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Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

File No. S7-02-03
Standards for Audit Committee Independence

Dear Mr. Katz:

I am writing as a principal of a small firm that provides securities brokerage, financial advice and investment banking to other small companies, both public and private. I am also writing as a current and/or former director of **six** public companies, and **as** a professional investor and investment manager, thus a professional consumer of the information the public market provides. I am extremely sensitive to the loss of public confidence in securities markets that the Sarbanes-Oxley Act seeks to remedy. Nevertheless, after a career spent working with small public companies, I am persuaded that the independence standards proposed would cause far more in actual disruption and cost than could be recouped by any possible increase in investor confidence.

On a general level, the focus of my comments is comparative cost/benefit analysis of the proposed rule on large and small firms. I believe the proposal will be quite expensive for small issuers, and far more onerous to these companies than to their counterparts on the NYSE. Consider for example, in this connection, the average size of a company's Board. For reasons of cost and flexibility, small issuers generally seek to **have a** Board of approximately five to seven members. In contrast, a Board of twelve is not unusual on the NYSE. In the former **case,** a restrictive rule that applies to **a** minimum three-person audit committee potentially affects fully half of the directors – an extremely high percentage, and much larger than for most listed firms. Add to this the fact that, in the current litigation climate, first class directors are more difficult for small companies to recruit than larger companies, and such directors may require substantially higher fees than are currently being paid. Finally, implementation of this rule will likely cause disruption in longstanding business relationships (newly forbidden by the rule) that may have taken the company many years to develop. Increased bureaucracy through maintenance of larger Boards and significantly higher Board costs are the most certain effects of the proposed rule. Again, the proportionate increase will be greater for small issuers, and that increase will have a larger impact on company earnings than for larger firms.

Equally important as the cost side, however, is the expected benefit of the rule. The Commission's underlying assumptions appear to be that (1) audit committees as presently constituted are unacceptable; and (2) a stricter standard of independence will substantially reduce financial fraud. I respectfully submit that the former proposition is simply unjust to the many thousands of public company directors, managers and audit committee members who seek (and have always sought) the highest level of integrity in financial disclosure, and have never allowed a basis for scandal or fraud in the companies they oversee. For these individuals and issuers (the great majority of public companies) the direct benefit of this aspect of Sarbanes-Oxley is not hard to quantify – it is nothing at all, because, as the companies have demonstrated, the financial integrity of the audit committee does not turn on a hyper-restrictive independence requirement. Moreover, the fallacy of thinking that there is any direct connection between independence and good disclosure could not be clearer than in the examples of Enron, WorldCom and Tyco, each of which had audit committees that would have been qualified by the current proposal. My point is not that Sarbanes-Oxley was misguided, or that the SEC should ignore it, even if that were possible. My point is that the Act does not require the air-tight restrictions on indirect cornpensation that have been included in the current proposal. When considering what type of restrictions should be implemented under the Act, the SEC should keep in mind the cost and disruptiveness (a certainty for any firm that doesn't now qualify, and much higher for small firms than large); versus the likely benefits (unquantified and speculative). This is a judgment call for the Commission to make on consideration of all relevant facts.

Finally, a note on the comment process as it relates to small firms. The request for comment specifically seeks infomation on the cost of this proposal to smaller entities. However, from my inspection, very few letters have been received on this issue. The reason, I believe, is that the comment process is far more efficient in reaching large well-financed entities, who either alone or in organizations have standing budgets devoted to lobbying efforts. "Fighting city hall" is not on the agenda of many small public companies, who are a disparate group not represented by any single association or entity. The lack of reliable cost information could be remedied by obtaining survey data, which I urge the SEC to consider. In its absence, the Commission should pay particular attention to the comments from the Nasdaq Stock Market, who of the various writers on the current proposal, is in the best position to represent small public firms. It is not an accident that Nasdaq and the NYSE have evolved different standards of independence – their constituent companies differ. The SEC should allow Nasdaq to implement its own listing standards as set forth in its letter of comment.

The balance of his letter is devoted to comments on certain of the specific questions raised in the SEC proposal.

1. <u>Should there be a de minimis exemption for indirect compensation</u>? Definitely. I believe the SEC has misdirected its concern with respect to audit committee compensation – not enough attention has been directed to the total dollar amount of such compensation, while too much has been devoted to the manner in which it is paid. Specifically, I see no reason to believe that a director who is paid $100,000 a year to sit on a Board is any less subject to pressure by management (with respect to retaining his seat) than another director who is paid $20,000 in

Board fees and whose law firm also receives $40,000 in fees. This perverse fact is highlighted by another commentator who noted that severing his part-time affiliation with his law firm – which would be necessary under the proposed rule for him to retain a longstanding directorship – will render him more dependant on Board fees and thus less independent of management, not more. The SEC asks how a de minimis exception can be reconciled with Sarbanes-Oxley, but that **Act** does not require antiseptic indirect compensation, which may be quite attenuated in reaching the public company director (unlike the direct consulting arrangements referenced in the legislation). The best approach on this issue is a reasonable cap on the amounts involved, coupled with disclosure. The current threshold for disclosure of interested-person transactions in the proxy statement is $60,000, so that is one convenient parameter. Another is the proposed limit for Board compensation on the NYSE, which I believe is $100,000 **a** year.

2. Should the restriction also be extended to ordinary course business relationships? Unfortunately, I do not understand the definition of this term, Why would a relationship with a firm to buy and/or service computers be considered "ordinary course" when a relationship with a law firm cannot? In my own case, the companies where I currently sit on the Board all use the services of my firm for occasional securities brokerage. The revenue is small but the relationships are extremely longstanding, and the companies benefit from my firm's familiarity with the markets (thinly traded) for the securities in question. This service does not involve financial "advice" and my firm has not had an investment banking relationship with any of these companies for more than ten years. While I do not believe this relationship is prohibited by the current proposal, a crisper set of definitions would certainly be helpful as a basis on which to rely.

I assume, however, that the reason that the Commission is posing this question is that it has difficulty coming up with any reasonable distinction between the prohibited services and those which might be allowed under the cover of '"ordinary course." Again, I agree it is problematic. The better approach is to use a combination of reasonable dollar exemptions plus disclosure. In any event, however, do not further tighten this rule. To extend the example of my own firm, if the services noted above are prohibited, I will have the option of stepping of€three audit committees, although in each case I am probably the director most qualified to be on that committee, and thereby handing the companies a fat bill for an otherwise unnecessary additional director. Alternatively, I can sever twenty-year business relationships between my firm and these public companies, in which case all parties suffer. There has never been a disclosure problem in any of these companies, so there is no visible direct benefit from the SEC proposal, although the disruption and costs are quite clear. An absolutist position – which essentially views an audit committee member with a hint of indirect income as untrustworthy and corrupt, and public investors as unable to process disclosure of business relationships – is neither required by Sarbanes-Oxley nor in the interest of the investors it seeks to protect.

3. Should the Commission's definition of "affilliated person" be amended? In my experience, large shareholders who do not accept compensation from a company are the directors whose interests are most aligned with those of outside public shareholders. While every director and member of management has some conflict of interest with shareholders though compensation

arrangements and the desire to retain their position, large shareholders have the greatest countervailing interest in preserving the value of the company's stock. Therefore, a restrictive definition that has the effect of removing these representatives from the audit committee will serve to remove from that committee the most independent members of the Board.

The current proposal allows that significant shareholders can be deemed independent by a test of facts and circumstances, but given the litigation climate and overall tone of this legislation, few Boards will wish to venture into areas left gray. The rule should be changed to state that any minority shareholder or representative thereof will be presumed to be independent if the other tests of that distinction are met.

4. Should there be a look back provision for applying independence tests? The only circumstance in which I can imagine that this would be warranted is in the case of former members of management who sit on an audit committee after retirement. Given the shortage of good directors (i.e. people who know something about the company) likely to be engendered by other aspects of the rule, I would not add an additional restriction.

5. Should there be restrictions on other relationships between management and directors? Let me answer this with another question – has there **ever** been a significant case of financial fraud in which such relationships figured prominently in any way? I believe the answer is no. The focus of Sarbanes-Oxley on audit committees is well-intentioned but fundamentally misguided because – as the SEC knows – financial fraud is overwhelmingly the result of failures on the part of accounting firms and management, with outside directors almost never involved. Business relationships will be severed, profits will be hurt and honest directors will lose their jobs based on the provisions written directly into the Sarbanes-Oxley legislation. Please do not add insult to injury with a multiplicity of tight regulations not required by the Act.

6. Should special exemptions or requests for relief be allowed by the Commission? If the rule goes into effect as proposed, all of the above should be permitted because the regulation is too tight. However, this is an expensive and bureaucratic procedure far better suited to large firms than small. The better approach would be to permit any firm to obtain an automatic one year extension from compliance (somewhat akin to the late filing exemptions) upon notification to the Commission,

In summary, audit committee independence should be kept in perspective. It is not a significant factor in determining the likelihood of financial fraud. Given this fact, the Commission should follow the Hippocratic oath: "first, do no harm." Reasonable de minimis exemptions, with disclosure, should be permitted. In this respect, the Commission should pay particular attention to the recommendations from Nasdaq, because they are in the best position to judge the burdens this rule will impose on the community of small public firms.

Sincerely yours,

Bonnie K. Wachtel