Report of the Size Subcommittee

to the

Advisory Committee on Smaller Public Companies

August 10, 2005

Introduction

Mr. Jim Thyen

Co-Chair, Advisory Committee on Smaller Public Companies

Chair, Size Subcommittee

Background on the Size Subcommittee

- Subcommittee Objective
  - To give the Advisory Committee a recommendation on defining "Smaller Public Company"
- Overarching Principles of the Advisory Committee
  - Further Commission's investor protection mandate
  - Seek cost choice/benefit inputs
  - Keep it simple
  - Maintain culture of entrepreneurship
  - Capital formation should be encouraged

Background on the Size Subcommittee

- Subcommittee Members
  - Jim Thyen (Advisory Committee Co-Chair)
  - Herb Wander (Advisory Committee Co-Chair)
  - Alex Davern (Internal Controls Subcommittee)
  - Dick Jaffee (Corporate Governance and Disclosure Subcommittee)
  - Patrick Barry (Accounting Standards Subcommittee)
  - Richard Leisner (Capital Formation Subcommittee)

- SEC Guidance
  - Gerard LaPorte, Chief, Office of Small Business Policy, SEC Division of Corporation Finance
  - Cindy Alexander, Assistant Chief Economist for Corporation Finance and Disclosure, SEC Office of Economic Analysis
  - Kathleen Hanley, Economics Fellow, SEC Office of Economic Analysis

- Process for Determining the Recommendation
  - Analytical support from the SEC staff
  - Analytical support and proposals from the "Size" subcommittee members
  - Extensive teleconferences, with active participation by all subcommittee members
  - Oral and written presentations to the Advisory Committee

Purpose of Presentation

- To seek:
  - Approval of the “Size” subcommittee’s recommendation
  - Approval of a working definition for other subcommittees
  - A good awareness of our work
  - A sound understanding of the supporting facts we used
  - An appreciation for the logic and reasoning applied in the formation of our recommendation

Purpose of Subcommittee’s Recommendation

- The purpose of the recommendation is to provide an umbrella under which the four subcommittees can bring forth recommendations that are meaningful for their specific end goals.

- To alert the SEC of our definition strategy and direction to enable their concurrent thinking of application.

  (Note: this recommendation does not preclude any subcommittee from recommending alternative metrics to be used for specific regulatory issues relevant to their work.)

Recommendation

Alex Davern

Internal Control Subcommittee

Factors Considered for Recommendation

- The SEC has asked the subcommittee to consider providing recommendations as to where and how the Commission should draw lines to scale regulatory treatment for companies based on size.

- The SEC has directed the subcommittee to consider whether the costs imposed by the current securities regulatory system for smaller public companies are proportionate to the benefits, to identify methods of minimizing costs and maximizing benefits, and to facilitate capital formation by smaller companies.

Factors Considered for Recommendation

- Smaller companies are inherently less able to take advantage of economies of scale, so the relative cost of regulation increases dramatically for smaller companies, resulting in situations where the benefits do not justify the costs.
- The regulatory burden may have a negative impact on capital formation by small companies
- Investor perception of risk is different relative to small versus large companies.
- Investors currently allocate companies to different categories relative to size.
- Most large institutional fund managers consider a stock with a market capitalization value of under $1 billion to be a smaller capitalized stock.

Factors Considered for Recommendation

- An excessive regulatory burden may encourage smaller companies and foreign issuers to avoid becoming public issuers in the U.S., weakening our capital markets relative to foreign exchanges.

- There are multiple ways to categorize “size” for public companies (e.g., market capitalization, revenue, number of employees, etc).

- The failure of a smaller public company will pose a significantly lower threat to the U.S. capital markets than the failure of a large public company.

- One of the Advisory Committee’s role’s is to further The Commission’s investor protection mandate.

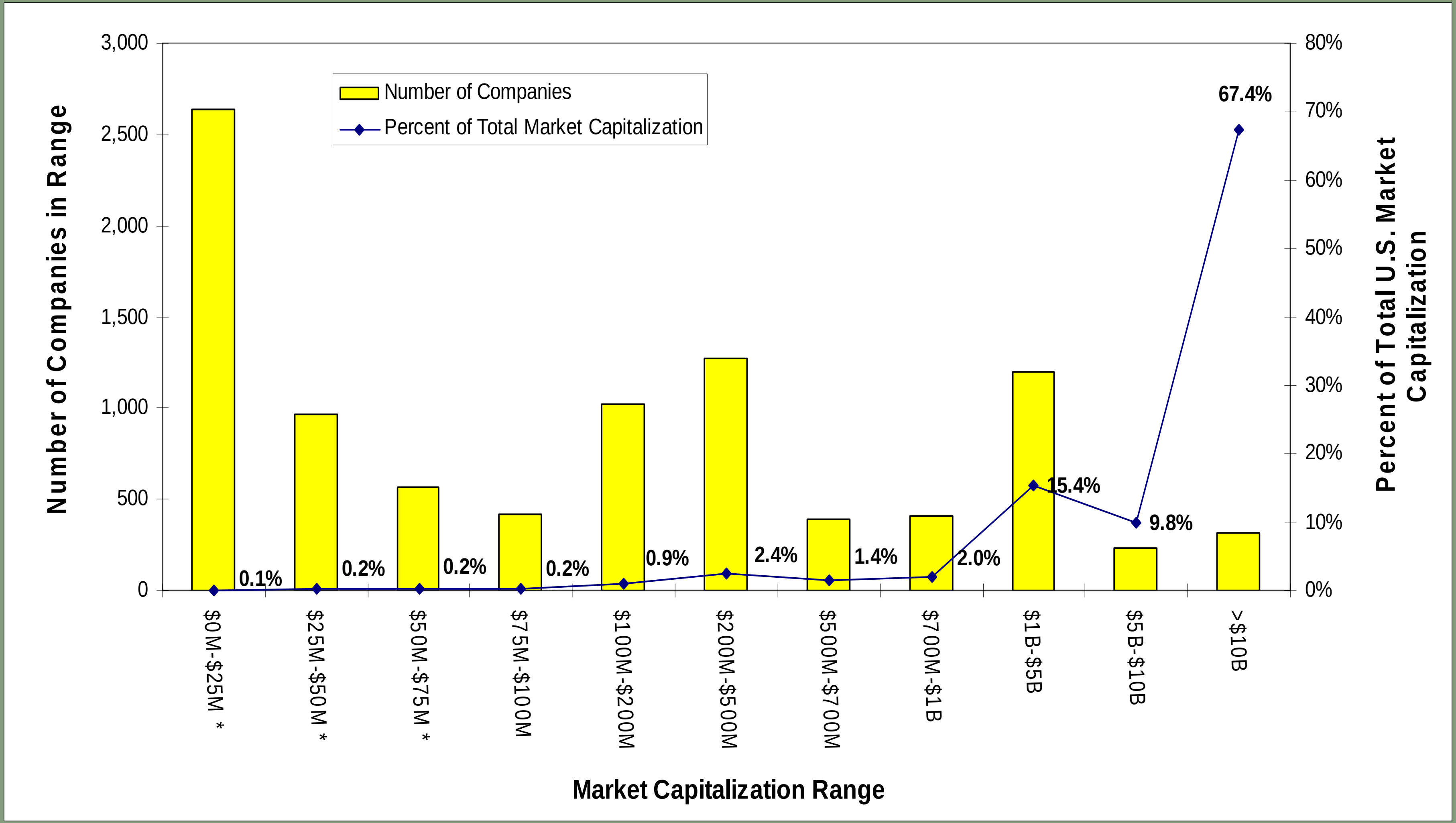
Some of the data the Subcommittee considered and related conclusions

CONCLUSION No. 1

At the macro level, smaller companies represent a significantly smaller risk to the capital markets.

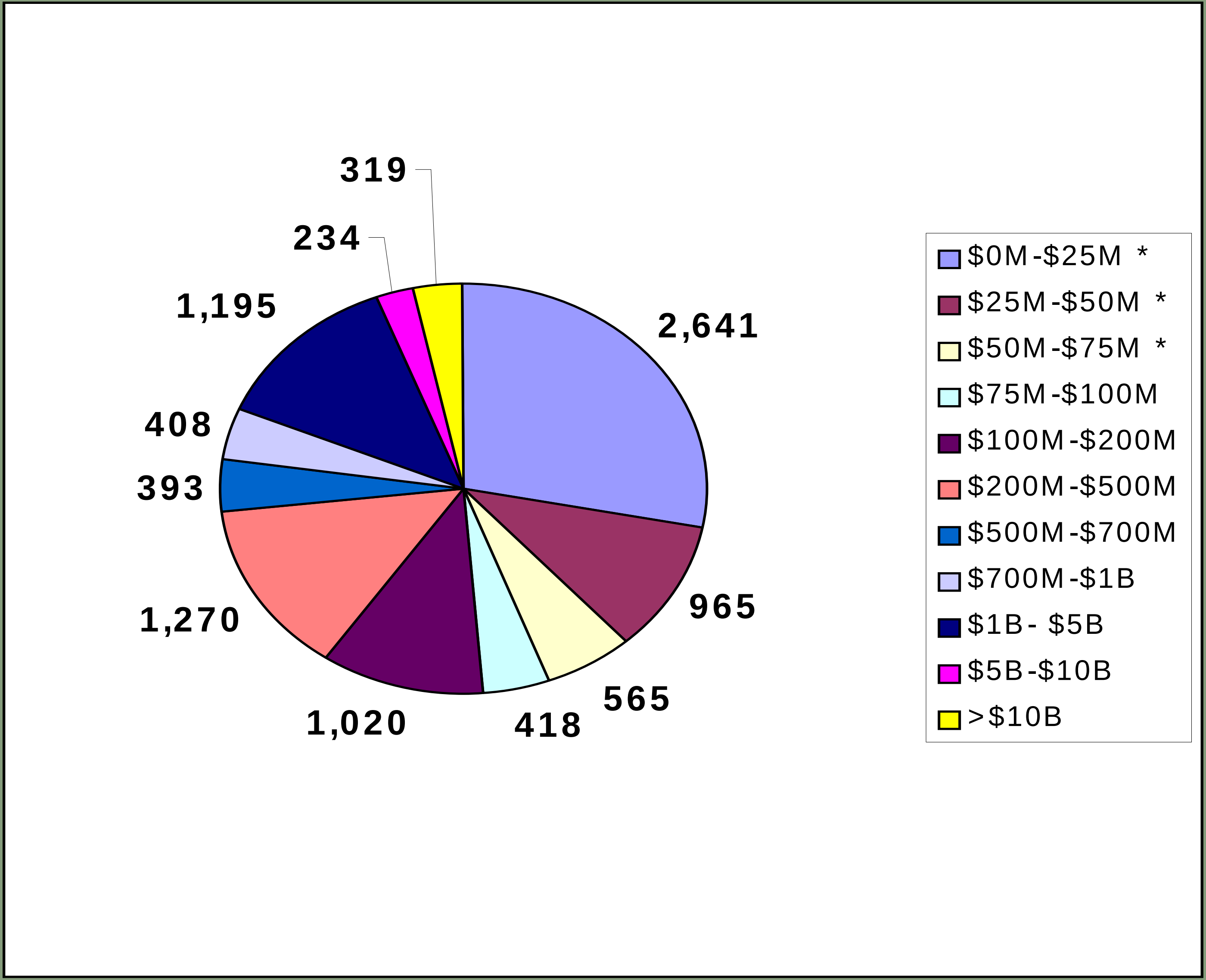
Distribution of Public Companies

(Investor Risk)

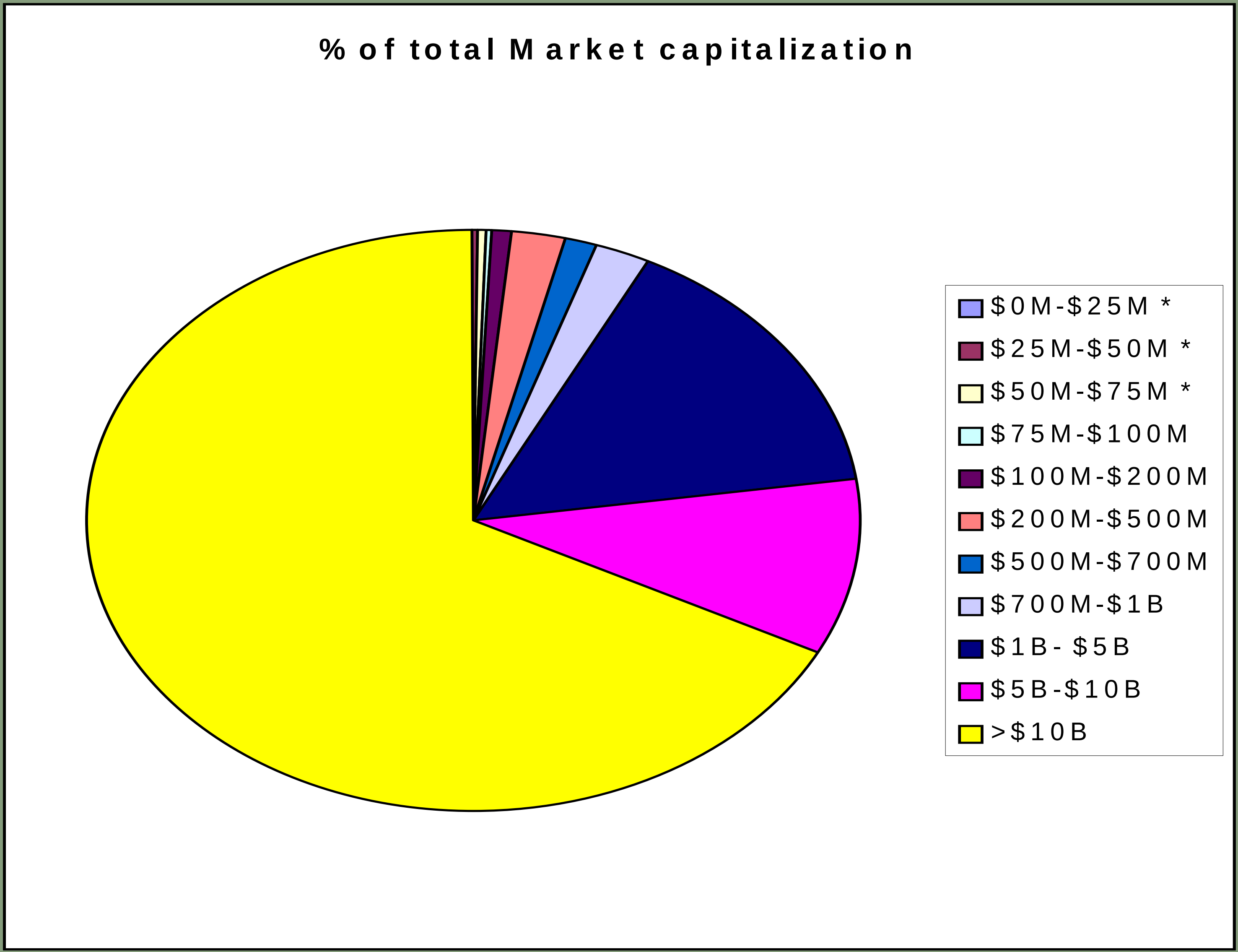


Source: *Background Statistics: Market Capitalization of Public Companies*
June 7, 2005; SEC Office of Economic Analysis

Distribution of public companies by market capitalization



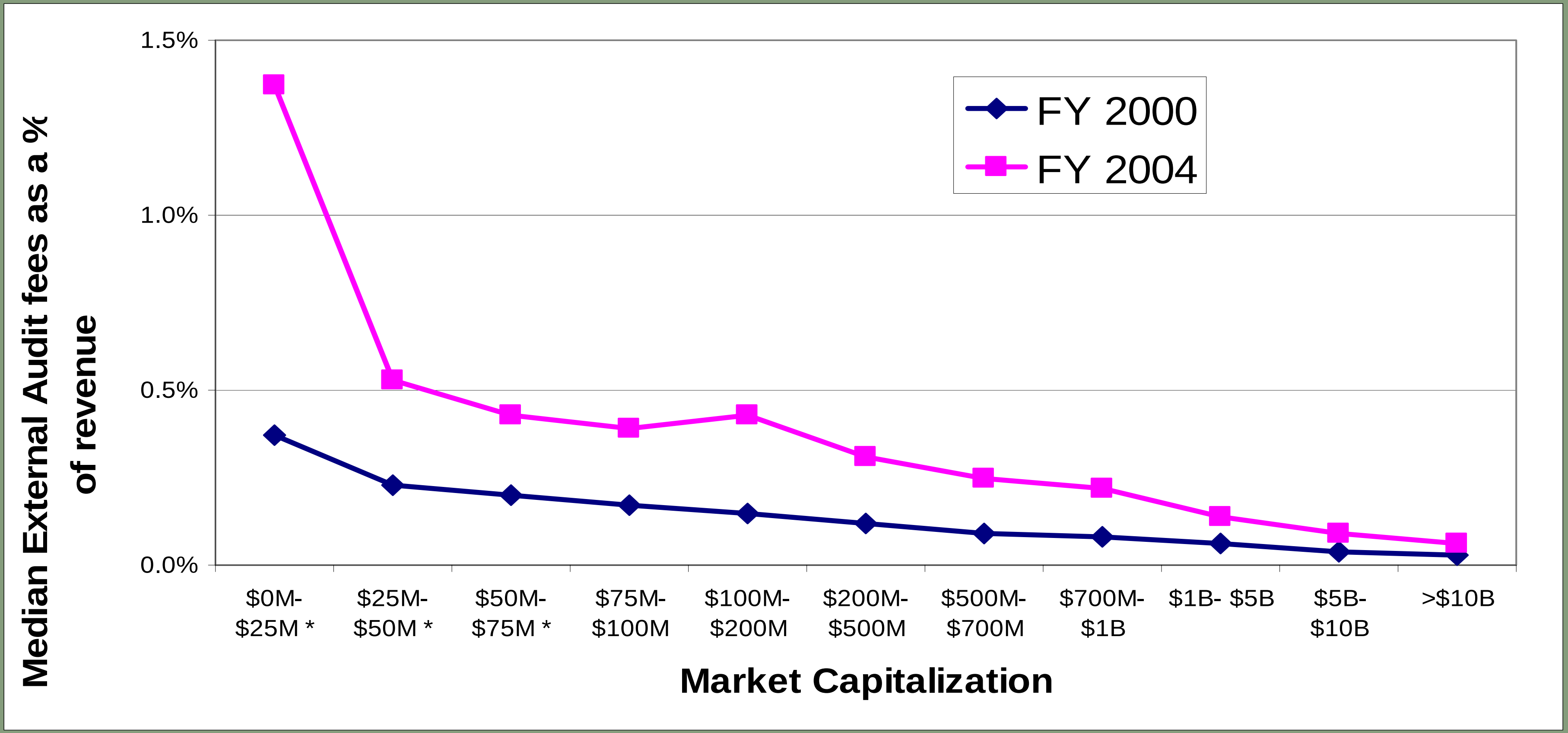
Distribution of market capitalization



CONCLUSION No. 2

The relative regulatory burden is not proportional for smaller public companies as they are currently defined.

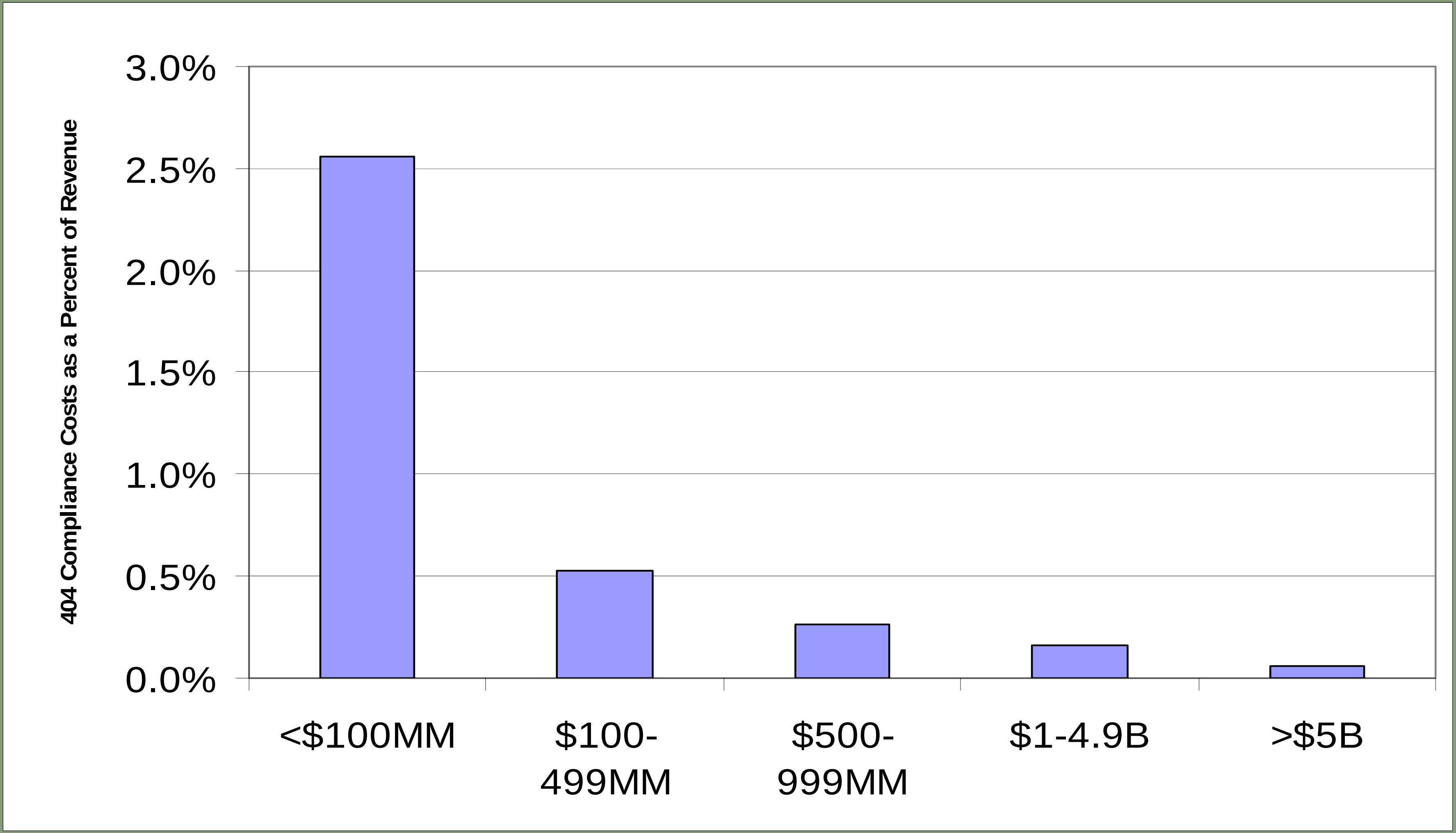
Median External Audit fees as a % of revenue



* Companies with a market capitalization of <$75M generally did not have to comply with Section 404 of Sarbanes-Oxley in 2004. It is expected that their audit costs will be much higher when they are required to comply.

Source: *Background Statistics: Market Capitalization of Public Companies* August 2, 2005; SEC Office of Economic Analysis

Example - Much Higher Relative 404 Compliance Costs for Smaller Public Companies



Source: American Electronics Association (AeA) Report on Sarbanes-0xley Section 404, *The 'Section' of Unintended Consequences and its Impact on Small Business* February 2005

CONCLUSION No. 3

Investors recognize that smaller companies carry greater investment risk.

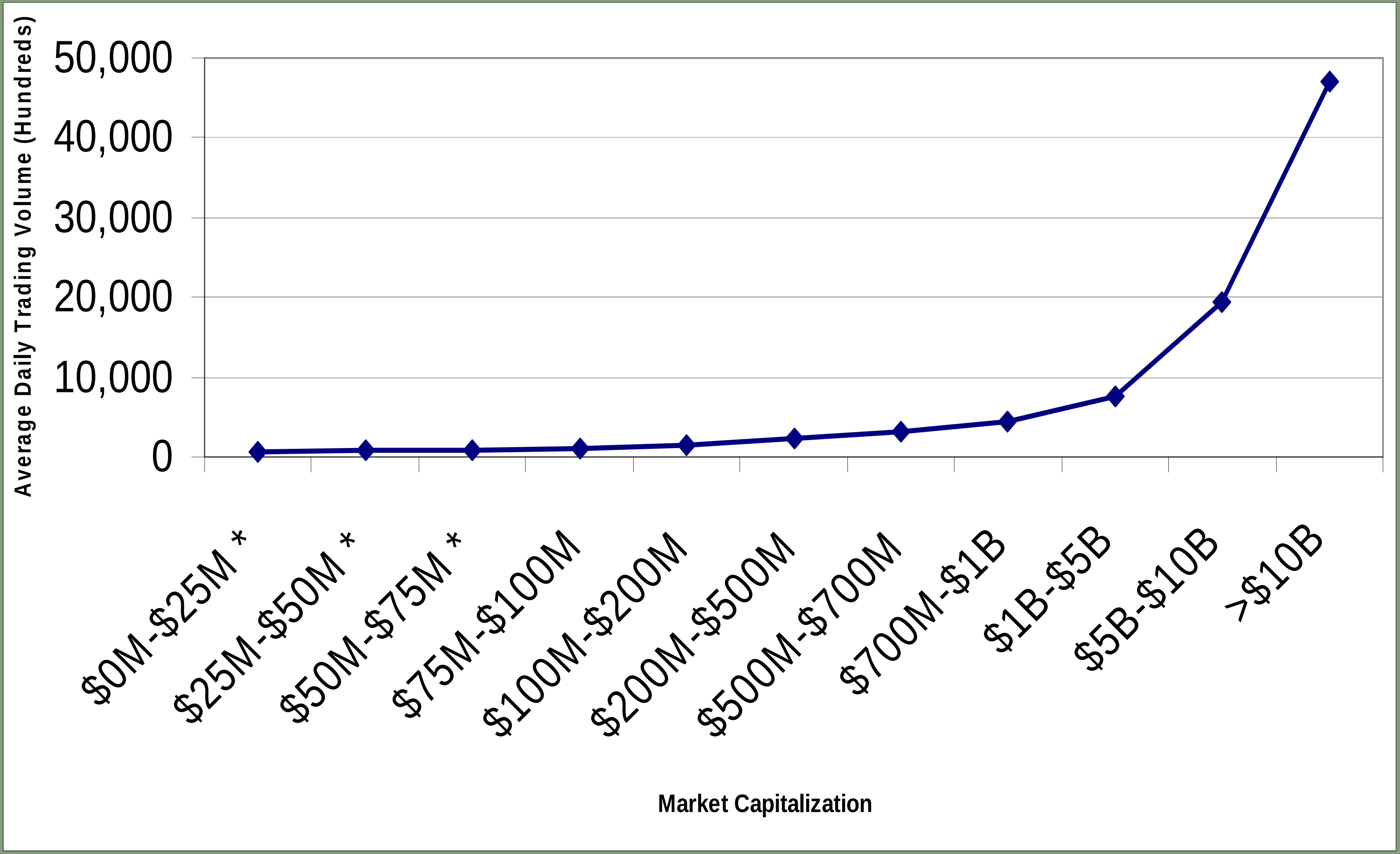
Investor Perception of Risk Relative to Size

- Investors currently allocate companies to different categories relative to size.
- Smaller companies are generally considered to have higher business risk.
- Most institutional fund managers consider a stock with a market capitalization of <$1B to be a smaller capital stock.

CONCLUSION No. 4

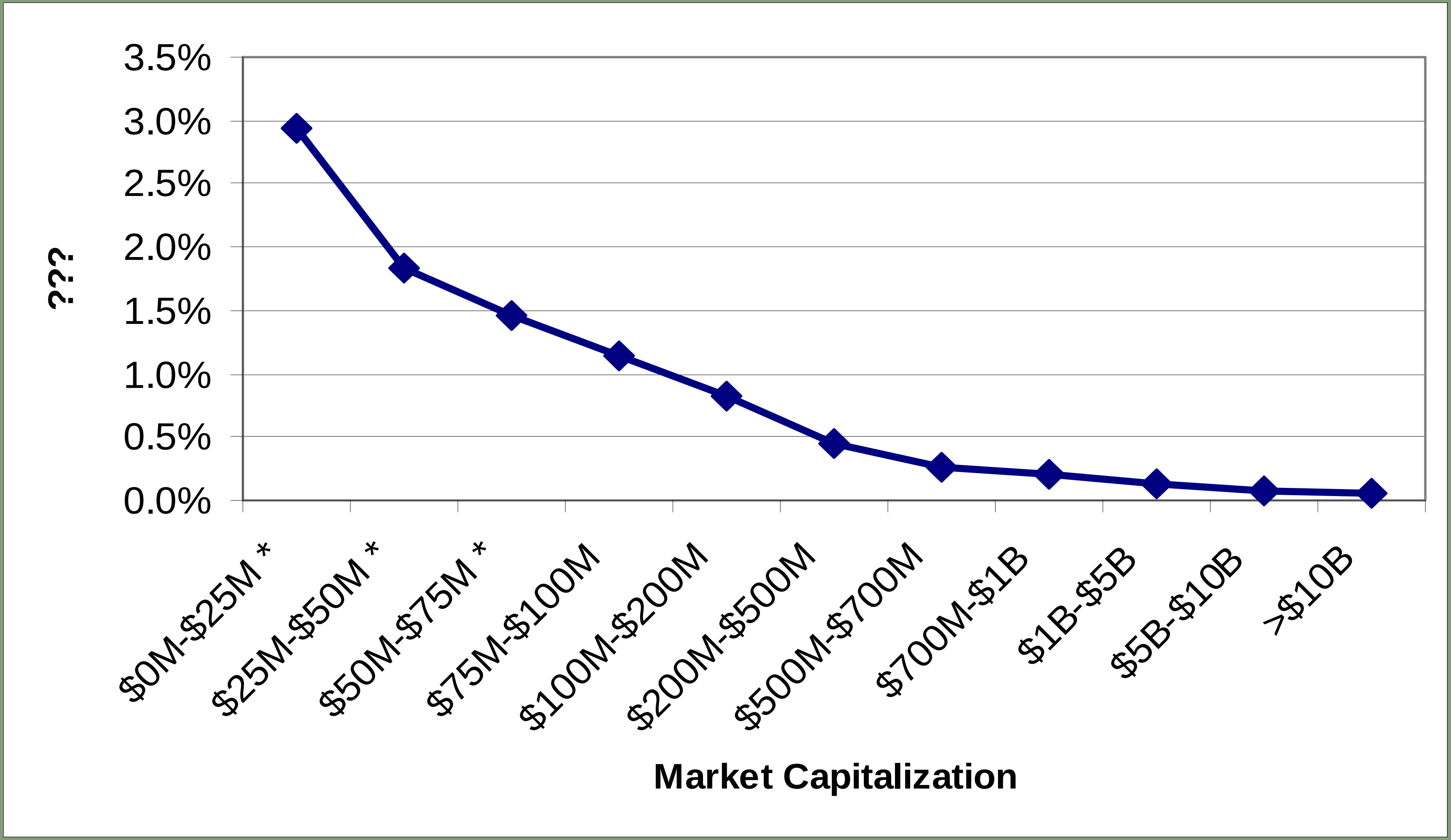
Smaller companies face different market conditions. The market for smaller companies is less efficient.

Trading Volume by Market Capitalization



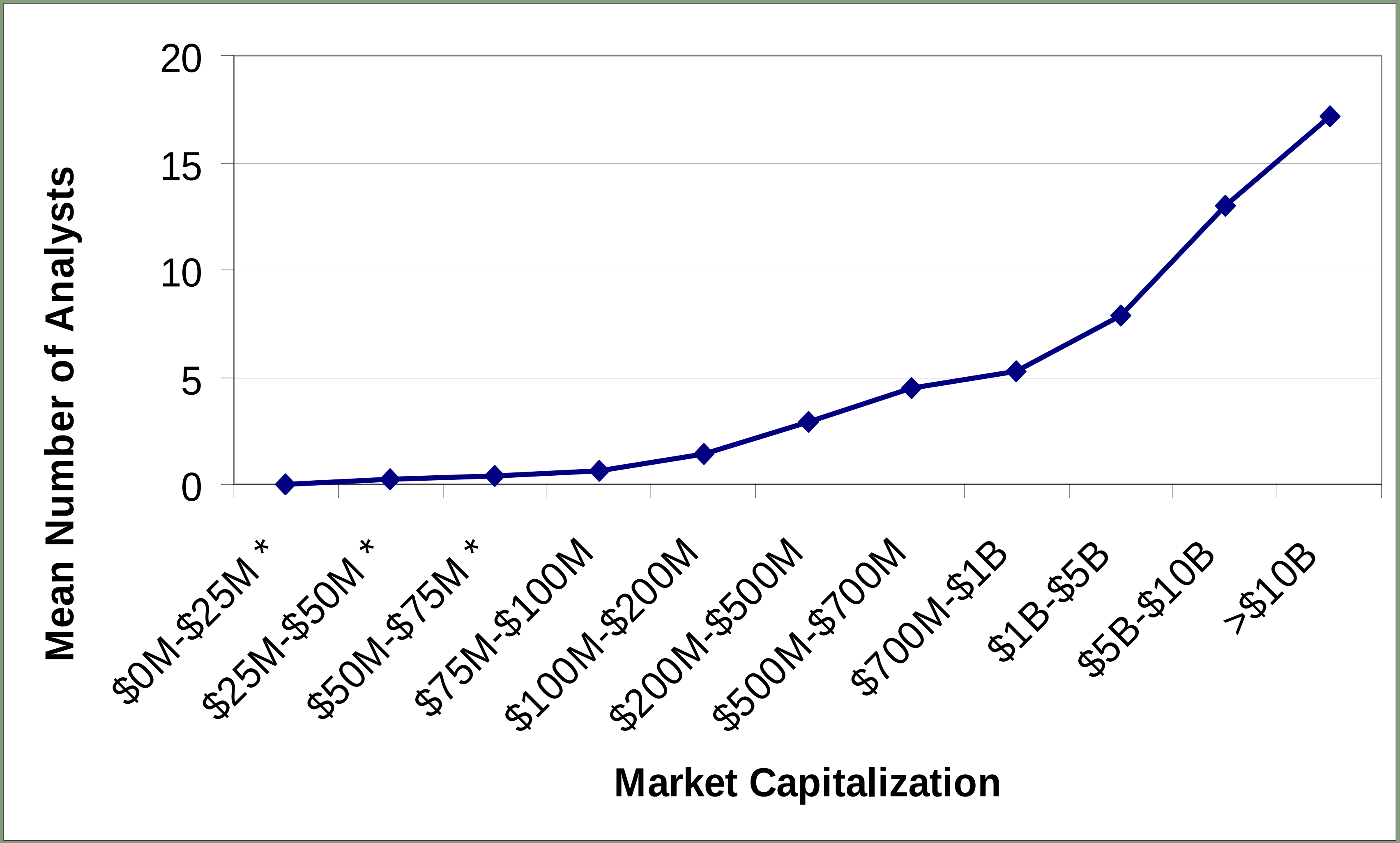
Source: *Background Statistics: Market Capitalization of Public Companies*
August 2, 2005; SEC Office of Economic Analysis

Mean Effective Spread Based on Market Capitalization



Source: *Background Statistics: Market Capitalization of Public Companies*
August 2, 2005; SEC Office of Economic Analysis

Mean Number of Analysts per Company



Source: *Background Statistics: Market Capitalization of Public Companies*
August 2, 2005; SEC Office of Economic Analysis

Mean Percent of Institutional Ownership

Source: *Background Statistics: Market Capitalization of Public Companies*
August 2, 2005; SEC Office of Economic Analysis

Other Observations

Impact on Capital Formation

- Proportionately greater cost of regulation for smaller companies significantly increases the cost of capital
- An increase in number of companies going dark and/or not going public
- Domestic issuers seeking to list abroad and foreign issuers seeking to leave the U.S. capital markets, which may weaken the U.S. markets while strengthening competition overseas

Some Other Observations Considered Relative to the Advisory Committee's Work

- Smaller companies have a more difficult time and incur a higher relative cost of complying with corporate governance regulations.

- Smaller companies may benefit from longer transition periods to effectively and efficiently comply with new accounting standards.

Definition of a
Smaller Public Company

Guiding Principles for the Definition

The definition of a smaller public company should be determined by:

1. The total market capitalization of the company
2. A measurement metric that facilitates scaling of regulation
3. A measurement metric that is self-calibrating
4. A standardized measurement and methodology for computing market capitalization
5. A clear date for determining total market capitalization
6. Clear and firm transition rules (small-to-large and large-to-small)

Subcommittee's Recommendation

The recommendation is that a company ranking in the bottom 6% of total U.S. public market capitalization, as defined by the SEC, when the capitalization of all public companies is combined, would qualify as a smaller public company. A company ranking in the bottom 1% of total U.S. public market capitalization would qualify as a microcap company.

Statistics for the Three Categories of Public Companies

	Approximate % of all U.S. Public Companies	Approximate % of all U.S. Public Company's Total Market Capitalization	Approximate Market Capitalization Cutoff
Microcap Companies	**50%**	**1.0%**	**< $100M**
Smaller Public Companies	**80%**	**6.0%**	**< $700M**
Large Public Companies	**20%**	**94.0%**	**> $700M**

Source: *Background Statistics: Market Capitalization of Public Companies*
SEC Office of Economic Analysis

Practical implementation

- SEC to determine, on the annual measurement date, the U.S. dollar value of the market capitalization levels for each category
- Issuers will use these market capitalization levels to determine the appropriate category for their next fiscal year

Implementation Standards

The definition of a smaller public company should be determined by six criteria:

1. The Market Capitalization of the company

- This acknowledges the relative risk to investors and the capital markets.
- The SEC has used market capitalization for other purposes.
- Total market capitalization is simpler than capitalization of “public float.”
- Market capitalization information is available from a variety of well-recognized sources.
- Total market capitalization is the best measurement of risk and exposure to investors.

2. A Measurement Metric that Facilitates Scaling of Regulation

- This allows for a long-term solution.
- Avoids a dollar amount definition, which would have to be rewritten from time to time.
- This allows for a measurement, which will move up and down with the market.
- This will work in both inflationary and deflationary economic environments.
- This allows for the definition of a smaller public company to be applied as appropriate with individual contexts and perspectives of the different regulatory areas.
- This will apply uniformly to all companies.

Implementation Standards

3. A Measurement Metric That is Self-Calibrating
   - This allows the cutoff point to automatically readjust without need for further action.
   - This provides certainty as to the rules for the companies required to comply.
   - This enables decisions based on objective, easily understood metrics
   - This allows for self-determination.

4. A Standardized Measurement and Methodology for Computing Market Capitalization
   - This provides clarity to the rules.
   - This reduces the risk of interpretation leading to litigation.
   - This allows for self-determination.
   - This enables companies to determine capital formation alternatives available by providing constancy in a measurement and methodology.
   - This enables decisions based on objective, easily understood metrics and avoids subjective opinions.

Implementation Standards

5. A Date for Determining the Total Market Capitalization Measurement

- This provides clarity to the rules.
- This should allow companies to determine the relevant category on the first day of their fiscal year.
- One date will apply uniformly to all companies.

6. Clear and Firm Transition Rules (Small-to-Large and Large-to-Small)

- These provide clarity for investors and companies.
- These allow companies to return to the smaller category when appropriate.
- These allow for self-determination.
- These will reduce regulatory burden of providing complex transition rules or interpretations.
- These allow companies to plan for transitions in a suitable time to achieve compliance with new regulations.

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- To alert the SEC of our definition strategy and direction to enable their concurrent thinking of application.

  (Note: this recommendation does not preclude any subcommittee from recommending alternative metrics to be used for specific regulatory issues relevant to their work.)

Conclusion

- The Size Subcommittee was unanimous in recommending that the SEC Advisory Committee on Smaller Public Companies approve this recommendation.

- Size Subcommittee Members
  – Jim Thyen *(Advisory Committee Co-Chair)*
  – Herb Wander *(Advisory Committee Co-Chair)*
  – Alex Davern *(Internal Controls Sub-committee)*
  – Dick Jaffee *(Corporate Governance and Disclosure Subcommittee)*
  – Patrick Barry *(Accounting Standards Subcommittee)*
  – Richard Leisner *(Capital Formation Subcommittee)*

- Questions

- Motion for a vote