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In corde hominum est anima legis.
1972

July 29, 2005

Advisory Committee on Smaller Public Companies
c/o Mr. Jonathan Katz
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

Re: File No. 265-23
Written Comments to Advisory Committee on Smaller Public Companies

Dear Committee Members:

The Sarbanes-Oxley Act of 2002 (SOX) and related Securities and Exchange Commission rulemaking imposed extensive—and expensive—new requirements on public companies. As others have observed in their written comments to you and their testimony at your public meetings, smaller public companies have been disproportionately affected by SOX due to their relative lack of financial and management resources to meet these new challenges. As such, the Commission took a significant step by forming the Advisory Committee on Smaller Public Companies to address these concerns and I commend the Commission for doing so. I wish you well in your task. You are doing very important work.

The Committee's overall purpose is to assess the current state of regulation of public companies and its impact on smaller public companies, with the goal of recommending changes to the Commission that would lessen this impact while still maintaining adequate protections for investors. Two primary areas of focus are the impact of the internal controls report required by Section 404 of SOX and defining what "smaller public companies" should be eligible for some degree of relief from that and other requirements of the federal securities laws. As you have recognized in your proposed Committee Agenda dated April 12, 2005, however, many other areas deserve attention.

I am writing to you to discuss one area for your consideration: improving the quantity and quality of publicly available information about non-Exchange Act issuers whose securities are traded on markets like the Pink Sheets—a topic related to Item 5 ("Disclosure Requirements") of the draft Committee Agenda dated April 12, 2005. Specifically, Item 5.7 of the Agenda states that the Committee may consider issues relating to "delinquent and deficient micro-cap disclosure" and Rule 15c2-11 under the Securities Exchange Act of 1934.

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Although this appears to be a relatively small part of your Committee's overall goals, it did not take long for R. Cromwell Coulson, the CEO of the Pink Sheets, to notice it. In his June 10, 2005 letter to you, which he expanded on in testimony before you at your meeting in New York City on June 17, 2005, he stated that the "current regulation of non-reporting issuers is woefully deficient and fails to protect investors" and urged the Committee to recommend to the Commission steps to remedy this problem. Mr. Coulson argued, among other things, that a non-Exchange Act issuer should have reporting obligations (1) when its insiders are trading securities in the public markets and (2) when the issuer is engaged in promotional activities with the intent of encouraging others to trade its securities. He also argued that these reporting obligations should be based on either Regulation A or Rule 144(c)(2) under the Securities Act of 1933 and that the Commission should establish a web site where this information could be easily available to investors. Mr. Coulson further wrote that the Commission should abandon its efforts to achieve similar goals by amending Rule 15c2-11 and instead place "the responsibility and burden of continuing disclosure where it belongs—on issuers."

I realize that the Committee intends to focus on scaling the disclosure and other regulatory burdens on public companies by their size, whereas the issues that I raise in this letter have to do with companies that are not Section 12 registrants and thus may not even be considered "public companies" within the meaning of your Committee's mission. However, I also believe, as Mr. Coulson stated, that the Committee should not ignore non-reporting issuers, particularly since they are such a large—and growing—proportion of the overall number of issuers whose securities are traded by the public. Having just completed a law review article that addresses many of these points, please allow me to explain briefly.[1]

The Problem of Non-Reporting Issuers

I believe that there is a pressing need to address the problem of non-reporting issuers whose securities are traded in the Pink Sheets. By now, we are all familiar with reports of the many public companies, particularly small companies, that have decided to "go private" or "go dark" in the wake of SOX and its panoply of new requirements (and costs). Many companies are able to do so relatively easily by exploiting a 40-year-old "loophole" in Section 12(g) of the Exchange Act by reducing the number of "record" holders of a class of their equity securities below 300, even though they may have beneficial or "street name" holders that number in the thousands. Others have called for the Commission to remedy this problem by amending Exchange Act Rule 12g5-1 to count beneficial holders as holders of record for purposes of Section 12(g).[2]

Another development that seems to have been forgotten in the swirl of more recent events, however, was the 1999 Commission approval of Nasdaq Marketplace Rule 6530 (known as the "eligibility rule") for the OTC Bulletin Board, which basically required all issuers whose securities are quoted on the OTCBB to be Exchange Act reporters, subject to a few limited

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[1] My article is entitled "Will More Sunlight Fade the Pink Sheets? Increasing Public Information About Non-Reporting Issuers With Quoted Securities." It is scheduled to be published in issue 2 of volume 39 of the *Indiana Law Review.*

[2] Petition for Commission Action to Require Exchange Act Registration of Over-the-Counter Equity Securities, submitted by Stephen Nelson, Commission File No. 4-483 (July 3, 2003), *available at* http://www.sec.gov/rules/petitions/petn4-483.htm.

exceptions for banking and insurance companies. Approximately 3,000 companies that refused to become Section 12(g) registrants were delisted from the OTCBB after this rule, and many of them now have their securities quoted on the Pink Sheets.[3] As a result of these and other developments, the Pink Sheets market "population" has surged from around 1,000 not long ago to more than 7,000 securities today, including approximately 4,600 securities that are exclusively quoted on the Pink Sheets. Because the Pink Sheets does not require issuers to be Exchange Act registrants, there are thus thousands of securities that can be traded without investors having much, if any, information about them. In effect, the eligibility rule traded one problem for another. Ironically, the Commission approved the eligibility rule in part because ensuring that issuers "will have current, public information that investors can access … when considering whether to invest," could "help to reduce fraud and manipulation."[4] This danger of fraud and manipulation remains for the huge number of Pink Sheets issuers that are not subject to any reporting requirements.

While Exchange Act Rule 15c2-11 attempts to address this problem, it is badly designed. Instead of requiring non-Section 12 issuers to disclose information when their securities are traded in a "quotation medium" such as the Pink Sheets, it requires *broker-dealers* to go about gathering specified information about the issuers. Moreover, as Mr. Coulson observed, the rule then tells a broker-dealer "to stuff the information into its files where, in all likelihood, it will never again see the light of day. Rule 15c2-11 is a rule of darkness." Add to this problem the fact that the actual information required by the rule is limited and could be very outdated (despite the rule's requirement that it be "reasonably current"), as well as the fact that the rule has exceptions for "piggyback" quotations and unsolicited quotations, and we have a recipe for ensuring that information rarely gets into the hands of the investor.

The Commission understands the problems of Rule 15c2-11, having attempted twice in recent years (1998 and 1999) to implement some fairly major changes to it. But more than six years have passed since the Commission's last attempt. As such, as the Commission has stated, many Pink Sheets issuers "do not file periodic reports or audited financial statements with the SEC, making it very difficult for investors to find reliable, unbiased information about those companies. For all of these reasons, companies quoted in the Pink Sheets can be among the most risky investments."[5] Meanwhile, although many of us may think of the Pink Sheets as a relatively small corner of the securities markets, the number of securities of non-reporting issuers quoted in the Pink Sheets continues to rise, as does overall trading activity.[6]

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[3] "Between 1999 and 2000, OTCBB de-listed about 3,000 of its then 6,500-name roster. … At that time, the mass de-listing caused the number of securities quoted on the Pink Sheets … to surge from about 1,000 to 4,000." Peter Chapman, *The Rise of the Pink Sheets*, TRADERS (June 2003).

[4] Exchange Act Release No. 34-40878, 64 Fed. Reg. 1,255, 1,257 (Jan. 9, 1999).

[5] Securities and Exchange Commission, *Pink Sheets* (Aug. 31, 2004), *available at* http://www.sec.gov/answers/pink.htm.

[6] For example, in a June 2004 letter to the Commission, the Pink Sheets noted that trading volume for April 2004 was over 20.6 billion shares of stock, with a market value of more than $2 billion. This would mean that the Pink Sheets' average daily volume was slightly less than 1 billion shares and approximately $91.7 million during that month. Compare this to *More Blue Chips Hit the Pink Sheets*, WALL ST. J., Jan. 21, 2003, p. D1 ("An estimated $75 million a day trades in Pink Sheet issues.").

Recent Efforts of the Pink Sheets

The Pink Sheets recently took a significant step toward addressing the problem of little or non-existent information about non-reporting Pink Sheets issuers by adopting a new Disclosure Policy.[7] Essentially, the Disclosure Policy adds a great amount of detail to the somewhat vague informational requirements of Rule 15c2-11(a)(5).[8] It also includes a second part that is based largely on the disclosure requirements of Form 8-K.

The Pink Sheets should be applauded for this very important step; it is encouraging that the Pink Sheets is concerned about this problem. However, the Pink Sheets Disclosure Policy has flaws. First, it only applies to issuers that have *not* previously had securities traded on an exchange, Nasdaq or the OTCBB. Thus, quotations of the securities of a formerly listed issuer that decided to "go dark" will never be subject to the Disclosure Policy. Second, the Disclosure Policy only applies to securities that are quoted on an unsolicited basis. Third, the Disclosure Policy applies only in certain situations, such as the when the security is first quoted in the public markets or when the issuer's insiders are offering, buying or selling its securities. The Disclosure Policy is thus not *always* applicable, unlike Exchange Act reporting obligations. The Disclosure Policy also contains substantive problems which I discuss in my law review article mentioned above, but which I will not cover in this letter.

More importantly, the Pink Sheets is not a regulated entity; nothing requires the Pink Sheets to get Commission approval of any rule changes or to submit proposed rule changes to a public comment process. As such, if the Pink Sheets were to find that the Disclosure Policy is sufficiently objectionable to the broker-dealers that use its services, it could discontinue it. Further, one wonders whether the Pink Sheets is sufficiently staffed to ensure compliance with its rules. Even if a violation is found, however, the Pink Sheets has no authority to impose fines. Finally, what is to stop a competitor of the Pink Sheets—one that does not share its commitment to investor protection and periodic disclosures by issuers—from becoming an alternative market?

I do not mean to sound critical of the Pink Sheets or to suggest that it lacks commitment to ensuring compliance with its Disclosure Policy. Again, it is taking steps to address an important problem and is doing so in imaginative ways. Moreover, Mr. Coulson's comments indicate a great deal of concern about the lack of good disclosure by many issuers quoted on the Pink Sheets. However, it seems to me that the preferred solution to this problem will involve Commission action. As such, I would urge the Committee to include recommendations toward solving this problem in its final report to the Commission. Some ideas are discussed below.

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[7] *Guidelines for Providing Adequate Current Information Pursuant to Rule 15c2-11* (Version 5.0, April 15, 2005), *available at* http://www.pinksheets.com/otcguide/15c2-11_guidelines.pdf (hereinafter Pink Sheets Disclosure Policy).

[8] This portion of Rule 15c2-11 details the information about a non-reporting issuer that a broker-dealer must review before entering a quote for that issuer's securities.

Suggestions for Change

What Information Should be Required?

The federal securities laws are largely designed to make sure that investors in the capital markets have current and reliable information about their investments and potential investments—and for good reason. The proper functioning of the securities markets requires that investors have good information before they invest. This is the main function served by the Exchange Act. While a case can be made why each item of information that the Exchange Act requires to be disclosed is important to investors, I do not suggest imposing full Exchange Act reporting status on Pink Sheets issuers because I believe that this would be too great a burden, even if the Committee recommends many significant changes to the Commission's rules and the Commission acts on all of those recommendations to lessen this burden. Instead, the guiding principle should be that the amount of information about issuers should be sufficient to provide investors with a good basis for making investment decisions, yet not result in an excessive burden on the issuer.[9]

To this end, I believe that the Commission should create a "minor league" disclosure regime that focuses only on information that is critically important to investment decisions, such as: recent financial statements prepared in accordance with GAAP, along with some level of MD&A; information about the issuer's business activities, its products or services, its properties and material legal proceedings in which it is involved; information about its management and promoters; and major events such as those that would trigger the obligation of an Exchange Act reporter to file a Form 8-K. In my article, I make a number of suggestions toward this goal by comparing and contrasting the relative strengths and weaknesses of possible disclosure models such as the Pink Sheets Disclosure Policy, Regulation A, and the Small Corporate Offering Registration (SCOR) form. Because each of these models has advantages and disadvantages, I recommend in my article combining various parts of the forms into a new disclosure model that would serve the goal of providing investors with critical information yet not overburdening issuers. I will not delve into any of those details in this letter.[10]

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[9] One should also keep in mind that an issuer's stock may be quoted on the Pink Sheets without its involvement or blessing. Thus, imposing disclosure requirements on *all* Pink Sheets issuers could be unfair, particularly since it would result in disclosure of sensitive financial and business information.

[10] Another idea is to require standardized "fill-in-the-blanks" forms, which should be particularly helpful for small issuers that have not previously been subject to securities disclosure requirements and that may not engage counsel for assistance in completing the forms.

How Can We Require Non-Exchange Act Issuers to Make Periodic Disclosures?

How could these needed changes be implemented? Two suggestions have been made recently, other than the Commission's attempts to modify Rule 15c2-11.[11] The first was the 2003 rulemaking petition to the Commission in which several institutional investors argued that Rule 12g5-1 should be amended to count beneficial or street name holders as holders "of record" for purposes of Section 12(g). The petitioners are absolutely correct in their assertion that conditions today with respect to stock ownership are vastly different than they were in 1964 when Section 12(g) was adopted. Back then, it was relatively rare for an investor to be a "street name" holder without a physical stock certificate. Today, of course, it is the norm, which leads to gross undercounting of the "true" number of holders of an issuer's securities. Indeed, the petitioners observed that some companies that have recently deregistered under Section 12(g) because they had fewer than 300 record shareholders stated in their filings that they had thousands of beneficial holders. However, if this proposal were adopted, it would result in perhaps thousands of non-Exchange Act reporters becoming Exchange Act reporters overnight and, of course, subject to the whole panoply of new SOX requirements. Again, I believe that this is too much to expect of many issuers and suggest instead a middle ground.

The second proposal was made by Mr. Coulson in his June 10, 2005 letter to the Committee. As noted above, he argued that non-Exchange Act issuers should have disclosure obligations when their insiders are trading the issuer's shares or they are engaged in "promotional activities" to encourage trading by others. Although there is much to admire about Mr. Coulson's proposals and I appreciate the fact that the Pink Sheets is trying to address this problem proactively, one should note that Mr. Coulson's proposals would result in a non-reporting Pink Sheets issuer having disclosure obligations only sporadically, i.e., in the two situations listed above. With respect to the first of these situations, Mr. Coulson argues that it is based on a "fundamental principle of market fairness: The uninformed may trade with the uninformed, those who are informed may trade with each other, but the informed may not trade with the uninformed." Allowing trading by well-informed insiders in the absence of publicly available information about the issuer would violate the last aspect of this principle; as such, we should require disclosures when this is happening.

But I believe that we can do even better; we can prevent the "uninformed" from trading Pink Sheets securities with the "uninformed." First, we should keep in mind the Exchange Act's approach—it requires information to be made public and requires this information all the time. In other words, the Exchange Act gives every investor the tools always to be "informed." Secondly, Mr. Coulson's observation that buyers and sellers who are equally in the dark will set a "fair" price

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[11] I do not mean to dismiss the Commission's 1998 and 1999 proposals to amend Rule 15c2-11. Had they been adopted, the proposals would have gone a long way toward making more information about non-reporting Pink Sheets issuers available to investors. First, the actual amount of information would have been expanded in many helpful ways. Second, the elimination of the piggyback provision and the creation of an "information repository" would have made it much easier for investors to actually obtain information. The exclusion of some issuers proposed in 1999, such as those with net tangible assets in excess of $10 million, would have been problematic, however. These exclusions would have meant that many non-reporting Pink Sheets issuers would remain mysterious, particularly former Section 12(g) registrants that still have more than $10 million of assets. In the end, though, I agree with Mr. Coulson that amending Rule 15c2-11 is not the preferred way to implement change, particularly the goal of making issuers (not broker-dealers) responsible for the information.

although perhaps not the "correct" price, begs a question: why not give investors the tools to set the "correct" price as the Exchange Act does?

Mr. Coulson argued that at times other than the two situations described above, "the benefits of … disclosure do not justify its costs" because "the cost of being a reporting issuer is now prohibitive" after SOX. In other words, Mr. Coulson may believe that the only available alternatives are continuing with the status quo (which is not desirable) or requiring non-reporting Pink Sheets issuers to become Section 12(g) registrants (which is prohibitively costly). However, I believe that it is possible for the Commission to revise its rules to require non-reporting Pink Sheets issuers to make periodic disclosures if they have purposely availed themselves of the public markets and—most importantly—tailor the disclosure obligations of such issuers so that they are far less onerous than what is required by the Exchange Act.

To do so, I suggest that a new category of issuers should be created: issuers that are not Section 12 registrants, but whose securities are quoted with some specified level of regularity in markets like the Pink Sheets, and that have taken some steps to facilitate a market for their securities. One means to achieve this result would be to amend Exchange Act Rule 12g5-1. Instead of defining the number of an issuer's holders "of record" for purposes of Section 12(g) of the Exchange Act solely in terms of "traditional" record holders or in terms of beneficial/street name holders, the Commission could amend the rule to provide for a two-tier approach. Specifically, if an issuer's securities were listed on Nasdaq or another market that requires Section 12(g) registration, then it would count only record holders.[12] However, the rule could further provide that an issuer that has fewer than 500 (or, for purposes of deregistration, 300) record holders, but which has taken some affirmative steps, or whose insiders have taken some steps, to cause that class to be quoted on a market like the Pink Sheets that does not require Section 12(g) registration, would instead count the number of its beneficial/street name holders—*unless* the issuer complies with the "minor league" reporting requirements described above. This would subject currently non-reporting issuers to an acceptable level of disclosure requirements, and give them an incentive to comply—the fear that they would be subject to Section 12(g) if they did not. This would also be a flexible approach that would allow the Commission to tailor requirements carefully to ensure a sufficient level of information, yet not require detailed disclosures that would overburden these issuers and result in negligible benefits to investors.

Other Suggestions

The next question is *where* this "minor league" information should be available. Obviously, we would do well to require that it be collected in a centralized location and available on the Internet.[13] To that end, I would recommend that the Commission examine the SEDAR system in Canada. SEDAR is easy to use for both issuers and investors, is free for investors and reasonably priced for issuers, and has EDGAR's "one-stop shopping" advantage.

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[12] Obviously, this would mean that all such issuers would be Section 12(g) registrants.

[13] In releases concerning proposed amendments to Rule 15c2-11, the Commission suggested establishing an "information repository" to collect and maintain current and accurate information about issuers subject to Rule 15c2-11.

Conclusion

Under current rules, issuers that have few record shareholders but whose securities are quoted on a market like the Pink Sheets are able to escape the Exchange Act—even if they have several thousand beneficial shareholders. Thus, there is a trading market for many securities about which little is known, despite the best efforts of Rule 15c2-11 and the Pink Sheets Disclosure Policy. Hopefully, you will agree that I have suggested an approach to this problem that will provide more information to investors without unduly burdening issuers and their markets.

I am not so naïve as to believe that these suggestions will be received with open arms by everyone. One likely objection will be from issuers that would be subject to a new disclosure regime—particularly if they took steps to go private and avoid the Exchange Act and SOX. The response to this objection is that they should not be allowed to have the best of both worlds. If they wish to remain "dark" they may do so, especially since the Pink Sheets is not structured so that an issuer can prevent its securities from being quoted there. However, if an issuer or its insiders want to gain the benefit of a trading market, then the issuer should be required to make the sacrifice of public disclosure of at least a modest amount of information.

Again, I realize that the mission of your Committee is very broad and that you have many other issues to consider in determining how best to scale federal securities regulations to the circumstances of smaller public companies. However, I would urge you not to forget the (as Mr. Coulson put it) "vast universe" of non-reporting companies that are traded in the Pink Sheets and to consider including some of the recommendations that I have made in this letter in your final report to the Commission.

I would be happy to discuss these matters further with any Committee members or other interested persons. Specifically, please consider allowing me to testify at your public hearing in Chicago on August 9, 2005. I would be honored to do so.

Very Truly Yours,

/s/ Michael K. Molitor

Michael K. Molitor