact on U.S. innovation, which is typically driven by companies of this size and ultimately impact on long-term health of the U.S. economy because I believe that that is driven by innovation.

So the goals of Sarbanes-Oxley are well intended, and I agree with them completely. I also agree with the vast majority of the specific provisions of the law. CEOs and CFOs should be responsible for their financial statements and systems and should put this in writing to the investing public. The whistle blowing provisions of the Act are beneficial to both the investing public and to honest executives. The portions of 404 surrounding both tone at the top and reporting of wrongdoing within a company are, I believe, the most valuable portions of the Act. These will cost effectively decrease malfeasance that damages shareholders, the recent massive magnitude of which resulted in the origination of Sarbanes-Oxley in the first place.

Where 404 goes too far, in my view, is the testing of other internal controls. Above all else, this damages shareholders because it is not economically justified, and that's what we should care about. Systems testing comprises the vast majority of the expense of compliance. If one examines on a historical basis, the number of systems issues that cause financial restatements and losses to shareholders, one would find few such instances that caused massive losses. The primary damage has been created by fraudulent executives. Are control systems better now with the first year of 404 for small and mid-cap companies, not microcap, yes of course? Yes, they are. Of course, they are. Should shareholders care? No, they should not, or at least only to the degree the compliance cost destroys shareholder value.

The dynamics of risk make it virtually impossible for the control portion of 404 to be cost effective for small and mid-sized companies. Well-intended people make intelligent decisions that result in over-engineered testing and systems. This includes the public accounting firms, departments of which have to be incredibly conservative in determining the scope of testing. They have too much to lose financially, including the destruction of their careers. Boards of directors are subject to similar dynamics. In 20/20 hindsight in the event of a restatement, what board member would want to be characterized as a proponent of lower compliance spent? No one, of course. Intelligent -- I'm sorry. In light of these risks, intelligent people will always make the decision to over-engineer.

The burden of 404 costs on our economy is massive. Some of the cost is justified for shareholders. We need to fix the portions that are not for shareholder value, for efficient allocation of capital, innovation, and ultimately the health of the U.S. economy.

MR. WANDER: Thank you. Dick?

MR. JAFFEE: Dick Jaffee. I thank you very much because you articulated in a much more elegant fashion what I had hoped to say to Mr. Turner if I had time to do it, because the idea that a company spends five percent of revenues or whatever percent, and that's analogous to deferred maintenance, in my experience, a company somewhat smaller than yours, is just not cost-benefit relevant and it is not in real world. The legislation may have been well intended. And even the reading of the legislation and even reading of the PCAOB guidance may indicate a return to a more balanced view, but the reality in the market place, the idea that the CFO can fill out a form in a day or a week on a company like ours, we had to hire 14 contract employees and two full-time people and spent $800,000 against control testing, which we don't feel has any benefit nor will it avoid any of the type of fraud that the law was written to avoid. So I compliment you and thank you.

MR. WANDER: Question? Yes, Leroy.

MR. DENNIS: Thank you. Again, this is Leroy Dennis. Along Alan's comments to everyone else on the panels, do you have some recommendations, especially in light of what parts of the Act -- you mentioned a lot of the parts of the Act were very beneficial and some parts that were not as beneficial. Would you have recommendations for this Committee on changes that you would see would help balance those things more in line with what you were talking about?

MR. HAHN: Well, I do, and importantly I do think some portions of the Act are extremely cost justified from the shareholder value standpoint for the investing public. It protects the public and it's cost justified. And those are primarily around the areas of tone at the top which gets tested in the normal course of 404 testing as well as the whistle-blowing policies and informing employees of these various rules. So to me that's the most important thing.

The major blow-ups we've had related to fraud were because people didn't know what to do within the company. Large numbers of people were aware of this fraud; they didn't know what to do. So Sarbanes-Oxley provides a tremendous benefit around that, I believe, where you're trying to stop wrongdoing which created these massive shareholder losses. And I'm not sure the intent, and it's perhaps not relevant, the intent of 404 was to provide better financial systems, per se. It is certainly having that effect. The problem is -- except at a larger company. In a much larger company it's -- my current company is on the borderline where it starts to be from a business perspective cost justified to have these more rigorous controls. So we were starting along the process anyway.

Except in much larger companies, you need to have a control from a business standpoint that you, the executives, and the management can keep control of the business and make sure you're doing the right thing. The problem is there's a cut-off, and this certainly falls below that of what you call SMID, a smaller mid-cap company, and certainly a microcap company, where from a business perspective, you would not have controls of that nature. It's a somewhat similar argument, and actually, it's a funny way to what Lynn was saying, is that as a CFO of a smaller company, and as a CEO in most cases, you can have a checklist of controls. You know your controls, you know your business, and so you can rest at night knowing that the numbers you put out are going to be correct.

The difficulty with 404 for these companies is then to prove it within a framework and have auditors attest to management's process, it's bringing it up to a standard of doubt and, again, testing and proof that just doesn't make sense. And I believe that the dynamics around that are going to be very difficult, if not, impossible to fix. Because, again, as a board member, as an auditor, again well-intended, you have to be out of your mind not to have a high degree of certainty that there are no problems with the systems that you're testing. Again, if you step back and you think about the number of systems issues, pure financial systems issues that did damage to shareholders, they are few and far between. Where we have seen major damage to shareholders through these breakdowns has been fraud, intentional fraud. And that has very little to do with the financial systems themselves.

The problem is, at least for our company, that's probably 80 percent of the cost of the compliance, is the pure financial systems, not the systems surrounding tone at the top and not the systems surrounding whistleblowing activities that would expose fraud, which again, is the cause of the vast majority of the damage that created Sarbanes-Oxley to begin with.

MR. WANDER: Okay. Any other questions? Yes, Janet.

MS. DOLAN: We've had some debate among various presenters to our Committee on whether we could reach the goal of reducing the systems and the other non-value adding testing and certification without a change to AS2 or without some structural change, because as you said, auditors and others are going to be fearful of doing anything less that what they think is required of them for larger companies. Do you think anything can be done short of actually changing some of the standards, or do you think we would have to actually change something with AS2 for companies?

MR. HAHN: You know, I believe the standards need to change, in that I don't think you can fix the dynamics. You can't tell the auditors, "We're going to hold you to a lower standard." There's just too much judgment required in order to do that, which is not to say that the auditors don't have judgment. Like anything, some do and some don't. But even for the ones who do, you want to look at this in a cold and a clinical fashion that with 20/20 hindsight, if you do miss something, your judgment will be called into question. And I know, and this doesn't have anything to do specifically with the audit partners in our account, but I've spoken -- the audit partners are frightened, and they should be. I would be if I were one, and to a large degree, I feel sorry for them.

At the same time as I feel sorry for them, I think they're inflicting a lot of damage making well-intended intelligent decisions. So I don't -- maybe I'm just not smart enough to figure out a way to stop that dynamic without changing the rules. And, you know, I'd suggest that perhaps the answer is to place greater responsibility on management who can make those judgments. It's the act of the testing that creates a lot of the problems.

MR. WANDER: I'm going to move on because we have -- I'm going to keep you all an extra five minutes to give Ann and Gerry ample time, so we're going to go to 10:20. If you want lunch tickets, you should run out at 10:20 and buy a lunch ticket, because they're going to close at 10:30. Gerry handed me a note. So I'm going to let -- who would like to go first? Gerry or Ann? Well let's take Ann.

MS. WALKER: Okay. Thank you very much. I would like to say thank you for holding this meeting here in California which gives representatives of companies from Silicon Valley and their advisers the chance to speak directly to the adviser Committee on smaller public companies. My name is Ann Yvonne Walker, and I'm a partner at Wilson Sonsini Goodrich & Rosati in Palo Alto. But in addition to that, I'm a very active member of the American Bar Association's Business Law Section, Federal Regulation of Securities Committee, and many of the subcommittees. And I'm currently serving as vice chair of the Subcommittee on Small Business Issuers. So to some extent my appearance here is based on that involvement. However, as a matter of formality, I'm actually testifying only on behalf of myself and the four other attorneys who signed our written letter.

I can tell you that all of us -- all five of us have represented and continue to represent smaller public companies on a regular basis, so hopefully you will agree that we do know whereof we speak. We are in the process of seeking formal approval from the ABA so that we can submit to you a formal comment letter from the ABA, and we hope that that will be forthcoming in the next week or two. And not surprisingly, it will probably cover many of the issues that were covered in our individual written testimony. The approach I'd like to take today, since we don't have that much time, is obviously not to go through the written testimony, which I'm sure all of you have read, but I wanted to just focus on a couple of the ideas that we raised in our written testimony and highlight them for the Committee's consideration.

But first I'd like to say a word about what I call the threshold issue, and that's the whole concept of small business issuer. Who are small business issuers, and what does it mean if they are? As you know the SEC, for many years now, has had a definition of small business issuer. It was companies -- still is, companies that have revenues and public float of less than $25 million. And the SEC has been very good at attempting to ease some of the regulatory burdens on these small business issuers. But as this Committee well knows, that is a far too narrow definition of smaller public companies in today's world.

So the first point as a threshold matter I'd like to make is it's important that that definition not be so narrow, that it be expanded significantly to recognize today's world and the fact that the current definition of small business issuer is far too small an issuer. In this regard I applaud the Committee's recommendation to the SEC that the SEC create a category of smaller public companies. And as Mr. Beller mentioned earlier, I think that's something that the SEC is considering on Wednesday in a fashion.

The second part of the threshold issue is that even if you are a small business issuer, it seems to me that the regulations that apply to small business issuers and the way they're applied by the SEC staff really needs to be further relaxed. Again, I applaud the Committee's recommendation for postponing the phase-in of Sarbanes-Oxley 404 for an additional year for these -- for the non-accelerated filers, and also the Committee's recommendation that the acceleration of '34 Act reports, periodic reports be frozen for the smaller public companies at the current level of 75 days for annual reports and 40 days for quarterly reports. So I think these are important steps in what the Committee's doing, and I just wanted to let you know that we are very much in support of that. And we hope the SEC will take favorable action on Wednesday in this regard.

Now let me touch briefly on a couple of the areas that are touched upon in our written testimony. First, in the area of capital formation, we make a general suggestion that it would be very helpful if the SEC staff could do, sort of, a thorough review of its administrative and interpretive positions as they relate to smaller public companies, because both in their -- to some extent in the rules themselves, but also in the way they're applied, sometimes it appears to make it disproportionately difficult for the smaller public companies. But in terms of specific suggestions, one thing I'd like to point out is that I think we need to make sure that we're not forcing companies to go public before they're ready to go public.

So one of the things that we address in our letter is what I see as a major problem which is the current operation of Section 12(g) of the Securities Exchange Act. And the way it is interpreted by the staff and has been interpreted into action letters is such that options are considered a separate class of securities; and, therefore, if you have more than 500 optionees as a private company, then -- and you also meet the assets test, you are required to become a reporting company. I don't think it needs to be that way, I don't think it should be that way. In my view, there's a distinction that needs to be made between options that are granted to employees in a compensatory context. Those are very different from capital raising transactions. And I think that once this has been recognized, you can see that it would follow that perhaps the fact that you simply have 500 optionees is not a reason that you ought to have to go public.

Now, the SEC, in trying to assist companies with this problem, has taken some steps in a series of no-action letters, but one of the elements which they have made as a key element in each of these no-action letters to date, to my knowledge, is that the companies provide financial information. Now, as some who has represented both private and public companies, I can tell you that if you force a private company to provide financial information even if it's only going to the employees -- well, of course, its employees and ex-employees because remember typically the options do have a life beyond when the person leaves the company, at least for three months or so. If you have to provide that financial information to your employees and your ex-employees, in today's modern society no matter how often you tell them it's confidential, it will become public. And that is a very difficult problem for private companies. It makes -- it causes -- can cause serious competitive harm.

So what we would recommend that the Advisory Committee consider in this regard is eliminating that information requirement and recognizing that options granted to employees should be treated differently than capital raising types of transactions. And if that -- and we would, you know, certainly think that you would want to make sure these are non-transferrable options and that they are issued in a compensatory context. But once you have those factors, that ought to be enough to not force the company to go public simply because they have 500 optionees.

In the alternative, you could look at it from the context of if you permit only net exercises of these options where you simply, rather than paying cash to exercise your option, you essentially exchange the option for a number of shares that is worth the spread on the option. So the individual employee is not out any cash out of pocket, all they have is an option that was granted to them and they're now exchanging it for shares. That would be another way of looking at it. If you only permit that type of exercise, then that might be another reason for arguing that 500 optionees in and of itself should not force a company to go public.

I'm going to skip now to another area of reform, and that's Sarbanes-Oxley. As you well know, Sarbanes-Oxley the statute does not make any special allowances for smaller public companies. And that's one of the reasons I believe that this Advisory Committee has been formed, is in recognition of that. This really needs to change. The SEC has historically, as I mentioned, tried to be helpful and sensitive to small company issues, and I believe that the SEC needs to take the step here to use its exemptive authority to provide some relief from various provisions of Sarbanes-Oxley for the smaller public companies. There are two specific areas that I think need attention. I'm only going to address one. One is mentioned in our letter which is the director of the independence requirements and how those might be eased in some fashion.

But I think more importantly -- and I apologize, I'm going to mention the evil word "404." I would like to focus on Sarbanes-Oxley 404 for just a moment. I know you've already heard lots of testimony on it. We have a specific recommendation which you may or may not have already heard or considered seriously. And that recommendation is this: Eliminate the auditor attestation requirement. I believe that that is the primary source of the extra expense that is imposed on smaller public companies by 404 because, as some of my colleagues mentioned earlier, the auditors, you can't blame them.

They -- it's very hard to say, "Well, we'll sort of do not quite as rigorous a job on this smaller company just because they're smaller, when we're doing a more rigorous job on the larger public company." As a lawyer, I would have a hard time getting comfortable with that. So take the accountants out of the equation. Let's rely on management, rely on certifications, the chief financial officer and the chief executive officer on every public periodic report. The cost simply outweighs the benefits of having the accountants involved in the 404 attestation.

I'll mention one more thing before I close, I'll try to keep this on schedule as much as possible, and that is the concept of what happens when you have a public company that needs to exit the reporting system. It is my experience that there are a number of companies out there that went public prior to the adoption of Sarbanes-Oxley. And at the time that they went public, it made sense from a cost benefit analysis. It no longer makes sense. In fact, some of these companies are in dire straits trying to keep up with the added regulation and the burdens that that imposes. The problem they face specifically is they can't really afford to stay a public company, but they also can't afford the price tag of going private.

And the suggestion that our group has is why doesn't the SEC consider something along the lines of a one-year amnesty program. I'll call it that for a lack of a better term. And during that one year, these companies that were trapped that went public before Sarbanes-Oxley and are now just hopelessly ensnared by all these additional regulations, relax the rule 13e-3 going private rules. Provide a kinder, gentler, simpler process that these companies can go through during that year to become once again a private company and actually give them a second chance. So I will close with that. Thank you again for the opportunity of presenting to this Committee and this Forum, and I would be pleased to take any questions.

MR. WANDER: I'm going to go to Gerry, and then we'll have questions for both of you, time permitting.

MR. LAPORTE: Herb, I just wanted to let you know that they've decided to keep the cashier open until 10:45.

MR. WANDER: It's like a ball score. So it's only the seventh inning, it's not the eighth inning. Okay. Thanks, Gerry.

MR. NIESAR: I'm Gerry Niesar from San Francisco also and with the firm Niesar Curls & Bartling. I'm going to ask everybody to shift thinking completely. I'm not going to mention a famous -- a recent famous legislative initiative that led to a palindrome section number that's been mentioned many times today. What I'm going to talk about is what a lot of people call finders but who are really unregistered broker-dealers. I submitted a letter on behalf of myself and Greg Yadley and Faith Colish who are also attorneys, and I will go through the process here. So I'm speaking on behalf of the three of us. Faith and Greg are present, the Co-Chairs of the task force of the American Bar Association, the business section, that is dealing with this issue and authored the report that was attached to our letter. And although they have positions of high esteem, actually I was the Chair before them, we are not speaking on behalf of the American Bar Association or anybody but the three of us.

What is a finder? A finder is a little bit like Santa Claus. "Yes, Virginia, there is a finder if you truly believe in it." What people call finders are really unregistered broker-dealers. Therefore, they have been acting illegally in assisting companies to raise money or do M&A transactions. The type of funding that is involved is generally between, say, $500,000, $10 million and up, but in those ranges, I think, is the concentration. They are alternatives to going to venture capitalists, and without having the finder/unregistered broker-dealer involvement, companies are more and more restricted from being able to find money because most small companies and even smaller public companies cannot do this work on their own. In the M&A area, we're dealing with both public and private companies, and a tremendous amount of the M&A work is done by unregistered broker-dealers involving public company securities, private company securities, etc.

So I've said that they're acting illegally, but that doesn't mean to say that they're not legitimate, moral, ethical business people. There are many, many, many of these people, and I would venture to say that every lawyer in this room has, at one time or another, represented one of them, certainly represented a company that has dealt with them. And we feel awkward dealing with somebody who we know is acting illegally, but there is really very little alternative in the smaller public company and small company arena. They're critical to raising capital for smaller companies, there is no real alternative. They're one of the reasons why small companies can raise capital and be competitive in the emerging company market.

In the past, the penalty for dealing -- for being an unregistered broker-dealer was basically that you could not enforce your contract to get paid at the end. Generally speaking, that has not been a big issue because very few issuers of securities who have been successful in raising several hundreds of thousands or millions of dollars are going to turn around and stiff the guy or woman that helped them do that. So generally that hasn't been a big problem. It also has not been a big problem in being afraid of enforcement because the enforcement has been essentially non-existent, which is one of the reasons why it was difficult to get people to agree to register as broker-dealers.

And California took a step in the wrong direction, in my view, in the past year enacting a law that effectively makes a finder that is an unregistered broker-dealer a guarantor of the deal. The investor now has a rescission right apparently against the broker and possibly against the company as well, if you read the statute in any way that makes any logical sense. There are six other states that have this kind of a law. So what has -- this has been a festering issue for many, many, many years. Marc Morgenstern, having a long history with the Forum, will verify that this has been probably the number one issue for the last, at least, three or four years and going back before that. The American Bar Association group involvement got started about six, seven years ago, and I wrote a letter to Rich Leisner, then chair of the small business committee, and suggested that we take it on as a project. It quickly grew into a task force project because it involves so much merger and acquisition work.

Let me give you an anecdotal report of how important this is to small public companies. I was talking this morning with a gentleman who is an auditing partner with a company that he said represents about audits about, 100 small public companies in the United States. I asked him, "What is your estimate of the amount of capital being raised by those companies that involves" -- as opposed -- not in the public offering but in a private placement. "How many of the private placements involve unregistered broker-dealers?" And his guess was about 80 percent, which I think is consistent with my own feeling. "How much -- how many of those companies are involved in transactions? What percentage of companies that are involved in M&A transactions would represent would be involving unregistered broker-dealers?" And that was up in the 20 to 30 percent range. So this is a very, very broad reaching important problem.

Unlike some of the other folks, I'm not going to wait for you to ask what our recommendation is. Our recommendation is clearly set forth in the report of the task force which is appended to the letter, and I'm sure you've all read it thoroughly. But what we're really suggesting is the following: There should be a simplified and less expensive and less reviewed basis for having these people, who are actually legitimate business people, come within the system and be registered. And we're suggesting a greatly simplified registration process -- this is on page 3 of the letter -- lower application fees, qualifying examinations that are consistent with the activities to be licensed, activities to be limited to private placements, no public offerings, not even regulation A offerings.

These people would not have custody of investors' funds, so there would not be the necessity to have extensive audits, or any audits for that matter. In fact, we're suggesting rather than having a minimum capital requirements --- $5,000 means nothing if you're raising even $500,000, let alone $10 million. So why have any net capital at all? If anything, perhaps have a bonding requirement. Record keeping should be consistent with the type of activity going on, and lastly and most very important, there should be no bad boy history in anybody who would be eligible for this. This would then create a group of people who could service these small public companies and private companies, both in the capital raising and the M&A activities, who would be known, who would be certified, who would be approved, and who could put their names in the Yellow Pages for people running these smaller companies to find. And it would also exclude from that group all of the fly-by-night actors who are the problems that we're dealing with on a day-to-day basis.

Finally, I wanted to mention that we apologize for the weather today. Rich Leisner said to me this morning why didn't I arrange to get better weather? Well, the answer to that is a lot of people talk about the weather; nobody does anything about it. That is not the answer to this private placement broker-dealer problem. This is something that we've talked about for 20 some years, this is something that is really time to do something about. I believe it takes the initiative of the Securities and Exchange Commission working with NASD and the state administrators, and our recommendation in our letter is that the SEC establish a task force to do that.

MR. WANDER: Thank you, Gerry. We have about two minutes and -- before Marc also summarizes. So I'm going to go to Leroy and Janet and then Drew. But very quickly, please.

MR. DENNIS: Okay. Very quickly Ann, I have a question for you on your recommendations, which I wrote down were to eliminate the auditor attestation, information for optioned employees, and consider something for companies going private, could you -- it seemed like most your comments were addressed toward the company perspective, and I'd like to know your perspective from the investors that if I'm an option holder, what information should I get? If I'm a shareholder in a smaller public company and I'm relying on management for the attestations of controls, without an auditor assurance on that, how would the shareholders feel with that? Should we even expand it further? I mean, the logical next step would be why certify the financial statements? So I'm just curious as to your viewpoint from an investor standpoint as opposed to a company standpoint on those recommendations.

MS. WALKER: I think from an investor standpoint, certainly taking the last part of your question first on 404 and then eliminating the auditor attestation, I mean, I tend to agree with Ken's very eloquent discussion earlier today that it's -- the cost benefit simply doesn't justify it. In the long run, or even in the short run, actually, the investors, they're also shareholders and they want this company to do well. It's not in their best interest for the company to over spend on accounting systems and controls. It's in their interest that the company not commit fraud clearly, but I don't think it necessarily follows the companies that are smaller, that if they spend five percent or whatever the numbers are on trying to comply with 404, I don't really see that the shareholders are getting concomitant benefit from that. That's the way I look at it.

Obviously in a perfect world, everybody would have perfect systems and shareholders could believe everything they read, but, you know, that's not real life, and we have to look at the cost benefit. And so I guess -- and I think that's partly an answer to your other question. But talking specifically, then, about the employee optionees and whether and when they should get information, it's my experience that the options are granted to the employees -- and most of the employees actually wait until the company goes public, because at that point there's public market for the underlying stock and they exercise when they know they have a positive spread on the option. There are not very many of them typically who will exercise while the company is private, but some will. Some will in order to avoid tax consequences of alternative minimum tax and so on and so forth.

I guess my point on the employee options is if they -- first of all, if they just hold an option, so they haven't exercised, they haven't come in and paid cash to actually receive shares, all they have is an option, and so we have more than 500 people holding options but they haven't exercised them -- because if they exercise them, they hold stock. And I'd be the first one to agree that if you have 500 stockholders, absolutely, you know, it's appropriate for 12(g) to kick in. But these people who are just holding the option, the right to buy, I can't see why that necessarily should force the company to go public. And I also frankly can't see why they necessarily need detailed financial information about the company unless and until they're ready to exercise. And that's a different discussion, and I'm not going to get into that now because we'll take forever. But I think that's kind of the way I see it. I hope that was responsive.

MR. WANDER: Janet?

MS. DOLAN: I'm going to pass because Leroy asked my question. It was towards investor reaction to having that.

MR. WANDER: Drew and Bob after that. Okay?

MR. ROBOTTI: Actually, I have a direct follow-on to that. You didn't address of the one-year amnesty to de-register the process. What happens to the shareholder then? What protections, what disclosures are going to be, going to come out of a reporting company? And I mean, what regulatory framework are those people providing information and can get information? So what happens from the investor side in that situation?

MS. WALKER: Well, I guess, first of all, if -- I'm -- I did not make a specific recommendation with respect to what parameters. I mean, the general parameter is company that went public before SOX. But, you know, obviously there would be discussions of other parameters that one might consider in actually preparing a program such as that. But I actually think the investors are being harmed when these companies are public and shouldn't be public. I don't think you are doing the investor shareholders any favors by remaining a public company when you can't afford to be public. First of all, my experience with these smaller companies is there's very little market for their stock anyway, so talking about losing a robust public market is not really the way to view it.

They may be losing a very limited market for their shares that probably, frankly, doesn't really reflect the company's potential because the company is being depressed by having to pay all these regulatory costs, they're also being depressed by having no analysts following them. So generally speaking, it's a very, very thinly traded market and it's typically very, very low priced, which in many cases that I've observed personally, it far under values what the company is really worth in any real world. So I don't think in those situations that you're really doing the shareholders any favors by remaining a public company. And I guess that would be my response.

MR. ROBOTTI: And I guess I would just follow on. That's why I'm really interested in reducing the cost of 404 so those companies can remain public and afford the cost of it. I'm not blind to what you say; however, if it's trading at a significant discount to what it's worth, you know, then it gives the company the opportunity to buy in for theoretically less than what it's worth. So you even have a mechanism to take advantage of that. But we're talking about stocks in the market, too. We're forgetting that there's investors. People own stocks in a company as an investment. We talk about a lot about investors and trading and that kind of activity. They're investment people who own stocks and own businesses and own fractional interests in business.

And if that business is something that they want to own shares in, why shouldn't they have that opportunity? Or why shouldn't they have protections afforded to them when the company made a deal and said, "Give me your capital, and I'll give you this information?" Because if it reverses out and gets the window, it will not have to provide any information to those shareholders and it disenfranchises people who invested in something who saw it as an investment, not as a trading vehicle, because they probably wouldn't get into the stock if it was a trading vehicle.

MR. WANDER: Drew.

MR. CONNOLLY: Thank you, Mr. Chairman. This is Drew Connolly. Firstly, I'd like to stand behind Bob Robotti's questions and acknowledge that he is one of the leading experts in the market place in distressed equities, undervalued equities, and patient investment, quite seriously. And by the way, without broker-dealers such as Robotti & Company, I'm not certain that we would have a robust public market place in the microcap space. So that's not just a left-handed compliment, it is a certainty.

Mr. Chairman, I think it was absolutely well advised the way the seating arrangement occurred; the only attestation signatory is sitting between the auditors and the attorneys. And I think that was well advised. Mr. Hahn, I salute you for your opening remarks, and it really strikes me that the term "innovation" was both well stated and also the basis for one of the significant reasons we're here. If the small public company space cannot innovate, the U.S. capital markets are in deep, deep trouble. I'd like to ask you two quick questions. One, how many U.S. employees do you have?

MR. HAHN: In my present company, we have roughly 600 U.S.

employees out of 1300 total.

MR. CONNOLLY: That's a significant number, and clearly the vast majority of those, I would take it, are option holders?

MR. HAHN: Yes, absolutely. In fact, I believe all of them.

MR. CONNOLLY: Okay. That's very important.

Ms. Walker, I just want to say, I tried to reach out to one of your colleagues, Ms. Harris, on Friday. One of my clients actually uses her law firm, and I knew I'd be seeing you here today. I'd like to congratulate you on the economy of speech that you used in that ten-page recommendation letter as one of the clearest of all of the voluminous documents this Committee's had to read. That was clearly one of the most direct, clear, and easily digestible submission that I've seen. So I'd like to thank you for that.

MS. WALKER: Thank you very much.

MR. CONNOLLY: And Gerald, if I may, finders has been -- I've been a participant for the last four years in the Forum, and finders has clearly been the number one issue on -- well, actually it's been number two with number one being let's readopt the recommendations from the year before. But, you know, being a capital formation specialist, which is, if I were prepared to do so, would be a euphemism for being a finder, but I'm not quite a finder, I recognize the problem. I have read the 92-page submission by the American Bar Association, I'm pleased to be on the same panel with Mr. Leisner for what was a thoughtful document, and it is clear, your statistics are about -- or anecdotal statistics, about 80 percent of the transactions that you're involved in, you probably have a finder.

The reality is that in the market cap space, there are no IPOs, there may very well be PIPEs, and we can talk about that, perhaps, privately later. But the access to capital and certainly the M&A transactions in this space, without finders, without a regulatory environment -- and I'm someone who was registered as a registered person for 17 years -- I would be more than willing to submit myself again on a simplified form. And I absolutely say that when you talk about them being in the Yellow Pages, I think it's even more significant that if there were a repository of legal registered finders, the folks looking for capital would have a lead list for people to go to, and I think that would simplify the process inordinately. So thank you for your remarks.

MR. WANDER: I apologize for going over. Marc is going to wrap up the discussion we've had with this first panel. We'll take, after Marc's finished, only a ten-minute break, and we may eat into our lunch five or ten minutes to catch up.

MR. MORGENSTERN: Thanks. And I don't know if this is terse or brief, but it's going to be short. First, you know, Alan Beller, when he started, said it correctly, this is a unique opportunity because this Forum is different than any of the other preceding Forums. It's different by who's here, it's different for the purpose. Hopefully it's different from the outcome, because you're addressing a very short-term opportunity. And over the course of this morning, as most of the Forums have been, this has been a very collegial, very impersonal, and fair presentation. It isn't about Gerry or Ann or Ken or Lynn or Dick, and it's great that everybody's maintained that tone and tenor at the bottom.

If you go back to the beginning, let me just say that the SEC has a unique tension because it has a dual mandate. And you always hear it reflected in this Forum. And the dual mandate is the SEC is charged with protecting investors, and it is charged with helping to assist in capital formation. And within every group and every person, you will hear a debate about is one the priority, is two the priority, or are they equally weighted? We don't have an answer to that, but that is always the question. With that question always comes what is the cost-benefit of regulation? Second constant through the years, no one has ever been able to adequately answer the question of what is a small business? And the proposed answers have ranged from a million dollars to a billion dollars to 47 formulas, and we've been wrestling with it for 25 years.

The views do tend to reflect the bias on where the person's capital comes from. So venture capital funded companies look at all of these definitions one way; angel funded companies look at them differently; owner managed companies look at them differently. And part of what's important to a dialogue here is that everybody understand those backgrounds. The third is that there has always been a perception right or wrong that there is a regulatory and legislative bias, and the legislative and regulatory bias is that fraud and problems come disproportionately from smaller entities. And that's a theme that's been played out over 25 years. The Forum attendees' bias, which I would tell you is right, is that without small businesses, public and private, without them you don't get jobs, you don't get wealth creation, you don't get innovation.

So the Forum attendees' bias has always been the rules have to be flexible, the regulatory people have to be flexible, you've got to distinguish rules, recognize cost to smaller business. Those are constants over 25 years. The only fifth constant I would suggest to you over the last two years is that in every discussion, the concept of global competition and the viability of U.S. capital markets, companies, jobs, and employees has become the fifth constant in all these discussions. And at least from my view, that would appear to be appropriate.

MR. WANDER: Thank you. We're going to adjourn to 10:45.

(Recess taken.)

MR. WANDER: All right. Please everyone take your seats. If everyone would take their seats, we'll start our second panel. I do want to thank the first panel for their remarks, observations, recommendations. We really appreciate the information, and we have an equally distinguished second panel. And rather than take time to introduce everyone, I'll let each of the panelists introduce themselves. And I'm going to start on my right, your -- I guess the audience's left with Chris because I understand you have another engagement in Sacramento.

MR. AILMAN: Thank you very much. Thank you for the opportunity to speak to you today, and thank you for the opportunity to speak with the Advisory Committee as well as the Forum. My name's Christopher Ailman, I'm the Chief Investment Officer for the California State Teachers Retirement System, commonly known as CALSTRS. We're a $130 billion pension plan, we represent about three quarters of a million school teachers here in the State of California. And what's an interesting fact is we're actually older than the Social Security system. We're about a 92-year-old pension plan, so we've been around for a long time.

Listening to the earlier panel, I guess the one thing I want to get across is we are the capital. As people talked about investors on all sides of this transaction, at $130 billion, we're about the second largest pension plan in the United States, fifth largest in the world. We are investors both in private equity and the stage of venture capital, growth equity and buy-outs. We're also investors in the public equity markets. We own almost $2 billion in over 1200 companies that are below $700 million in cap size. So we're an investor on both sides of these markets. We feel this issue on both sides.

I'm under the impression that there's a misconception out there that investors, particularly from people in this room, that investors don't care about Rule 404. We don't seem to ask questions about it, we don't seem to grill some of the corporate, corporations that are here about it. I want to let you know from our perspective and from the institutional investors that I associate with, we do care a lot about it, we do focus on it, it is very important to us. We rely on the financial statements that management sends out to make our judgments about how much to own in a particular company. So the quality of that financial statement is absolutely critical. And I heard another comment from the earlier panel about the cost of implementing Rule 404, and I think one thing I'd like to leave you with is when you look at the cost, consider the cost to all of us when investors lost confidence in Wall Street, lost confidence in those financial statements. My pension plan alone saw our market value decline over $15 billion in value, and believe me, I heard from a good portion of those three quarters of a million teachers, particularly the retired ones.

When you look at Rule 404 from our perspective, we think it's an outstanding rule. You know full well that it received bipartisan support, it has been very popular with individual investors, it has been less popular with corporations. But we think it is a good rule for good businesses and a good rule for investors. The issue at hand, I believe, is really how do we implement that rule, not whether or not that rule is valuable or not, but -- and I read the charter that Chairman Donaldson gave you, it really is about how do you implement that rule to small businesses. We understand the difficulties of small businesses. My private equity staff has told me before that in the venture capital space, we do see issues on when we're going to become public, the cost of coming public. In the buy-out space as you heard earlier, we do see opportunities for companies who want to go private because they don't want to pay the cost of implementing that.

We're already an investor in those companies. We're not interested in taking a company private that has poor accounting or poor standards or poor governance. The reality is when you take a company back private, you have total control over that company and you can effect change and improve the governance of that company. But for small businesses, we are sympathetic, we do see the cost, it does have an impact. But part of our challenge that we would want to leave you with is do we really -- are we really able to measure that cost today? We think as you look at the implementation, one of the best approaches might be to phase in the implementation. Now, with that I would caution you, we're concerned that since it's been almost two years, a lot of companies and some of the people in this room believe that by not implementing at this point, that this rule will be carved out or eliminate them. And so we're under the impression that some companies are simply sitting on the side lines not trying to even begin to implement some of these facets of Rule 404. They're hoping it's delayed forever.

What we would suggest is you need to send a strong message to the capital markets that you do intend to implement Rule 404 but in a phased-in approach. I've heard comments before about the high cost of accounting. We've seen that ourselves on our venture capital companies. When you look at the accounting industry, our impression has been that we've seen a knee jerk reaction from the accounting firms. They've seen a shift in where they got their revenues, they are now causing a double audit, in essence, to implement Rule 404. And we think like any reaction in the market, there's a knee jerk reaction in the market. And that the cost of implementing this at this point is excessive. If you phase in this approach over time, it will give the opportunity for second-tier accounting firms, other accounting firms, and frankly for the PCAOB to step in and really regulate those accounting firms. And we think the markets will rationalize, and the cost of implementing this in the initial phases will go down as time goes on.

When you look at the cost benefit analysis, one of the other challenges is the cost I keep hearing only deals or focuses primarily in that first year. Well, that first year, a lot of it is implementation cost. We really want to look at it again, as a 90-year-old pension plan and one that will hopefully be around for the next 90 years, as investors in the public markets, we have a very long-term view. So we're not as focused as just the one-year cost of implementing this, but the long-term value to us as investors. How can you put a price tag on quality financial statements? And again, it wasn't that long ago, we have school teachers who have no faith in Wall Street, they have no faith in management of companies, and they have very little faith in the financial statements that they issue. How can you put a price tag on bringing that faith back? That concludes my remarks. I'm open for questions, or if you want to pass on.

MR. WANDER: I thank you both for your remarks, and they're right to the point. Thank you. Questions from Janet?

MS. DOLAN: I appreciate your comments. I would like to know if you have some suggestions on this question of it's not the law, it's how it was implemented, because I think a lot of people are certainly saying that. But our job is to figure out how you to get some realistic and practical solutions to how do we solve that. So do you have some suggestions of what has gone awry in the implementation? And some of the issues are the amount of money spent on testing systems and things that are not likely to compromise the integrity of the financial statements. So do you have some practical suggestions that you would ask us to consider to reduce this cost, and yet, maintain the protection you think your investors are looking for?

MR. AILMAN: I do. Obviously the cost, and it's been addressed earlier by the panel, is the accounting costs, and that's really an issue where we think it really has to do with the market of the accounting firms and what they're charging for that service. And phasing that in may be the best way to let that part of the market rationalize. I think some of the other rules to us as investors, one of the most critical factors -- and I know there are a couple of you who are board members here. One of the most critical factors, the independence of the board members, having an independent nominating Committee, having an independent compensation Committee, having independence lead the accounting Committee.

We could live with phasing in some of the accounting standards to help lower the cost of that initial cost of accounting, but getting better independence on the board should not have a cost. It should be able to find quality independent directors who can speak their mind. And to us, that is a big step toward restoring faith in the corporation as it's represented by management.

MR. WANDER: Yes, Dan.

MR. GOELZER: I was just wondering if you could elaborate a little on what you see as a phase-in for smaller companies for 404. I guess I can think of one possibility being a longer period of time for a company after it comes into the system to have its first report. I guess another possibility would be management report first, the auditor attestation delayed a number of years. Another possibility might be to look at portions of controls in sequential years. I'm wondering what you see as the best approach for a phase-in.

MR. AILMAN: I think overall in the big picture to us, the best approach is don't water down Rule 404, don't carve anybody out. But if the cost is too great as we sit right now, then phase it in over time and let the capital markets do what they do best is, which is rationalize. So I would agree with both of those, or those several points that you made which is to set a time frame where you're going to hold the accounting standards and make them effective. That way we can see more second-tier firms step up. And hopefully the PCAOB can step in and work with some of the Big Four to get them to look at what are the standards that they're accounting to.

I mean, we're -- as you are hearing, we are hearing, that they want two whole audits; one for the financial statements, and another for Rule 404, and that the cost is, in essence, doubled. Well, part of that, frankly, from our perspective is the loss of revenue those accounting firms have seen since we're asking them not to play dual roles in a corporation of business advisory. So phasing in some of the higher cost levels to different years, setting them so they become effective at different standards, you're right, it doesn't -- if a company's coming public in 2007, they're now going to have to step up to the plate, but we believe that will allow the market to rationalize that and lower the accounting and some of that initial hurdle cost.

MR. WANDER: Yes, Mark.

MR. JENSEN: This is Mark Jensen. Your comments talk to quality of financial reporting. I guess the question I want to ask is 404 -- and it was said earlier this morning -- largely put in place because of frauds at the CEO suite, not really specifically targeted at, quote, "quality financial reporting," but rather accuracy and fraud detection. Do you make a distinction between those two when you think about 404, or is your opinion that 404 is bringing in a needed improvement in the financial reporting system in the country?

MR. AILMAN: We do make that differentiation, but what we look at is it's bringing in two things; it's bringing in accountability, accountability at the CEO level and accountability in the corporation. But from our perspective, what we really see is -- and Chairman Donaldson has said it recently, is that it's bring back investor confidence in management and in those financial statements. When you break that trust, as we experienced for several years, it will take a long time to win it back. So we would separate those too, but they're both equally very important to us.

MR. JENSEN: So you feel -- just one following on. So you feel, as an investor, financial statements that have 404 attestation attached to it, that the quality of financial reporting in those statements, in your mind, is higher?

MR. AILMAN: Yes. Yes. We think that gives a level of comfort to investors and a level of comfort to us that is needed in these markets. Again, it gets back to that issue, you break trust, you can't simply just ask investors to grant it back, you have to win it back by higher standards.

MR. WANDER: Leroy?

MR. DENNIS: Leroy Dennis. Thanks, Chris. Follow on to that comment, then, do you then require a lower return on capital for companies that are investing or completing 404 and doing it properly as opposed to companies that are not? So non-accelerated filers versus accelerated filers?

MR. AILMAN: That's a multi-faceted question because it has a lot to do, obviously, with the difference in the corporations. But as discussed earlier, micro cap stocks and small cap stocks, yes, we have a higher expectation of return in those smaller areas. Inherent with that comes with less clean governance that we would expect in, say, a Russell 1,000 or an S&P 500 company. So while we may have higher expectations for the smaller stocks, that also is partly because we're expecting bigger growth out of those smaller stocks. Some of our managers have made the distinction in the quality of the financial statements, but I can't quantify that for you to tell you that it's worth 50 basis points or 10 basis points on a return premium.

MR. WANDER: Jim?

MR. THYEN: Yeah, Chris, this is Jim Thyen. I'm not sure I understood you correctly, but I thought you said you have no faith in statements and management and the reports. And I know you said once trust is broken, what do you say to those companies that have not broken the trust?

MR. AILMAN: Thank you. I want to clarify that statement. I have faith. We have $130 billion worth of faith in the financial markets. The success of our fund in funding our teacher's pensions and reducing the State of California's cost is based on our investments across the public and private markets. So we have faith, but we believe very strongly that you need to have a high standard of faith when it comes to reports and information from management of companies. When we say that we think investors' loyalty has been breached, what we would say to quality companies -- and in fact, we said it recently to a quality company here in south part of San Francisco in the lower part of the bay, which it was making outstanding changes to their governance, so it's a stock that's been beaten back, a company that's undergoing changes, making great governance changes.

That while Wall Street and analysts on Wall Street doesn't say, "Now they've separated the role of chair and CEO, I'm going to move it to a "buy" signal," but the reality is to investors that's part of the whole package to turning around that company, if you have confidence and the management of that company is trustworthy, honest, loyal, that has a higher degree of confidence that the earnings of that company are going to turn around. So to us, and we have said it to companies, which is if you have good governance, why try and rise to the lowest common denominator? Why try and raise to what is the rule and expect it? Raise the bar, improve yourself so that you're above reproach, and can approach the market and Wall Street without any questions, and that just adds to the value of that company and to the story that they have to bring.

If there are shadows of doubts about you when you come to a table, any of you that come to a business table, if you walk into that room with shadows of doubt or trust or honestly, you know how much more difficult it is to get that transaction done, and if you're a company, it's that much more difficult to attract capital. And we think given the environment we've been through, we actually need to step up to the higher standard and not accept the low standards.

MR. WANDER: Are there any others? Janet?

MS. DOLAN: I just want to follow up. I think all or most of the people who have come before us agree that many of the features, independence of the board, whistle blower, a lot of the good governance features, are very admirable and should be applicable to all. But the question is spending time going back and documenting paperwork on who was at a particular meeting when you decided to put a particular control into your IT system and all the other, sort of, minutiae that we have been spending money on is where people are questioning it. So I guess what I'm still struggling with is are you saying that 404 is without question, providing all the value you're looking for, or are you also urging us to look at ways to calibrate it for small companies? I'm just trying to distinguish --

MR. AILMAN: Let me be absolutely clear. We believe whole-heartedly in Rule 404 and we as investors support it strongly. And we believe it should be implemented. In an ideal world, we would like to see you implement it tomorrow and make it effective for small companies. The reality is we understand that that cost might be too high, it may hurt the microcap stocks, it may hurt initial public offerings; so, therefore, we're finding a balance point. We feel -- again, I want to be clear, we feel Rule 404 needs to be implemented for small companies, but we want to be realistic on how we implement that.

MR. CONNOLLY: Mr. Chairman?

MR. WANDER: Yes, Drew.

MR. CONNOLLY: I'd just like to ask the same question that I've asked the previous panel. Sir, is your pension fund able under pension rules to invest in either Pink Sheet or Bulletin Board securities?

MR. AILMAN: We are able to under our rules, correct. Yes.

MR. CONNOLLY: You are. And as a matter of practice, do you have any understanding of how large an investment overall in microcaps?

MR. AILMAN: In microcap in our particular fund right now, it's a very de minimis investment. We're starting to look at, because of our sheer size, you could imagine if we put $500 million into the microcap space, we could swamp some of those managers and exceed the trading volume. So in our case, it is particularly difficult to get down into that market. Now, at a billion-dollar endowment, they've had more flexibility to get down in microcap stocks.

MR. CONNOLLY: Even with ERISA or Prudent Man rules?

MR. AILMAN: Right.

MR. WANDER: If there are no other questions, I'm going to go all the way to the end of the panel and call on Bill Hambrecht, please.

MR. HAMBRECHT: Well, thank you. It's a pleasure to be here. I listened to some of the remarks earlier today, and I'm sure there are a lot of people here who have a much clearer view and a stronger view on Sarbanes and 404. And I'm sure you're going to hear a lot of learned opinions about it. I thought what I would like to do at least is sort of give you an idea of the practical application that we're seeing in the market place, particularly as it affects the IPO market. First of all, it's no question that it's costing more.

You'd have to be crazy to ignore it. I used to argue with private companies, particularly ones who had venture capital investors, that the cost of going public and the cost of maintaining reporting to a public company was really not that different than what they were spending to report to the venture capitalists and private investors. Some people will argue that, but private investors want monthly numbers, they want a lot of numbers too.

So normally the transition from, particularly a venture backed company into the public market, has not been terrifically costly, nor difficult. But when you look at it now, some of the numbers that my people gave me at least was, you know, the S&P small cap audit fees are up 84 percent in '04 over '03, and that the average cost of going public is now around 3.4 million. Again, a significant -- with the audit fees being up 96 percent. And I don't know -- you can argue numbers, but it's clearly more costly. The question is is it worth it? And I would agree with the gentleman from Sacramento that, first of all, investor protection, I think, demands some improvement in our overview of accounting. I think that the major problem in the market place, to a great degree, was numbers that were inflated, expectations that were inflated.

I must admit that I've been a big proponent of going one step farther, which is to put the estimate into a prospectus, because that's the number that drives the market value and drives the investment decision on almost all IPOs. Mr. Beller and I have talked about that at length. I think some day, I think -- and incidentally, there's been some significant moves in that direction, I think. But some day not only will you need clean Sarbanes-cleansed numbers, I think you're going to need some way of getting an estimate into the market place so that all investors are dealing with the same kind of information that the big institutions are, and that the estimate is arrived at in a prudent and sensible way.

I think from a practical point of view, as I've seen companies go through adjusting to Sarbanes, first of all, I would suggest that the SEC could do the accountants a big favor if there were some definition of materiality that could be defined. We spend an awful lot of time worrying about a tiny little item that really doesn't have a lot of impact on the numbers. And I would argue that in the world that I live in there's two major issues that are always there and that are always subject to abuse, and that's revenue recognition and inventory. And those numbers are big and are basically, in the small company world, I think, defined by the CFO and the CEO. So from the point of view that Sarbanes puts accountability on the CEO and CFO, I think it's a very good step.

What we do in our firm to try and rationalize the numbers as best we can, it's really three principles that we've used in our own due diligence that Sarbanes in some way has some impact but, frankly, not an awful lot. First of all, you know, there is an issue of size, and I'm a big believer in after-market history, that the way you really decide what works and what doesn't work is you go back and you look at the history of all the underwritings and what worked and what didn't work. And professor Jay Ritter at Florida I think has a great database, and, you know, his database says that the returns to investors are significantly better if the company has more than $50 million of revenue. We've adjusted it to sort of develop our own secret sauce, and I personally think it isn't revenue as much as it is gross margin. But if a company is generating enough gross margin so that they have money to reinvest and build the business, generally the investor comes out. So I think size does have an effect in the long-term, and I'm not advocating that it be legislated in, but I do think it has an impact.

The second thing we do is we have two ex-CFOs on our staff now who go in and do the due diligence on the numbers as we are writing the registration statement. And they're separate from the bankers because the bankers are salesmen, they're there because -- probably because they've given the company the rosiest picture of what they think the market is going to do. And you can't really expect them to go in and be the devil's advocate on the numbers. So we have two guys that go in and they're pretty good at smelling out style and approach, and we found that to be extraordinarily important.

And then finally my own pet project has always been I always ask for the tax return, because what you see when you look at the tax return is a difference when management is arguing for the most conservative approach to numbers because it costs them money, every dollar that goes into profit, versus the ones that they report that gives the market value. I've always thought that the real answer is just have one set of books and let the tax return be that set of books. And I think you'd get a lot cleaner numbers. But that's for --

MR. WANDER: That's a little about beyond our --

MR. HAMBRECHT: Well, okay. And then finally how has it affected the IPO process? Well, first of all, I think the IPO process has improved and there are some significant changes coming, to a great degree instigated by the IPO Committee that the SEC is involved in, although it was the NASD, the New York Stock Exchange run Committee. But the SEC was very important. And I think the research issue has been, you know, basically cleansed by transparency. I know we moved towards outside research on IPOs and there isn't -- the market seems to favor it. So I think the market will ultimately demand an outside research model, outside of the underwriter. There's improved transparency. The road show is now part of the prospectus, in many cases we make it a standard practice to do that, which says that anything management says to the big institutions, they're going to say to everybody. And I think that's been a big step.

And there's also been some evidence that pricing has moved closer to after-market pricing because of basically market pressures. We use the auction as a way of price discovery, and our position, of course, is that you ought to price an IPO at the market, that giving an artificial discount creates guaranteed profit, which ultimately finds its way into hands that have nothing to do with who wants to own the stock. And I think that this is still there, I think the transparency that was brought to the process is due to the fact that mutual funds are embarrassed about the fact that they flipped IPOs and paid commission business. That's starting to correct itself. But I would argue that it's just moved to the hedge funds, because the hedge funds don't have to report and they're great commission generators. So you will see more and more of the discounted underwritings going to the hedge funds.

Our position has been let the market determine whether an auction or a negotiated price should work. Over the five years we were out there, we did two a year, and the two that started to break the ice were Google and Morning Star. Morningstar in particular was almost a clear example of one way versus the other. And we're starting to see the market change. We have done three this year with seven on file, and about 15 that we're preparing for next year. So I think, you know, the market place is starting to recognize that there will be -- that there is another way of finding price discovery and finding a better price.

I think from a legal point of view, the crucial thing will be what happens on the E-Toys case that just came out of the New York Supreme Court. As you know or probably you do know that the New York Supreme Court ruled that the underwriter did, indeed, have fiduciary responsibility for pricing and that the directors could go back against the underwriter for mispricing an issue. And there's -- it's -- you know, it is a kind of a thing that will change underwriting practices dramatically. We've seen in one of the more conventional deals where we're co-manager, the manager, the book runner insisted on a clause that basically said that they disclose they had lots of conflicts of interest, and they specifically refused to take fiduciary responsibility. I would argue that disclosing a conflict of interest doesn't eliminate it, but perhaps, gives you gentlemen a place to look. And so I think a lot will depend on some of these cases that are in the Southern District Court now, but I think you'll find some real changes. I'd be happy to answer any questions.

MR. WANDER: Before we go to questions, I would like to recognize Commissioner Paul Atkins who's with us now. And we're delighted to have you here, and we're all looking forward to your comments and to your luncheon speech. So thank you very much for joining us.

Questions of Bill? Yes, Mark.

MR. JENSEN: This is Mark Jensen again. I always have questions. One of the things we've heard from a number of people over the course of a lot of people speaking to us is that the IPO market has changed significantly since Sarbanes, and that companies, specifically in a case I'm most familiar with, venture backed companies are more interested today in being acquired than going public because that route provides them liquidity value at presumably a value equal to the public market place without the cost of all the regulation that goes along with being a public company. And I'm curious if that's your experience, and if it has been, if that's good or bad, and then maybe a prognosis on the future, if you think that will be a factor?

MR. HAMBRECHT: Well, clearly, I think people are comparing. And I know there are a number of venture capitalists that will tell you that and use it in their way of appraising which way to go. I do think that the public market has been and will continue to be the market that provides the best valuation for a company if it's private, because, you know, liquidity has value and it opens up your investment opportunity to a broad range of channels. It's just not a small group of private buyers or a corporate buyer. So I find that most of the time they go through the process and end up deciding that if they can go public, they probably should, even if they ultimately want to sell out, because then ultimately somebody is going to have to compete with the public market.

MR. WANDER: Yeah, Steve.

MR. BOCHNER: Thank you. Steve Bochner. Bill, that was great. Thanks for being here today and for your remarks. You touched on two topics that the Advisory Committee has also taken a look at, and I'm wondering whether you'd be willing to say, if you could waive a magic wand and make changes in the areas of financial guidance and IPOs and materiality, what kind of changes would you make? I take it in the materiality area, you're talking about a more definitive standard than SAB 99 currently provides, but if you'd care to elaborate on that, I'd love to --

MR. HAMBRECHT: I'm not sure what standard is out there now. I used to -- it used to be five percent, right? Which I remember thinking it was awfully big. You could drive a lot of things through five percent of your inventory. But, you know, the time spent on a 5,000 or $10,000 item seems to me to be out of proportion to the value. Now, the time spent on reviewing revenue recognition, reviewing auditing processes and everything I think is money well spent. So to me it would be some materiality and some guidance as to where they ought to be putting their emphasis, because I -- the impression now is that they're just sort of doing a whole new audit and saying, "Okay, we got to go down and we can't afford to have a discrepancy between internal accounting and GAAP."

MR. WANDER: Yes, Drew.

MR. CONNOLLY: Very quickly, Mr. Hambrecht, firstly, thank you very much for being here. I'm an admirer of yours coming from the business side, and I'd like to just thank you very much for the comments that particularly talk about your favoring of outside research and the disclosure model, the sponsored research. I presume that you would -- soft dollar research is still something that you would be willing to support?

MR. HAMBRECHT: Well, that's a whole different issue. I think the soft dollar issue revolves around should analysts or should the buy side pay directly for research, or should they package it into a commission rate? Or should they go out and try to find the lowest commission rate and basically execute it most efficiently and then buy whatever research they want? I would favor the latter.

MR. CONNOLLY: Okay. And very simply, as someone who has to balance in their day-to-day practice, and I believe has done very well, that the potentially competing interests of your clients the investors and your client's the underwritings, in terms of pricing, without opening the beehive, which is certainly a beehive, but your sense is that discounted -- as opposed to the auction model, the discounted offerings are more and more going to be taken up by hedge funds with a locked-in discount and, therefore, as an unregulated environment, they have out-sized opportunity to gain?

MR. HAMBRECHT: That's correct. I don't think it's any accident that the four or five prime hedge funds, brokers, you know, guys who basically get the brokerage from the hedge funds are all leading underwriters.

MR. CONNOLLY: How would we address -- how would that in an ideal world be addressed?

MR. HAMBRECHT: Well, again, I think transparency solves most problems, and I think a lot will depend on just how much is asked of hedge funds to report.

I think the minute people have to report how they get these returns, that generally there is a correcting kind of mechanism that goes to work.

MR. CONNOLLY: Thank you very much.

MR. WANDER: Mark, sure.

MR. JENSEN: I want to talk about companies going public for a second. I think Google was 404 compliant at the time they filed, and I think even when it filed its registration statement. But companies aren't required to be 404 compliant when they file and presumably wouldn't have to comply for, I think, the year after they filed their first 10-K. Of the companies that -- I think you probably talked about this. Of the companies that have filed so far this year, have they all been 404 compliant?

MR. HAMBRECHT: No, no.

MR. JENSEN: Would you favor some kind of phase-in for 404 compliance for companies going public?

MR. HAMBRECHT: Yes. I think that would make a lot of sense. I think -- we have one company, for example, that initially had a legal opinion where their lawyers said, you know, "You should be compliant and then you should report for three quarters to test the systems before you're really set." I think something like that can be very legitimately done once you're public.

MR. JENSEN: You as an underwriter with underwriter liability and all the other issues that you have?

MR. HAMBRECHT: No. I think we have to do our own due diligence, and I think we have to look at areas other than what Sarbanes focuses on, because as I say, I think to an underwriter, the biggest risk of any IPO is the numbers. So you have to do a lot of due diligence on your own.

MR. WANDER: Any other questions? If not, why don't we go to the other end of the -- oh, I'm sorry. Bob, sure.

MR. ROBOTTI: So to a certain extent, what you're saying is the testing that you're doing as an underwriter is totally uncorrelated to the 404 testing.

MR. HAMBRECHT: I think the 404 that I've seen focuses very much on the adjustment of book to GAAP. We very much focus on what are the accounting principles that generate revenue? How are the books run in turn, and what are they designed to produce? I think when you read an Enron book, for example, and you see, you know, the processes that are in place to provide the best numbers possible under GAAP, that's the thing that we have to be careful of.

MR. WANDER: Questions? If not, we'll go to the other end of the panel, and Michael McConnell, please.

MR. MCCONNELL: Thank you, Mr. Chairman. Good morning, ladies and gentlemen of the Committee. I appreciate this opportunity to speak to you today. My name is Michael McConnell, I'm a partner at a direct investment firm in Los Angeles called Shamrock. Essentially we've been in business for 26 years, began as representatives for the Disney family, and have broadened ourselves to manage institutional capital under a variety of strategies today. We currently have a fund that is targeted in the small microcap area called the Shamrock Active Value Fund, approximately $500 million. We endorse full and timely implementation of SOX 404 as it is. In our experience, good controls lead to more reliable financial statements which hopefully result in restoration in the integrity and confidence in the market. And we're beginning to see that. And hopefully it will result in a lower cost of capital. In many respects we see this as a virtuous rather than a vicious cycle.

I'd like to make five points this morning, hopefully briefly. First has to do with the benefit. I think we're beginning to see evidence that suggests that capital formation and cost of capital have not suffered, particularly over the last three years. Mr. Turner, in his quite lengthy report, did a lot of research and referenced a lot of data that talked about increase in IPOs and increase in M&A activity. And certainly with market multiples in the Russell 2000 today, one could argue that the cost of equity capital has declined considerably for public companies in that particular index.

Second, cost. We've heard a lot about that today. Obviously I think context is really, really important here. Again, the good folks at Glass Lewis raised one particular instance where the market loss in value of one company exceeded the incremental cost of one year's implementation of SOX 404. In many respects we struggle with the cost benefit of lenses being the only lens to look at this problem. In many sense, it's like insurance, and in many respects the insured on an individual basis. Is it really justified simply on a cost measure. If it were, I guess our insurance companies wouldn't be making much money.

I'm going to talk a little bit later on about the owner/agent relationship, and I think Mr. Ailman here from CALSTRS highlights a very, very important lens, and I would encourage this Committee, will at the conclusion of my remarks too. And I know it's not the purview of this Committee, but there are significantly more cost issues associated with our capital markets and not the least of which is dialogue around executive compensation. But that's not the purpose of this Committee.

Third, I'll talk a little bit about our experience. Since the last three years, we've been involved in two companies that have come public from our private equity fund and currently have two companies that fall into our small cap public equity strategy. In talking -- in some instances we've been on the board, but not all. In talking to the CEOs and CFOs and other board members of that company, there are three general conclusions that were related in preparation for being with you today. The first is that the cost is not as significant, I guess, in these companies as I've heard from others. In general, it's costing about $300,000 in year one and then an ongoing cost of about $100,000. In many respects I think that has to do with we've got some CFOs that are pretty tough negotiators and that's frankly what they ought to be doing with owners' capital. And so I think if you've got some good competent managers, the cost may not be as severe, certainly along with what we're hearing, I guess, anecdotally, although this is anecdotal as well.

The benefit, which was a bit of a surprise to me, is that the internal knowledge of the business has improved. And how one quantifies that on a long-term basis, it's quite difficult. But in all four instances, the CFOs indicated that their ability to understand and the staff's ability to understand what's making the business work has improved; again, hard to put a measure on that. Lastly, the bureaucracy, there has been some sort of concern about the level of bureaucracy, although admittedly most have said that the worst is behind us in that regard. But perhaps that's an area that I'm sure the Committee's thinking carefully about.

Fourth, need. I think there is some compelling evidence that suggests reform is necessary and underway, but still needed. Several studies show that half to three quarters of the restatements of public companies in the last sever several years have been in either revenues under a half billion dollars or market cap under $100 million. And certainly in the last 18 months, we've had about 600 companies report material weakness. So this suggests that there's good work under way, and we'd certainly hate to see that good work not continue. Lastly, I guess I just sort of -- fairness. Utilitarian arguments around, you know, strict cost benefit analysis, certainly when it comes to public policy. Often you could be considered really, really carefully. We've had a history of a uniformity of regulation in our capital markets, and I think that this Committee ought to meet there carefully in the Commission of sort of stepping on the slippery slope of backing away from that uniformity. When the agents in our capital markets request owners' capital, we think there's a basic price of admission. And in theory, they're doing that because that capital is cheaper than private capital.

I'd like to conclude with those comments as background with maybe a macro lens that this Committee could think about. I would strongly, strongly encourage each of you in your deliberations to consider the voice of the owner as distinct from the agents in our capital market system. As I prepared today it struck me that certainly a majority of the testimony before you came from the agency community: lawyers, bankers, managers. And really I think what we're trying to do here is protect the owners themselves. Now, that's difficult, actually, in our capital markets as they've democratized over the last 50 years. The role and voice of the investor or the owner has, I wouldn't say has been lost, but been diminished. And secondary to the influence of the agents, I think we're seeing that in the number of people who have come before us here.

And agency relationships are often difficult and agents themselves are uncomfortable with heightened standards of accountability. I think that's the nature of the beast. And so I would just think if you'll think very carefully about what have the actual owners and investors said to you before your Committee, and maybe perhaps weigh that more heavily because at the end of the day, as Mr. Ailman as suggested, and we too, our direct investors, not only with their own capital but institutional capital, I think from what I've read is most of the investors do not have a problem with the cost of SOX 404. And if it's their capital we're worried about, and if they're not worried about the added cost here, I think that's a message that ought to be considered very, very carefully. Thank you very much for the brief time with you, and obviously I'm here to answer any questions.

MR. WANDER: Certainly. Janet.

MS. DOLAN: Thank you very much for your testimony Mr. McConnell. We are very much interested in trying to ascertain what the market really believes about the value of 404, not just what they say, but what they believe. And so I have a couple questions. Do your funds invest in any companies that do not have a 404 certification?

MR. MCCONNELL: Yes, ma'am. Obviously it's being phased in as we speak, and we're in a market cap segment -- actually our fund is a billion and a half or lower. So we are currently investing in companies that are not, but it is under the expectation and the anticipation, markets are forward looking, that these rules will be fully implemented.

MS. DOLAN: Do you invest in any global investments?

MR. MCCONNELL: Yes, ma'am. We have for many years.

MS. DOLAN: Even though they don't have 404?

MR. MCCONNELL: Yes.

MS. DOLAN: Okay. Thank you

MR. CONNOLLY: May I just follow on?

MR. WANDER: Yes, Drew, and then Bob.

MR. CONNOLLY: Drew Connolly. Mr. McConnell, once again, thank you for your testimony. To follow on Ms. Dolan's, I can't help but think it's Dolan and Connolly to chance McConnell. As you said, two of your key investments went to IPO.

MR. MCCONNELL: Yes, sir.

MR. CONNOLLY: So -- that you were, in fact, a seller into the market place from having had a private equity, presumably a sufficient rate of return. To Ms. Dolan's point more specifically, are any of your investments either traded on the Bulletin

Board or in the Pink Sheets?

MR. MCCONNELL: No, sir, they are not currently.

MR. CONNOLLY: Thank you.

MR. WANDER: Bob.

MR. ROBOTTI: One of the statistics you quoted, I guess it's also in the Glass Lewis report, and it says that of the companies that had restatements on financials, 48 percent of those were on $100 million market cap.

MR. MCCONNELL: Yes, sir.

MR. ROBOTTI: And, of course, that's about the number of companies that are under 100 million market caps, 48, so therefore statistically that group is not a larger violator, but yet is proportionate with the large companies; is that correct?

MR. MCCONNELL: I'm not sure of the second level of facts, but I assume you're correct.

MR. ROBOTTI: Because it seems as if some of their statistics come to the idea that there's additional weaknesses and larger weaknesses with small companies who's kind of the purview of this group here. And it seems as if the statistics that you quote and that they quote really don't show that there's a higher preponderance of this kind of problem than there is in larger ones.

MR. MCCONNELL: Correct. Although, I think in an absolute sense, we'd like to see those deficiencies remedied.

MR. ROBOTTI: Thank you.

MR. WANDER: Dick?

MR. JAFFEE: Yes, Dick Jaffee. I'm speaking from someone who owns a significant part of a smaller publicly traded company. It is good business to have good internal controls. No one would disagree with that. However, and this is all anecdotal, I suspect that more losses to investors are incurred because of poor decisions on capital investments, poor decisions on marketing expenditures, poor decisions on new product development and implementation. And it just seems to me to be somewhat out of proportion to have this focus on transactional controls and documentation of them when we don't think about all the other reasons why investments don't pan out.

So it's not that we're against good internal controls, it just seems like this focus on them and the cost of implementation -- I must tell you that, in all deference to previous testimony, the companies that I know about and that I'm most intimately involved with, the costs have been enormously out of proportion to the benefit. So I think there's a lot of things we can look at in addition to tightening up transactional and internal controls.

MR. MCCONNELL: Yes, sir. Actually, I think you raise a very good point, and in fact, I think you know our position and flexibility on SOX 404 could change. For example, if shareholders actually had true access to the proxy to address some of the, I think, more fundamental and larger concerns that you raised, that do result in shareholder value destruction. But that is not the case today. And, therefore, I think as shareholders, we look for whatever's up on the table to best protect our interests. And sure, if the broader landscape changed like true access to the proxy, yeah, I think there would be more flexibility around SOX 404.

MR. WANDER: Mark.

MR. JENSEN: The question I want to ask is I always like to say that just because something isn't audited doesn't mean it could be wrong. Companies should get it right first, and then an auditor should come in and do what they do. My question to you on 404 in the smaller company environment, would you as an investor feel comfortable with management's assertion, management's testing without auditor involvement, without the external auditor being involved? Because that tends to be the issue that many people raise, that's the -- you know, that's the abnormally high cost of compliance.

MR. MCCONNELL: Is the auditor wanting to gain comfort so that they can attest to the statements in addition to management?

MR. JENSEN: Well, it's the requirement that the auditor retest what management has already tested, and then the auditor basically putting their opinion that management's assertion is correct.

MR. MCCONNELL: A difficult question, don't have a firm view. I think it goes a bit to what Mr. Ailman was talking about with respect to restoration of investing confidence in the markets. I think we're a short way down that path from what happened a couple, three, four years ago. And so until that gets to the level, I think, where people are really comfortable, I'd probably be more conservative, but honestly haven't thought about the trade-off.

MR. WANDER: Leroy.

MR. DENNIS: Thank you. Leroy Dennis. Mr. McConnell, I assume most of the companies you invest in are -- have a growth plan and are trying to get to that next level to be a Fortune 1,000 or very successful company. We heard earlier about a group of companies that tend to not ever make it to that level and that there are costs when you're stuck in being in a situation where their stock isn't traded or they have no liquidity, they're kind of in this orphan public company mode. In your view is there a break somewhere where we should provide benefit or provide relief for those type of companies that maybe aren't accessing the capital markets ongoing or are still public reporting companies versus a company that is trying to continue to grow and access the market? Or should this be a shareholder request? You know, if we got a company that is a smaller company not accessing the market, the shareholders say, "We think 404 is not cost beneficial for us." I'm just interested in your views on those types of things as a shareholder.

MR. MCCONNELL: Actually, of all the material that I read in preparation for visiting with you today, the one idea that perhaps intrigued me most is, I forget where it was, the idea that perhaps shareholder approval for either implementation or continuation of SOX 404 might be a good idea. In general, I think, you know, the more voice you give the owner in his or her enterprise or piece of ownership of that enterprise isn't a bad thing, and I guess that would be in the details of that type of shareholder approval. But I think it's a very interesting idea.

MR. DENNIS: Do you think there's a break point where you would allow that type of thing to happen versus -- obviously a Fortune 1,000 company, you would not.

Where do you see in your investments that break point would be a possibility of allowing that type of decision?

MR. MCCONNELL: Yeah, two comments instinctually. I would not support that slippery slope without sort of addressing the broader shareholder voice, I guess, in its ownership positions in the country, and I guess the second as a matter of sort of principle, that management team and board, I guess at the time, did, in fact, take shareholder capital and there was a price of admission for that. And I think that they ought to honor that commitment, unless the earlier idea that was discussed could sort of develop a bit further, and would it make sense for everybody.

MR. WANDER: Any other questions? Comments? Sure, Commissioner.

MR. ATKINS: Michael thanks for coming. I believe we've spoken on the phone a few times. And I wanted to pose a similar question, I guess, that was posed earlier to Mr. Ailman as to whether or not you've seen the results of a 404 report or the deficiencies coming out of it that's had a concrete effect on the valuation of the company. Because I guess the disconnect that I'm picking up around the country when I go around and talk to portfolio managers of various types is that they know what they're getting when they think they're looking at GAAP financials or other things, but they don't really know what to think of these deficiencies that are coming out of these 404 reports. And so they don't know how to compute that into the valuation. So I'm wondering if you've seen that that's affected you that way.

MR. MCCONNELL: Sure. Two comments; one, certainly it's quite a complex set of circumstances evolving over a short period of time here and to, you know, sort of statistically prove causality between something like quite a minor or immaterial SOX 404 weakness to the valuation in the market place could be difficult. But in general, I think that if you believe markets are forward looking and they operate under the expectation of a heightened sense of responsibility and accountability amongst boards and management teams, of which this is a part of it, and you believe that multiples are an indicator of cost of capital, certainly within the Russell 2000, we've seen that multiple expand dramatically over the last three years, and so one would suggest that the cost of capital has, in fact, in the aggregate, gone down for these companies. Whether or not it's directly related to the matter that you've raised, I think it's going to be very hard to determine precisely.

MR. WANDER: If there are no other questions, we'll go to the other end. Mr. Federman.

MR. FEDERMAN: Thank you very much. Good morning, members of the Committee, ladies and gentlemen. Thank you very much for the opportunity to address you this morning. Unlike the tone of the previous speakers, I am not a great fan of Sarbanes-Oxley or 404 in particular. And I believe that the aspect of both, and particularly 404 that compels very careful scrutiny, has to do with over regulation.

A commercial fisherman thinks a great deal about the size of the holes in his net. If they're too large, the big fish get away, but if they're too small, he catches everything that swims and gets a hernia pulling in the load. Now, how to snare the relevant quarry while not disabling any critical mechanisms in the process is what I believe effective legislation is all about. About 25 years ago the Hewlett-Packard Company published some shocking information which revealed that Japanese made semi-conductor devices were far superior in quality to those made by U.S. companies. It turned out that Japan Inc. had merely learned from the teachings of U.S. manufacturing experts, notably Deming & Juran, and had implemented statistical process controls and intelligent work flow protocols.

U.S. factories, on the other hand, employed armies of quality control inspectors, a virtual cadre of Nazis who wore special smocks or badges to announce their authority and whose object was to shut down the manufacturing line if they found something amiss. It didn't take long for U.S. operating executives, after absorbing the data and reflecting upon how foolish it was, to place adversarial battalions on the factory floor to mend their ways. And now one never hears anything about Japanese ICs being better than American ICs, nor are most Japanese made products not stipulated to be superior in quality.

At the time of those HP revelations, financial executives, unlike their operational counterparts, were in the process of abandoning adversarial internal audit functions in favor of stronger internal controls, separation of responsibilities, improved processes, and more proactive board audit Committees. Those CFOs were way ahead of their factory colleagues in efficiency improvements. They were systematically excising fear mongers and small minds and replacing that DNA with a more cohesive team spirit with shared objectives, all operating with the framework of prudent parameters. Sarbanes-Oxley, 404 in particular, has created an unfortunate reversal and regression of that thoughtful process. Internal audit departments are now springing up like toadstools. I'll avoid melodrama and I won't call them death cap mushrooms, but they're largely inedible nonetheless.

These new functions in addition to the not insubstantial finance department head count expansion occasioned by SOX are adding, as everyone knows, as we've spoken about, a significant cost element to all U.S. businesses, both public companies as well as those hoping to become publicly held, and particularly to smaller organizations. But perhaps a more pernicious impact is that the compliance function commands an immediacy of perceived priority. Because judgment has been significantly subordinated to check lists and C.P.A. firms cannot sign off on financial statements unless those lists are fully accounted, the dictates of internal audit often take precedence over operating requirements. And this is not an exaggeration.

A new term has been added to the corporate lexicon. It is "process owner." Those owners also happen to be sales executives, operations people, cost accountants, and other employees. It is probably beyond reckoning, certainly beyond my reckoning, to determine the ultimate cost of SOX compliance. A $100 million revenue company probably spends one to two percent on fees alone, figure two percent when you add in all these other accountants. And if such a company earns 10 to 15 percent pretax, then the Sarbanes-Oxley compliance tax in a price earnings based financial market could be as high as 20 percent of market cap. Someone should calculate that extraordinary dollar cost across the broad market and determine whether there's any way on God's green earth that the supposed savings are worth it.

Wouldn't pre-SOX good practices as prescribed by FASB, under GAAP, audited carefully and then signed off by management and the audit company, wouldn't that get the job done, especially concerning the prospect of personal liability in the litigious environment which now prevails. It seems to me that we have built a very small holed fishing net indeed, and the average American shareholder is getting the hernia. To ask whether a shareholder -- what a shareholder thinks about 404, what they think about the cost of it is a non-question. What they can't know is what that stock would be worth if those costs, if that misdirection of activity were not occurring.

I'm skipping some of this stuff which I wrote down, which after hearing other comments, seems to be redundant and perhaps not relevant. I would just say that "one size fits all" with moo moos and men's socks, but not with small companies and the SOX which we are talking about. The relegation of executive and independent audit firm judgment to universal criteria, despite the particular needs to understand the business conditions of a particular business which compel knowledgeable assessments, that is not a good thing. Requiring smaller companies irrespective of whether you phase it or don't phase it, smaller companies with modest resources and less infrastructure to comply with complex sets of requirements designed primarily for multi-nationals is not a good thing.

Corporate America is not a hostel for criminals. Entrepreneurialism is as much a necessity for larger companies attempting to reinvent themselves as it is for younger ones attempting to grow up. We should not forget that the object of the earnest executives of both should be to create shareholder value, not to be mired down in asserting the proof of their pursuit of that outcome. The intent of SOX and 404, it may be beyond reproach; however, its form and implementation in my view does not warrant equally gracious regard. I fear that the few ne'er do wells than they are indeed a minority will nonetheless manage to do their mischief, I know that the ethically private class action litigants are going to continue to have a field day, and the hapless shareholder will be obliged to carry a Sissyphean load in order to support marginally effective good intentions. I think a serious overhaul is truly in order. Thanks for your attention.

MR. WANDER: Thank you very much for your remarks. You brought your routing section. Questions? Drew?

MR. CONNOLLY: Mr. Federman, my name's Drew Connolly. I don't really actually know what to say.

MR. WANDER: Well, then, don't.

MR. CONNOLLY: To try and frame the question. What I'd like to do is to give some substance, some additional substance to the remarks. You represent the U.S. Venture Partners in this testimony. Could we have a sense of how much capital you've got deployed and how many companies you're invested in, the scope and magnitude of their employment, what they've created -- what you've created into the economy, and how you're exiting into the public markets with your capital?

MR. FEDERMAN: Our firm was founded in 1980. We raised nine funds totaling about three and a half billion dollars. Amgen, Sun, others like that have been products of our investments. Before I became a venture capitalist, I actually worked for a living, and I was a C.P.A., a CFO of three companies, I was president and CEO of a publicly held company. I sit on two very high-cap public boards today and two smaller cap as defined by this Committee. So I'm representing my own views, I don't assert that I'm representing to a T the views of even all of my partners, certainly not the venture capital industry, but you've got what you got.

MR. CONNOLLY: I've certainly got a couple of microcap clients who would be delighted to have someone of your eminence on their board. Thank you for your testimony.

MR. FEDERMAN: Eminence? Only my wife thinks that. Sometimes I'm not sure of that.

MR. WANDER: No questions?

MR. JENSEN: I can't let Irwin get off that easy. What's your view of -- is there an impact -- just going back broadly and let's just leave 404 alone for a second, but let's just go back to all of Sarbanes-Oxley rules, requirements, and obligations. Has it had a negative impact on the U.S. venture capital in the history in your view? I know it's anecdotal and it's a Committee of one, but I respect your view.

MR. FEDERMAN: I don't believe that Sarbanes-Oxley or 404 has had any negative impact on the formation of capital for early stage companies. That's the business we're in, early stage technology companies. I don't think the flow of capital into that segment has been disaffected in the least. I'm not convinced that the flow of capital in the public markets has been disaffected by Sarbanes-Oxley. I have no way to measure that, I don't accumulate those statistics, nor do I know any of them. I think the value of those holdings has been disaffected. I'm not as cynical or even skeptical about the quality of financial statements, as so many are.

I think GAAP and FASB have created more confusion with pro forma reports and GAAP reports. There should just be one statement, one financial statement. One shouldn't have to reconcile between two statements and try to figure out what that's all about. That's not Sarbanes-Oxley fix, that's a FASB/GAAP fix. I think that if all of that was in order, as it had been for a very long time with very few dramatic aberrations and added this -- the notion which I fully support, that the executives should sign off on the financial statements and the audit Committee sign off on the financial statements to bring a sense of personal responsibility, I think you got the job done.

MR. WANDER: Janet.

MS. DOLAN: Thank you for your testimony. I would like to go back to your -- the imagery you began with which is the comparison of the American industrial market place with the Japanese and the different approach. Are you seeing anything -- I'm very interested in the globalization of capital markets, and we're creating a tremendous bureaucratic structure here with 404 and the rest of the world is standing still. So I'm just curious, are you seeing any view as to where you think the global capital markets are going to go and what we're doing to the competitiveness of America's capital market?

MR. FEDERMAN: I think Bill Hambrecht to my right is much more -- is far more competent to speak on that subject. But it's interesting that you brought that up because what I omitted from these, which I had prepared marks, was just last Friday, a less than $700 million market cap public company, which USVP initially funded, received two acquisition offers; one from a U.S. company, and one from a UK company. The UK company's offer was 15 percent higher, and they asserted -- they knew they were paying a premium. They asserted that part of that premium was as a result of what they think could happen when that company was released from the grips of Sarbanes-Oxley, and I tell you no lie. I actually had it written down, but in the interest of time I decided to skip it.

MR. WANDER: Yes, Dick.

MR. JAFFEE: Just a comment, it's interesting here today and in Chicago, without exception the CFOs who are working with 404 and Sarbanes-Oxley all said without exception that the costs were too high and the benefits were too low. The testimony we've had from other witnesses who are not involved in complying with Sarbanes-Oxley have not had to do it for all -- pretty much without exception saying the benefits are there and the cost isn't as big. So I just remind the Committee that the people who are in the trenches doing the work are the ones who are saying that the benefits are low and the cost is high.

MR. WANDER: We've heard, actually, we've heard a full spectrum, I think, over --

MR. JAFFEE: I haven't heard one CFO who said, "Gee, whiz, I got a lot of benefit and it's not costing me so much." If I did, I don't remember.

MR. WANDER: In any event, any other questions? Steve.

MR. BOCHNER: Irwin, thanks a lot for that. We've got to take all this testimony and the responses to the questionnaires we get and actually produce some tangible specific recommendations. And I take it that the -- you know, the thrust of your remarks were really directed at 404, but I'm wondering from your unique position in funding small companies having to consider whether to go public or get acquired and then see some of them go public, is there anything else in Sarbanes-Oxley and all the changes to the SR listing standard and so on, there's just so many of them, it's hard to lump SOX in one bucket and say, "This is good," or, "This is bad." The loan prohibition director independence, are the small holes in the fishing net primarily 404, or do you have sort of a second and third and fourth level kind of issue with some of the other changes?

MR. FEDERMAN: Just to summarize what I did intend to say and what I didn't intend so say, I did not intend to say that our intentions to grow these companies or help them to grow to become publicly held companies have changed. And I fully agree with Bill's comments; the maximum value that's going to be realized will be from a liquid security in which the people who are making the company happen are still committed to its future growth. So nothing in Sarbanes-Oxley or 404 has caused us to divert our attention and our desires from that outcome. I was addressing the issue much more broadly. I think that there are measurable costs, but I fear that there are very heavy non-measurable costs.

And I think that the Committee should be trying to take a broad view of what the object of the exercise is and how to accomplish that without causing a cultural change within the operations.

MR. WANDER: With that last comment, let me move on to John Hickman. And I'm sorry, by the way, Michael, you're in the sun, and so is Chris.

MR. AILMAN: The sun's moving.

MR. HICKMAN: I too would like to thank the Committee for this opportunity to speak to you today. Let me just introduce myself. My name is John Hickman, I have worked in the capital markets for the last 25 years. For about 25 years I was a money manager with various institutions managing primarily small cap, aggressive equity portfolios for institutions. At one time I managed or was responsible for about a billion and a half dollars. More recently, I've become a sell side analyst focusing almost exclusively on small or microcap companies in the life sciences and technology arenas. So in one way or another for the last 25 years or so, I've made my money as an investor.

What I've noticed -- or a lot of what I was planning on saying has been said, so I'll just go to the practical items. What I've noticed in speaking with the management teams that I have become acquainted with over the last few years of companies that I follow very closely is that they are complaining about the costs of implementing SOX and particularly 404. There have been comments that in some respects this exercise has been beneficial to some of the their operational procedures, but by and large, the benefit has -- or the costs have exceeded the benefit. And in my practice looking very, very closely at companies to decide whether to recommend them or to buy them -- I mean recommend them as buys or sells or whatever, I have noticed that companies are spending, particularly very small companies, are spending a lot of money implementing these new regulations.

And some of it, I believe, is redundant, I think it's nit-picky, I think some of it is not material. And that these costs, like Mr. Federman said, are -- some of them are measurable, but when you get down to actually valuing the company and what the company might have been worth without those costs in the equation is a very, very difficult exercise. Just what I think is happening here is it's in some ways lowering the return on -- it's lowering the return on investment that an investor can expect from a small micro or microcap company. And I think that in some instances, projects are not getting undertaken, they're not getting implemented, investments are not getting made. I think it hurts innovation, I think it hurts technological advancements, I think it hurts job creation.

And so I would -- at the same time I do appreciate the need for accurate transparent financial statements, and I do think that the intent here is valuable and worthwhile, but I think that like the regulation that large institutional broker-dealers have to deal with versus what small institutional broker-dealers have to deal with, those are -- there's a very different set of regulations that take into the fact that some companies have ten employees and some companies have ten thousand employees. And I think that that type of differentiation in SOX 404 should be implemented to benefit the smaller microcap companies.

Just if I could cite one example, I'm intimately involved in a small biotech company out of Tennessee. This company has roughly eight full-time employees right now, they're a development stage pharmaceutical company. They are not a filer now, they are a delayed filer, but they anticipate that they will have to be compliant mid next year. And they anticipate that compliance for them will include the addition of another full-time equivalent individual to that corporate staff. And in my mind, that's not a productive asset. That company is having to spend money on a non-productive asset. And that's a detriment to the whole -- to the value of that company. And if you multiply that effect across hundreds of thousands of small companies in this country, I think it's a waste. I think it's a huge waste of productive assets, or assets that could be invested in other places.

And you know I can't prove this, but we've been through a pretty nice economic recovery in the last couple years here in the United States. And individuals in my industry, you know, in the Wall Street investment world are still puzzled over the lack of robust pick-up in IT spending in this country to go along with the economic recovery. And one of the factors I believe strongly is that companies are unsure of the costs of Sarbanes-Oxley and the regulations, they're unsure of the costs that they're incurring right now, and they're unsure of what it's going to cost them down the line. And I think it's having an effect on the monies that they might otherwise put into that segment of our economy. And that's the end of my remarks.

MR. WANDER: Thank you very much, John, and we'll open it up for questions. Everybody must be hungry.

MR. HICKMAN: I did have one other comment in answer to Mr. Jaffee's question earlier. You know, I think this whole issue of is it okay to have management sign off and not have an auditor sign off, I think it goes ultimately to the quality of managment. And that's up to, you know, the information available to the investing public.

MR. JAFFEE: I totally agree.

MR. WANDER: Sure there are no other questions?

MR. CONNOLLY: Herb, now that you're asking, my name is Drew Connolly --

MR. WANDER: That was a cue.

MR. CONNOLLY: Principally because of your background as an equity analyst, I'm interested in your perception of the lack of research in the microcap space and whether or not a solution to that can be found either in company sponsored research free of conflict and with disclosure, or whether or not there's another format such as the proposed, you know, three-year -- this group and the NASD has proposed an alternate. How do you see research -- obviously you see it as valuable because that's what you do for a living, but how do you see it encompassing the microcap space in a better way, and how do you get paid for it?

MR. HICKMAN: Well, I do think sponsored research has a role. I think there's some quality companies out there doing sponsored research. And it might be one of the easier ways for companies to get initial notice from Wall Street. But I do think that there -- somebody made a comment earlier about markets making knee jerk reactions. I do think that in the past, we had more broker-dealers focused on researching smaller and microcap companies, and that through the decade of the '90s, many of those broker-dealers got bought up, acquired, and are now part of much, much larger institutions.

I think what I'm seeing right now is kind of a resurging of many smaller broker-dealers who are finding their niche in focusing on companies that have traded on the Bulletin Board and even Pink Sheets that are in this microcap space where there is no research where you can do very -- where you can have a real value added component to what you as a small broker-dealer can provide Wall Street. And so I think there's a mini resurgence going on in that area, and that's how we're getting paid right now. I mean, my -- the firm I work for now has 20 people in it, and that's our whole focus is analyzing and coming up with companies that no one else follows.

MR. WANDER: We're going to move on to Mr. Shapiro.

MR. SHAPIRO: Good morning, ladies and gentlemen. Thank you for this opportunity to share some of my views. I'll try to tie in some of the comments of my fellow panelists as well as some of your questions to move through this. My name's Andrew Shapiro, I'm the president and portfolio manager of Lawndale Capital Management. For the past 13 years, Lawndale has managed funds that specialize in relational and activist investments in micro and small cap companies. As a results of this active approach to investing, I've often times served personally as board member or a board observer in some of our portfolio companies.

Presently I'm independent Vice Chairman of the board and chair the corporate governance and nominating Committee of Arlington Hospitality, and until last year I also served a unique role somewhat in a public company, it's common in venture capital private entities, the role of board observer of another Lawndale investment Earl Scheib, which recently deregistered as a public company and no longer files SEC reports or is pursuing any compliance with SOX and trades infrequently on the Pink Sheets.

Through this experience, I'm aware of the costs and burdens, thus, of implementing governance and other regulatory change, I've also witnessed the many benefits derived from some of these reforms. To tie in some of the comments made here by the panel at the table, I think there is a relationship with the amount of director independence, qualification and active involvement with that of the amount of regulatory mandate that might -- that has been promulgated and may either need to be weakened or strengthened. And I think they are not usually exclusive. They go hand in hand.

And to help illustrate that, in 1999 we drafted and forced implementation of one of the strongest governance bylaws, then ever adopted by a public company, into a company called Quality Systems. The bylaw targeted improving QSI's board independence and functioning, and it was opposed by the company's Draconian and considered out of the main stream by many of the investment community. Yet as a result of these reforms, it's created a new and more independent and active board and management changes, Quality Systems has flourished. Since 1999, actually since the fiscal year ended March of 2000, this company's revenues more than doubled, the profits have grown more than five times, investors have also placed a far higher premium on this improved operating performance resulting in a market value that increased steadily through one of the worst bear markets in our history, an amazing 1200 percent over the past five years. The point should be clear is that I, and my firm, we firmly believe that good governance adds shareholder value.

Now, what was in this bylaw and why did I bring it up? It required that 100 percent of all key board Committees and the super majority of the board as a whole consist of independent directors. Further, it called for an independent chairman or a lead director to lead at every board meeting and executive session of independent directors. Now, do these reforms which we successfully fought so dearly for in 1999 sound familiar? Because they are now only last year adopted as minimal governance standards of the exchanges. I do think that those standards that were put in have greatly enhanced accountability, and with strict enforcement on the independence standards and other issues, will lead to better operating performance, the right decisions being made. Not only the tone at the top and within management, but also with respect to financial controls and other issues.

Now, I have heard comments made, I think some of those comments are being evaluated by the Committee and such, I think even one or more of the commissioners of the SEC have commented that we have had a lot of reform and maybe it's too much all at the same time, SOX and other things piled on it. I heard that in particular in response to proposals to allow shareholder owners to have open access towards nominating alternative slates of directors to put them on the boards to enhance accountability, independence, etc. And the issue here is that maybe there's a lot of governance and a lot of new rules that have been proposed on small companies and microcap companies, but certain ones have soft costs, certain ones can be implemented. And I will acknowledge, with a few comments shortly here on SOX, that there are some hard costs that create somewhat of a flat tax that may be excessively onerous for the smallest of public companies.

Some individuals representing management interests contend that the minimum governance standards are examples of regulation itself run a muck. Both the investing public and companies have benefitted from having directors who are independent, qualified, and actively involved. Minimum governance standards and increased public scrutiny from corporate scandals, I think in recent years have raised the bar for directors at all companies. It's certainly harder to find directors, as some who complain about this regulation, but it's -- their issue is it's harder to find directors who are willing to be controlled or lulled into inactivity by management. I think there was some good comments recently made by Lynn Turner, I think, in his Glass Lewis letter to this Commission that was filed just this last week that I had seen, and I would echo those concerns. I am a member of the National Association of Corporate Directors. They have a director registry. The FEI is another. There are plenty of people who are willing to serve as directors of companies, but they're never called, they're never tapped. And I think there is still a reason. That culture has to change. And if this Commission and this Committee can help promulgate rules and areas in this way, I don't think it's necessarily hard costs.

Now, while I believe rules governing board independence and function ought to be improved and maybe even strengthened further, I'm also cognizant of the cost to the very smallest of companies of the other recent regulatory mandate such as SOX 404. And I consider it and I think many here view the idea that a fixed cost from a one-size-fits-all mandate are like a flat tax rather than a progressive tax because of the disproportionate burden such mandates create on small companies. It doesn't mean the mandate shouldn't exist, but the mandate should be used sparingly and set at levels that do not completely close out public market access to smaller companies. So in contrast to the alleged increase cost of improving the boards of directors and other governance standards, I view the cost associated with present SOX 404 standards to be real and substantial, and actions, I don't know if I have any specific ideas unfortunately for your Committee to reduce the cost, again, I would leave that to vendors and agents here who are much more trained in the audit area. But I am concerned about the high costs that serve to close public access to an unreasonably large number of the smallest of companies.

Now, when I refer to that, I saw a table, I think it was in the Glass Lewis analysis, it might have also been in your work where you defined what was a small cap, I think you called it, in what is a microcap, the one percent and six percent rules. What I'm referring to here is the one percent. There's still an enormous amount, I think it was 50 percent of all the public companies that were below the one percent measure. That is where my concern is. I think the above one percent measure the current SARBOX standards ought to be adhered to. I think there's an issue that was created when the phase-in was initially announced, it was too tight. You created a Y2K -- they created a Y2K kind of problem where you had a small amount and a reducing amount of vendors, accountants, etc., being required to provide all these services and that created, I think, possibly inordinate costs.

So above the one percent level keeping the SARBOX as it is with particular phase-ins might -- and other steps you may recommend to reduce the cost might have, I think, good and positive impacts. When it gets down below the one percent, I think we should think about something here which is there exists multiple tiers of public market listings, from Pink Sheets to Bulletin Board, small cap listings, and the National Market System. This existing tiered market structure provides a ready mechanism for investors to freely differentiate between companies that carry greater risk and require a higher cost of capital. And those are -- because they meet higher standards will likely obtain more favorable valuations.

A similar illustration is frankly also found in the fixed income market where pricing varies based on credit rating. The tiered exchange rules are objective primarily to market cap liquidity presently while the credit rating system is a qualitative system, yet both work to allow the free market to price risk. So a more progressive system that would not result in so many small companies being, in effect, taxed out of the public markets would be one that allowed some public market access, but I do believe that if you did it that way, like a SARBOX or COSO Light in terms of your standards, you need to have full disclosure of the attendant risks of the weaker controls.

I'm not arguing for no controls, I like the concept someone tossed out as long as there's legal liability, and you can have senior management, CEOs and CFOs really legally on the hook, maybe you can get to a point where you have a certain level. And then the issue is do you provide that extra belt and suspenders of the external verification? Well, maybe at the above one percent level. I do not believe and agree as an owner of the businesses in both above the one percent and below the one percent size that companies with market caps, and I think you're cut-off of the one percent was 75, 100 million, somewhere around there?

MR. WANDER: Probably a little over a hundred.

MR. SHAPIRO: Okay. I believe companies with that kind of market capitalization can afford, with other recommendations you may make to reduce the cost, they can afford and ought to be doing the regular SARBOX. But in terms of the SARBOX or COSO Light, below that level, it only should come if you could have, one, the full disclosure of where the company stands, some form of rating system, some form of market tiered system that investors are fully aware of the attendant and the increased risks that come along with the weaker credibility, possibly, in the numbers. Okay? And at the same time, I think you cannot roll back even in those smaller companies because you rely on this other issue; the governance, independence, accountability standards with respect to the boards of these smaller companies. Because if you get an independent active qualified board in these smaller companies, those board members will do quite a bit towards having a company internally compliant with the SARBOX type standards which we want. Because no board member's going to want to be on the hook with faulty or bogus numbers, they're going to want certain levels of internal control.

Okay. Last, or final points. As you do this, or even if you didn't do this, as an investor in companies that are in the Pink Sheets, I know Drew's asked this question of others, I'm going to -- I have invested in companies in the Pink Sheets, I have many companies that have, for rising costs of being a public company, not just limited to SARBOX, but certainly SARBOX has been a contributor, have gone to the Pink Sheets. There is a problem, a big problem because there's so many public companies now that are in this market cap range that are moving this way, of what you probably heard elsewhere of going dark. And there needs to be some way within the SEC Division of Corp. Fin, somewhere in the Edgar databases for a third-party vendor where financial statements, financial information on these companies can be mandated.

Because somewhere in the discussion earlier today there was this talk about, well, these companies are too small to be public, they should be out of the public domain, and they could just get bought out. The problem, and Bob Robotti brought up succinctly, is until these companies are bought out and held by their own private investors who may want to pillage from themselves, it is inappropriate to allow those companies to pillage from minority shareholders who are stuck in the dark area of the Pink Sheets. We need to find a way, frankly, of raising certain disclosure obligations in a cost efficient or cost effective manner, not necessarily having to subject those small ones to the SARBOX, maybe SARBOX Light. But there needs to be some way to improve the breadth and level of disclosures in those market tiers.

And if you did that, you'd have a more effective system, whereby now you can have these small companies be the SARBOX Light and not closed completely out of the financial markets. Think of the yield requirements of a AAA bond and then think of the yield requirements of a company that is below junk bond status. Big gap. Okay? If you could find ways of finding homes in the public access to markets for these various companies without closing off completely public access, so high up in the market cap for many good companies, you won't -- no offense to my venture capitalists on the right, they require in the leverage buy-out world, private equity world, or the venture -- you know, new industry area, they require very high IRRs, return on capital. And the public markets require less. They just do. But we need to find a way of keeping that gap low.

So I'm open to questions with this final comment for the Committee: As you deliberate and hear the testimony regarding recent regulatory reforms, do not forget that while costs and burdens may be present and tangible, the benefits of these reforms often come over time and are not always easily measurable by value added, but often also create tangible benefits by value that is not lost. And please keep that in mind as you do your cost benefit analysis.

MR. WANDER: Thank you very much. And Drew? Any questions? Yes, Drew.

MR. CONNOLLY: Mr. Shapiro, my name is Drew Connolly. I'm delighted to, in the third of our public hearings, meet a Pink Sheet investor. Thank you very much for your confidence there.

MR. SHAPIRO: And I was a late add.

MR. CONNOLLY: And I might want to add, the president of the Pink Sheets is in the room. And that begs the question of why the demarkation is so strong? Our previous testimony from Mr. Colson has really been very much a strengthening of the disclosure regime for the Pink Sheets within the non reporting arena, voluntary reporting and other --

MR. SHAPIRO: Echoing my suggestions.

MR. CONNOLLY: Correct. And my sense of it is that there are already -- and speaking as a former broker, I recall a number of the penny stock rules. There are already major distinctions and speculative warnings, if you will, toward investments in both the Pink Sheets and the Bulletin Board, and the penny stock letter that one would have to sign that essentially says you're a riverboat gambler, prepared to lose all your money, etc. The fact is the corporate governance standard that you have initiated within your world, I endorse whole heartedly.

The question, I guess, becomes how to, since there is no institutional capital in the Pink Sheets and very limited institutional capital, we have heard here today, in the Bulletin Board, that leaves the individual investor solely invested in places like the Pink Sheets and the Bulletin Board. How do we find a way to allow them to continue to make those investments and fund the innovation and balance that with some level of investor protection?

MR. SHAPIRO: You know, I appreciate the question, but I actually need you to clarify it a little bit as to what you were asking.

MR. CONNOLLY: Okay. Is it your sense that the governance issues, the independent director issue by and of itself, would you support, for example, voluntary reporting as a -- as Mr. Coleson had suggested in order for the insiders in these Pink Sheet companies to essentially liquify their holdings, there needs to be some current disclosures in place. How do you --

MR. SHAPIRO: I guess I'm more militant. I would require that there be a certain amount of financial disclosure via low costing EDGAR or otherwise systems that exist that should be in place for those companies, not only -- not simply to allow the insiders to trade or not, but that there ought to be an increased level of obligation. Now, some of that may be in the purview of state law. Under Delaware law, I can, and I do at Lawndale, I will go make a records request. We will go after these pink sheet companies that do not provide the financials and we will get them out of them. But the poor little individual investors can't necessarily easily avail themselves to Delaware counsel to go do these things.

I, frankly, think that some modest level of regular reporting ought to be mandated in those tiered levels. It's just too far of a -- it's like a big huge water fall, but it's Niagara Falls and it isn't just some little brook. And it is because of that we have this bright line that I think has exacerbated the pain and suffering of SARBOX 404 and other large fixed cost mandates, we have this bright line of either you have access or you don't. And some argue that, well, you shouldn't have access if you can't comply with that. That's fine. It's just was the minimum standards and the minimum tests of SARBOX and COSO really taking into account a good chunk of the public companies in America, or was it targeted towards the very largest companies where you just had billions and trillions of dollars lost? All these pensioners at CALSTRS -- it's ridiculous.

And it's the right goal, it's the right attempt, and it needs tweaking, it needs fixing, and it needs cost reduction. And then we still need the issue of not making this a Niagara Falls, find some way where the free markets, where investors can appropriately price premiums and discounts for risks. How do we know what risks? I think it comes from disclosure.

MR. CONNOLLY: Thank you very much.

MR. WANDER: And Alan, and that will be our final remark before we break for lunch.

MR. BELLER: I just really want to close the second -- I first want to Marc, from your point of view, anything you want to add before lunch?

MR. MORGENSTERN: Is that why you took the microphone?

MR. BELLER: Yes.

MR. MORGENSTERN: No. I just want to thank the SEC and you personally for all the good works that you do, Alan.

MR. BELLER: You may.

MR. MORGENSTERN: I was just going to say, for those of you who don't know, I went to college with Alan, so I have known him for about 40 years now.

MR. BELLER: Twenty years.

I want to thank all of our panelists, both the current panel and the panel that was on before. I think the remarks have been extremely illuminating. I think they've given both the Forum and the Advisory Committee a good bit to chew on. The chewing for the Forum, I guess, will proceed immediately after lunch with the breakout sessions that are scheduled and are indicated in the program. The Advisory Committee is going to get together. I don't know what their informal arrangements are, but they're going to get together for a public session tomorrow morning at which those recommendations will be presented. And I think we're going to hear some testimony from Larry Rittenberg of COSO, and we'll go from there.

I think this was very, very interesting, and again, I thank you all. I thank the participants of the Forum for listening with us, and I'm sure that the discussion this afternoon will be interesting. I ask you all -- we're all heading to lunch where we're going to hear from Commissioner Atkins. Thank you very much.

(Proceedings adjourned.)

CERTIFICATION

I hereby certify the accuracy of this record of the proceedings of the SEC Advisory Committee on Smaller Public Companies.

Herbert S. Wander
Committee Co-Chair

11/22/05
Date

Index of Written Statements Received

Listed below are the written statements received by the Advisory Committee between its meetings of August 14, 2005 and September 18, 2005 and the dates of receipt.

Sep. 19, 2005	Larry E. Rittenberg, Chair, Committee of Sponsoring Organizations of the Treadway Commission
Sep. 19, 2005	Kurt M. Swenson, Chairman/CEO, Rock of Ages
Sep. 14, 2005	Robert N. Beury Jr., Chief Legal Officer, Cogent Communications, Inc.
Sep. 13, 2005	Gayle Essary, Managing Director, Investrend Research; CEO, Investrend Communications, Inc.; Executive Director, FIRST Research Consortium; Administrator, Shareholders Research Alliance
Sep. 12, 2005	Gerald V. Niesar, Niesar, Curls Bartling LLP
Sep. 12, 2005	Jean Harris, Greenburg Trauring, LLP, Phoenix, AZ; Stanley Keller, Palmer & Dodge LLP, Boston, MA; A. John Murphy, Wickersham & Murphy, Palo Alto, CA; Ann Yvonne Walker, Wilson Sonsini Goodrich & Rosati, Palo Alto, CA; Gregory C. Yadley, Shumaker, Loop & Kendrick, LLP, Tampa, FL
Sep. 12, 2005	Steven S. Heinrichs, Vice President, General Counsel and Secretary, Neenah Paper, Inc.
Sep. 12, 2005	Gregory C. Yadley, Jean Harris, Stanley Keller, A. John Murphy, and Ann Yvonne Walker
Sep. 12, 2005	Gerald V. Niesar, Gregory C. Yadley, and Faith Colish
Sep. 07, 2005	Maureen H. McMeekin, MS, Executive Partner, San Francisco, California
Aug. 29, 2005	Susan Strausberg, President and CEO, EDGAR Online, Inc.
Aug. 23, 2005	Ron Hansen